

Southwest Expansion To Continue In 1995

*"...the Southwestern states
have performed well over
the past two years."*

The Southwest¹ economy continued its strong expansion in 1994. A robust construction sector, a strong national economy and growing trade with Mexico drove economic prosperity in the region. These factors, along with long-term influences such as low costs of living and low business costs, enabled the Southwest's economy to outperform that of the nation for the fifth consecutive year.

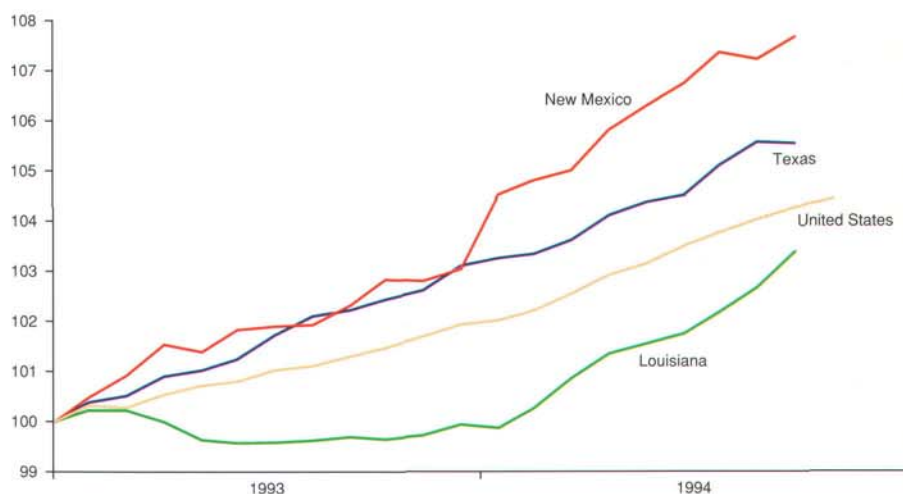
As described in the national outlook, a U.S. expansion that is nearly four years old has resulted in high levels of capacity utilization and rising interest rates. These factors should dampen growth both nationally and regionally in 1995. However, while economic growth in the Southwest is likely to slow slightly, it will continue to outpace the national average.

Regional Growth Strong in 1994

As shown in Chart 1, the Southwestern states have performed well over the past two years. In 1993, Texas and New Mexico grew faster than the national average. In 1994, New Mexico and Louisiana outper-

Chart 1
Total Nonfarm Employment

Index, January 1993 = 100



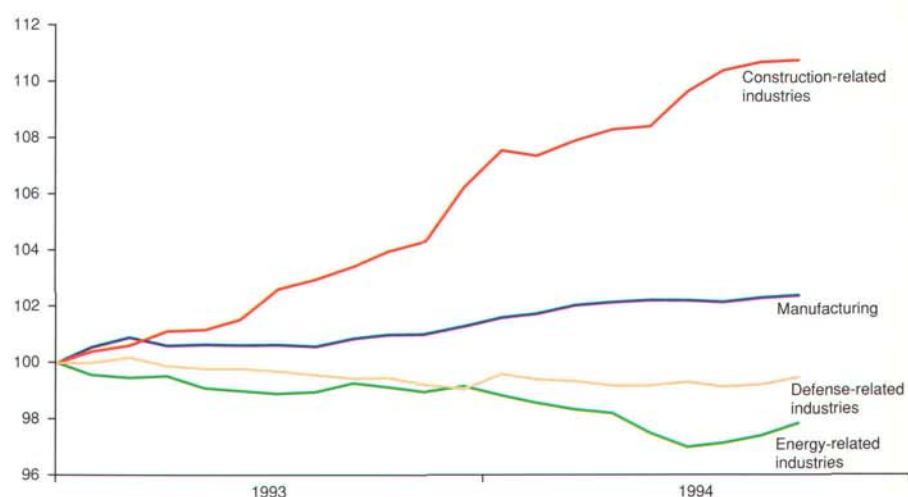
formed the nation, while Texas grew at about the same rate as the nation. Employment growth in the three-state region grew at an annualized rate of 3.6 percent during the first nine months of 1994, up from 2.9 percent in 1993. The Southwest's 1994 growth rate was faster than its 3-percent average over the past 26 years and faster than 1994 national employment growth, currently estimated at 3 percent.

Factors strengthening the economy

varied throughout the Southwestern states, but construction surged in all three states. Beginning in 1993, low residential and industrial vacancy rates in many markets, coupled with declining interest rates, prompted a large gain in construction-related employment that continued through 1994. The gains in the construction-related sectors helped offset continued weakness in defense- and energy-related employment. As shown in Chart 2, construction-

Chart 2
Southwest Employment

Index, January 1993 = 100



NOTE: Defense-related industries are electronic equipment, primary and fabricated metals, scientific instruments and aircraft. Energy-related industries are chemicals and allied products, petroleum refining, oil field machinery and oil and gas extraction. Construction-related industries are construction, furniture and fixtures, lumber and wood products, stone, clay, glass and concrete products, and fabricated structural metal products.

related employment in the Southwest grew at an annual rate of 6.8 percent in the first nine months of 1994.

In Texas, increasing exports to Mexico were an important source of strength in 1994. The implementation of the North American Free Trade Agreement (NAFTA) rang in the new year with 48.9 percent of U.S. exports entering Mexico duty-free, compared with 17.9 percent just one year earlier. Despite political uncertainty in Mexico, trade and investment growth there picked up strongly. In the first eight months of 1994, U.S. exports to Mexico increased 20 percent and U.S. imports from Mexico rose 22 percent, compared with the same period in 1993. Also, as described in the box entitled "NAFTA: One Year Later," exports from Texas to Mexico increased sharply in the first half of 1994.

The Louisiana economy was bolstered in 1994 by rapid growth in the gaming industry that resulted in strong employment gains in the construction, tourism and hotel industries. In mid-1994, four riverboat casinos were in operation and licenses had been issued for seven others. The world's largest land-based casino, scheduled to open in late 1995, was under construction in New Orleans.

The energy sector in Louisiana was weak throughout most of the first half of 1994 but recovered in the second half after oil prices rebounded in midyear. The petrochemical industry also showed improvement in the second half of the year as prices and profits rebounded due to stronger than expected international demand.

In New Mexico, the continuing expansion of electric and electronic equipment manufacturing and stability in the state's defense industry set the stage for strong economic expansion in 1994. Firms such as Intel and Motorola have been responsible for much of the manufacturing expansion. In the past 18 months, Intel alone has added 2,100 jobs, which represents 4.7 percent of total manufacturing employment

in New Mexico. Employment at Sandia and Los Alamos national laboratories has been stable despite sharp cuts in defense spending nationally.

Growth in 1995 Will Remain Stronger than in the Nation

Long-term trends are one factor contributing to the region's above-average growth. One long-term pattern that has persisted since the early part of this century is that per capita income and employment growth in the Southwest has been stronger than that of the nation. Chart 3 highlights the relative strength of employment and income growth in the Southwest. An increase in relative employment means that employment is growing faster in the Southwest than in the nation.

The growth patterns highlighted in Chart 3 likely result from long-term factors such as relatively low costs of living and doing business. While nominal incomes in the Southwest have historically been lower than the national average, a lower cost of living has allowed workers in the Southwest to buy more goods and services with a given wage than their counterparts in many other parts of the country.² In 1993, for example, Austin was the site of more California business relocations and expansions than any other U.S.

city. Companies moving to Austin were able to pay their workers lower nominal wages, and yet, because of lower costs of living, the workers enjoyed higher standards of living. The combination of relatively low nominal wages and low cost of living remains an important stimulus to economic growth in the Southwest.

Short-term factors also will contribute to the region's economic growth in 1995. Although growth in the region's manufacturing and construction sectors is likely to slow, an improvement in the Mexican economy and low cost of living in the Southwest are likely to continue to produce economic strength. After increasing an estimated 3.6 percent in 1994, employment in the Southwest is likely to grow between 2.8 and 3.4 percent in 1995.

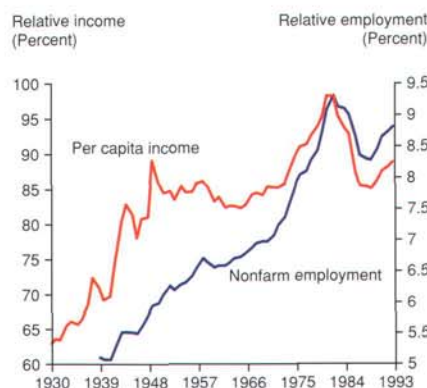
While exports to Mexico in the first half of 1994 showed strong gains, they likely would have been even stronger were it not for political uncertainty, a weak Mexican economy and uncertainty about the new rules and regulations associated with NAFTA. With much of the political uncertainty resolved and the economy showing improvement, the benefits to Texas and other Southwestern states from NAFTA are likely to be even stronger in 1995.

Another factor affecting Texas in 1995 will be the federally mandated deregulation of intrastate trucking that goes into effect on January 1. The deregulation will likely result in lower trucking rates within the state, which should reduce transportation costs for many businesses.

Gains from NAFTA, trucking deregulation and long-term factors, however, likely will not offset the drag on the economy caused by a weaker national economy and a construction sector whose robust growth is likely to slow in response to capacity and resource constraints. Overall, Texas employment growth is likely to slow slightly, dropping from 3.1 percent in 1994 to around 2.8 percent in 1995.

Louisiana's tourism industry is

Chart 3
Southwest Per Capita Income and Employment as Percents of U.S.
Per Capita Income and Employment



likely to remain strong in 1995. The multiplier effects of the gaming industry's rapid growth and renewed strength in petrochemicals should allow employment growth to remain healthy next year. The price for West Texas Intermediate crude is expected to average between \$17 and \$20 per barrel. While an increase in world oil demand is likely, current capacity estimates suggest that the demand can be met at or near existing prices. If natural gas prices are generally stable, then the energy extraction sector will be a neutral factor in the state's economy in 1995.

The outlook for New Mexico is also one of relative strength. Planned expansions by Intel and Motorola and continued stability at the national labs and military bases should allow New Mexico's employment growth to continue to lead the states in the Southwest. Long-term factors such as standard of living considerations should continue to attract companies to the state.

The Crystal Ball Is Fragile

Forecasting economic growth is more of an art than a science. Because so many factors can affect a regional economy's performance, many important assumptions must be made to make the forecast tractable. In other words, there are many risks to the forecast. One important risk to any forecast is that the data used to produce the forecast will be revised later, showing a much different economy than was pictured when the forecast was made. The Dallas Fed has taken some steps to try to reduce this type of risk. (See the box entitled "Data Sources and Revisions.")

One important risk to the current forecast is that a sustained significant drop in oil or natural gas prices would reduce the potential growth in the Southwest. This would have a particularly negative effect on growth in Louisiana but would also be important for Texas and New Mexico. Another risk is that nontariff

NAFTA: One Year Later

Trade with Mexico has been an important stimulus for the Southwest economy since Mexico joined GATT and began liberalizing its economy in 1986. In recent years, Mexican demand for Southwestern retailing, manufacturing and tourism has helped these industries become among the fastest growing in the nation. Today, the North American Free Trade Agreement (NAFTA) is accelerating trade between Mexico and the United States by reducing the risk and lowering the cost of participating in the Mexican economy. The Southwest stands at the crossroads of the agreement and will benefit greatly.

In the center of North America, the Southwest is attractive to firms wishing to do business in Canada, Mexico and the United States. A large Hispanic population and already strong ties to Mexico make workers in the Southwest valuable for budding international companies. Ports in Houston and New Orleans already handle shipments to and from Mexico, and a new port in Shreveport-Bossier City was recently opened to help funnel goods between the Midwest and Mexico. Nearly 75 percent of goods traded between the United States and Mexico travel on Texas highways. Most of those goods flow through Laredo, the largest inland port on the U.S.-Mexican border. The economies of many cities, particularly along the border, are already intertwined with Mexico's and will benefit from rising income in that country. Although all three states in the Southwest have benefited, Texas has been the most successful in capitalizing on the expanding Mexican market.

In the first six months of 1994, exports from Texas to Mexico increased 13.2 percent above year earlier figures. Exports increased strongly for electronic equipment, computers, transportation equipment, plastics, fabricated metals, brick, glass and food products. Exports from Texas to Mexico represent a significant share of the Texas economy. In 1993, for example, exports from Texas to Mexico totaled \$20.4 billion, representing about 20 percent of the state's total manufacturing sales.

Not surprisingly, the complexity of NAFTA rules and regulations slowed the agreement's implementation. Border officials had to digest large volumes of new regulations, while manufacturers tried to figure out how the trade pact affects their products. Many companies complained of additional paperwork, most notably, point-of-origin restrictions that require manufacturers to document the source of all inputs, including asking suppliers where they get all their materials.

Manufacturers must also contend with frequent rule changes and rising nontariff barriers. All three NAFTA countries have been accused of using antidumping, labeling, and health and safety standards to protect domestic industries. Shippers complain that Mexican rules change quickly, sometimes stopping shipments that were authorized only days earlier. The Eleventh Federal Reserve District has been especially affected by strict enforcement of Mexican import laws, which has reduced retail sales growth along the border.

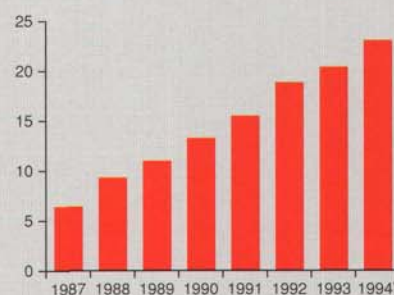
Helping companies comprehend changing regulations and unfamiliar laws and tax codes generates new opportunities for the service sector. Accounting, communication, consulting and legal firms are expanding to help companies learn how to trade in the new environment. To overcome information and cultural obstacles, many businesses use joint ventures, mergers and acquisitions to help speed entry into a new market.

The strength of trade growth between Mexico and the United States since NAFTA's implementation is particularly startling considering the relative weakness of the Mexican economy. Mexico was in recession when NAFTA became law on January 1, 1994. Although the Mexican economy was expected to accelerate in 1994, political uncertainty slowed growth and led many investors to move cautiously. By the end of 1994, the political situation in Mexico stabilized, boosting the peso and the Mexican economy and laying the foundation for faster trade growth in 1995.

—Fiona Sigalla

Chart A
Texas Exports to Mexico

Billions of dollars



* 1994 data is second-quarter data annualized.

Data Sources and Revisions

One of the key data sources regional economists use to judge the economy's performance is the Current Employment Statistics (CES) produced by the Bureau of Labor Statistics in cooperation with various state agencies. In Texas, the Texas Employment Commission (TEC) releases the CES data about 25 days after the end of the reporting month. The CES data are available for most two-digit Standard Industrial Classification industries and selected three-digit categories.

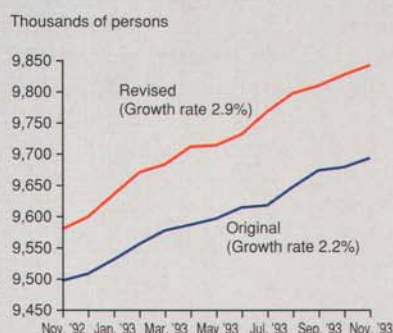
The *Southwest Economy* forecast for 1994 predicted that Southwestern employment would increase between 2 and 2.5 percent in 1994. The data thus far show that growth will likely be closer to 3.6 percent. One reason for the disparity is that at the time the earlier forecast was prepared, data showed that employment during 1993 had been growing at a 2.2 percent rate (through November), yet that data was revised up significantly to a growth rate of 2.9 percent (see Chart A). The more moderate rate of growth originally reported for 1993 influenced the forecast for 1994.

The Dallas Fed has taken several steps to reduce the impact of revisions to the CES data. This is done by a unique two-step seasonal adjustment procedure, and for the Texas data, early benchmarking using a more comprehensive data series (the ES-202) released by the TEC about six months following the release of the CES data. These procedures, which were highlighted in the July/August 1993 issue of *Southwest Economy*, should ensure that the CES data continue to be one of the most reliable data series available to regional economists.

The Texas employment data used in this study contain ES-202 data through the first quarter of 1994. At the national level, the BLS announced in November 1994 that the national data for the period from March 1993 to March 1994 would likely be revised upward by 700,000 jobs when national benchmarking is done in 1995. This upward revision will not affect the data for Texas that we used in this *Southwest Economy* forecast because we have already benchmarked the Texas data through March 1994.

Revisions to the data, however, cannot be avoided. Therefore, it is important to monitor a variety of series on regional economic conditions, such as data from the household survey on employment and unemployment, the Beige Book survey conducted by the Dallas Fed, the Texas Industrial Production Index, the Texas Leading Index, retail sales and personal income. An analysis of series such as these confirmed the strength of the Southwest economy in 1994 and contributed to the forecast for 1995.

Chart A
Southwest Nonfarm Employment



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barriers could materialize on many products shipped between Mexico and the United States, resulting in a reduction in NAFTA's potential benefits. Overall, however, the most likely result is that the Southwest economy will continue to expand in 1995 but at a slightly slower pace than in 1994.

—Keith R. Phillips

Notes

- ¹ In this article, the Southwest refers to Texas, Louisiana and New Mexico.
- ² Walter W. McMahon in "Geographical Cost of Living Differences: An Update," which was published in the *Journal of the American Real Estate and Urban Economics Association*, vol. 19, no. 3, 1991, estimates that in 1990 the cost of living in Texas was 27 percent lower than Connecticut, 24 percent lower than in California and 6 percent lower than the unweighted average of cost of living across all states.