

# the Southwest ECONOMY

THE FEDERAL RESERVE BANK OF DALLAS

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## The Southwest Economy is Picking Up Steam

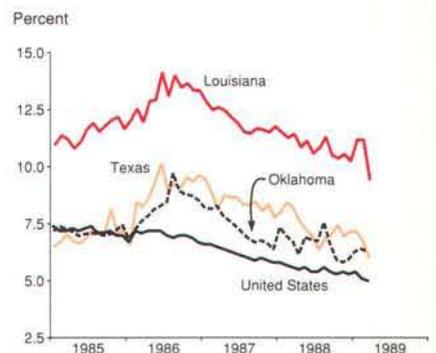
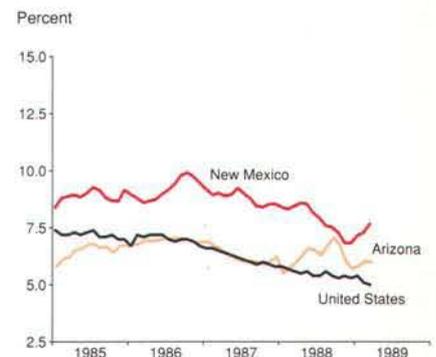
In 1986 the drop in oil prices triggered an economic downturn in Louisiana, New Mexico, Oklahoma, and Texas. These states have since adjusted to a smaller energy industry, but their economic recoveries have been handicapped by other problems—most notably those in construction and the financial sector. Now, most of these problems are moving into the past, and other factors are bringing economic resurgence.

Unlike the other Southwest states, Arizona benefitted from the decline in oil prices and continued to expand in 1986 and 1987. In 1988, however, problems in construction spilled over into other sectors, and growth flattened. Stronger employment growth in the first quarter of 1989 provides optimism that the Arizona economy may expand more rapidly this year.

The downward trend in unemployment rates throughout the Southwest indicates an improving economic situation (*Chart 1*). In fact, the gap between the national unemployment rate and those of the oil-producing states in the Southwest has generally narrowed over the past two years. And, since the third quarter of 1988, the Arizona unemployment rate has come closer to the U.S. rate. Nonetheless, unemployment in the Southwest remains higher than in the United States as a whole.

The next few years should bring even stronger growth to the Southwest.

Chart 1  
Unemployment Rates in the U.S.  
and Southwest States



Much of the United States, as well as Europe and Japan, is operating near capacity. The strained capacity elsewhere provides the Southwest with the opportunity for stronger growth. In comparison to some other parts of the world, the Southwest possesses a larger pool of available labor and more industrial capacity (*Table 1*). With these resources, the Southwest should be able

Table 1  
Industrial Vacancy Rates

	Percent
National Average	6.0
Dallas	7.8
Houston	8.9
New Orleans	9.0
Oklahoma City	6.0
Phoenix	7.7

to capture additional growth over the next few years.

The Southwest also should benefit from improvements in some previously weak sectors. The recent rise in oil prices will boost growth in the oil-producing states of the Southwest. And, problems in the financial sector are on the mend. As financial institutions in the Southwest are recapitalized, lending should increase, promoting economic growth.

To get a clearer picture of the economic outlook for the Southwest, this article looks at each of the major sectors in each state of the Southwest. Although the states of the Southwest possess some similar characteristics, their patterns of growth have varied, and their outlooks differ somewhat.

### Manufacturing

A resurgence in manufacturing has helped drive economic recovery in the Southwest. In most of the Southwest, manufacturing employment began to grow by April 1987 (*Chart 2*). In that year, Louisiana, New Mexico, Oklahoma, and Texas all saw their manufacturing sectors expand more rapidly than in the nation as a whole.

The major impetus behind manufacturing's initial strength was the depreciation of the dollar. Industries sensitive to the value of the dollar—such as transportation equipment and petrochemicals—expanded rapidly as U.S. products became more competitive overseas.

In 1988, however, manufacturing in the Southwest did not grow as fast. Although nondurable-goods industries

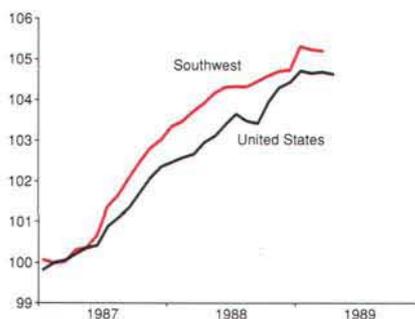
did somewhat better than in 1987, growth in durable-goods industries slowed.

Manufacturing strength has varied by state across the Southwest. In New Mexico, manufacturing has been a powerhouse over the past two years, growing at twice the national rate. Although growth has been more moderate in Louisiana and Oklahoma, manufacturing employment in those states has continued to expand more rapidly than in the nation.

In Texas, manufacturing has not expanded as rapidly. After outpacing the nation in 1987, employment growth in manufacturing fell behind the nation in 1988. Slowing growth in industries producing transportation equipment, electrical machinery, and nonelectrical machinery contributed to the weaker growth.

Chart 2  
Manufacturing Employment,  
The Southwest and United States

Index: Feb. 1987 = 100



In Arizona, manufacturing has taken a different path. Weakness in the manufacture of nonelectrical machinery and some other durables kept manufacturing employment flat in 1987 and 1988. Only in first quarter 1989 did Arizona manufacturing show signs of accelerating growth.

With signs of recovery in Arizona, manufacturing should be a source of vitality across the Southwest during the next few years. With much of the nation facing capacity constraints, the excess industrial capacity and available labor in the Southwest should enable

manufacturing in the region to expand more rapidly.

### Services

As in the nation, the service-producing industries in the Southwest make up the largest sector and account for a growing proportion of total employment. Service-producing industries account for nearly 80 percent of non-farm employment in the Southwest, up from 70 percent in 1981.

In the early 1980s, service employment grew at about the same rate in the Southwest as in the United States (*Chart 3*). When the economies of the oil-producing states in the Southwest faltered, however, growth in their service-producing sectors also slipped. In mid-1987, service employment in Texas, New Mexico, and Oklahoma resumed growing. But, in Louisiana, employment in this sector has not yet shown signs of recovery. In Arizona, growth in services slowed in 1988. For the Southwest as a whole, the service-producing sector has been growing more slowly over the past few years than in the United States.

In most of the Southwest, the fastest-growing component of the service-producing sector has been business and personal services. In each of the five states, business and personal services is either the first- or second-largest component of the service-producing sector. In 1988, growth of this large component was flat

Chart 3  
Service-Producing Employment,  
The Southwest and United States

Index: Jan. 1982 = 100



in both Arizona and Louisiana. In the other three states, however, growth was strong. In Texas, employment in business and personal services jumped by 6 percent in 1988.

Finance, insurance, and real estate (FIRE) has been weakest component of the service-producing sector across much of the Southwest. Closures of banks and thrifts have depressed employment. In Arizona, Louisiana, and Oklahoma, FIRE employment steadily declined over the past year. In Texas, FIRE employment fell in 1988, but showed signs of strength in the first quarter of 1989. In New Mexico, FIRE is showing signs of recovery after two years of stagnation.

Overall, the service-producing sector should continue to gain momentum in 1989. For many services, growth depends upon other sectors, and expansion in manufacturing and energy should benefit the service-producing sector.

### Energy

Though smaller than in 1986, the energy industry remains important for all Southwest states except Arizona. The recent increase in oil prices will stimulate economic growth in Louisiana, New Mexico, Oklahoma, and Texas.

The price of oil began to rise after OPEC reached an agreement in November 1988 to restrain its oil production—and actually showed signs of doing so (Chart 4). The price of West Texas Intermediate crude surged from about

\$14 per barrel in November to more than \$20 in April. Not convinced that higher prices were sustainable, energy companies were slow to respond. From November through February, oil field exploration and development continued to fall.

By late February, however, it became apparent that the strength of oil prices did not depend solely upon OPEC restraint. In fact, despite OPEC's agreement to curtail production, world oil production is now higher than it was in November. The release of revised data for 1988 revealed that growing world oil consumption accounts for much of the recent strength in oil prices.

OPEC hopes to keep prices at or around \$18 per barrel for its market basket of crude oils. This would mean prices of about \$20 per barrel for West Texas Intermediate crude oil. The cartel will meet in June to set new, higher production quotas in an attempt to prevent sharply rising prices. The strength of oil demand suggests that they will be successful in preventing any price collapse.

OPEC's success would stimulate economic growth in most of the Southwest. Gains will not be limited to the energy field. Rather, spillover effects from the energy sector will be felt throughout the economy. In Texas, higher oil prices eventually should boost employment by 110,000 jobs (1.6 percent); in Oklahoma by 36,500 (3.2 percent); in Louisiana by 30,000 (2.0 percent); and, in New Mexico by 5,500 (1.0 percent). Arizona, the only oil-importing state in the Southwest, stands to lose about 7,000 jobs, about 0.5 percent of its total non-farm employment.<sup>1</sup>

### Other Mining

In 1988 and early 1989, other Southwest mining had mixed fortunes. Copper prices rose and uranium prices fell.

Political instability and health problems in Africa and social unrest in Peru disrupted copper supplies, pushing

copper prices to record highs. As a result, copper mining employment in Arizona grew by 5 percent in 1988.

Over the past year, uranium prices have dropped more than 40 percent. Consequently, uranium mining employment in Arizona and New Mexico has declined. That price drop may be reversed, however; the possibility that uranium prices have been illegally manipulated is under investigation in the U.S. Senate.

### Agriculture

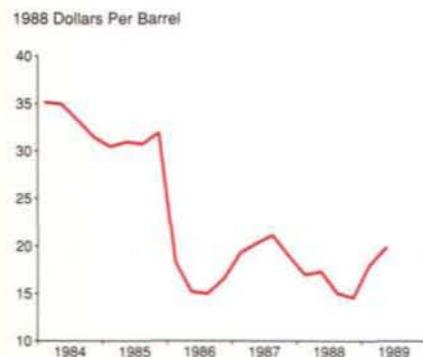
Although soil moisture conditions in the Midwest have improved since last summer, drought remains a concern in much of the Southwest. Subsurface soil moisture conditions in the Southwest remained dry for much of the winter (Map 1). Most of the Southwest also has suffered from a lack of surface moisture (Map 2). The lack of soil moisture has created problems for wheat farmers and cattle ranchers throughout much of the Southwest.

In Texas, Oklahoma, and New Mexico, wheat harvests are likely to be meager. The lack of moisture during the winter stressed the wheat crop. Temperature extremes in February further damaged the crop. Most of the wheat crop in Texas and Oklahoma has been rated as fair to poor, and almost all of the wheat crop in New Mexico has been rated as poor to very poor. Most dryland wheat across the Southwest will not be harvested. Yields on irrigated fields are expected to be about 60 percent of normal.

The drought has also hurt the cattle industry by reducing pasture forage and pushing up the price of feed. The high cost of feed has encouraged the continued slaughter of cattle. This will boost beef supplies in 1989, but will probably mean less production, higher prices, and lower farm incomes in 1990.

Despite federal assistance for drought-afflicted farmers, agricultural incomes in the Southwest will probably be lower in 1989 than last year. The drought has increased production costs,

Chart 4  
Inflation-Adjusted Oil Prices



and government support payments for crops will continue to fall.

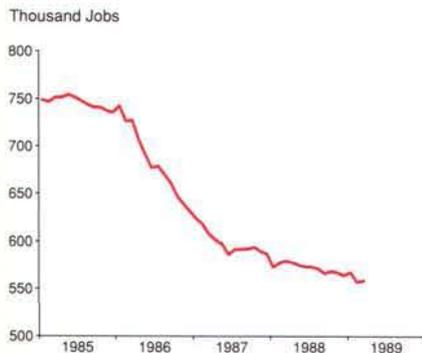
### Construction

Across the Southwest, overbuilding has led to large declines in construction activity. While other sectors of the economy have turned around, construction remains weak. In most of the Southwest, contract values continue to decline, and vacancy rates remain high (Table 2). Construction employment continues to drop—but more slowly—in most of the Southwest (Chart 5). The exception is Louisiana, where construction employment began growing in March 1988. In 1989, construction is likely to remain the weakest sector in much of the Southwest, but it should no longer act as a significant brake on economic growth.

Table 2  
Metropolitan Office Vacancy Rates

	Percent
National Average	19.7
Albuquerque	19.2
Austin	34.5
Dallas	27.0
Houston	28.2
New Orleans	26.6
Oklahoma City	30.4
Phoenix	24.7

Chart 5  
Construction Employment  
in the Southwest



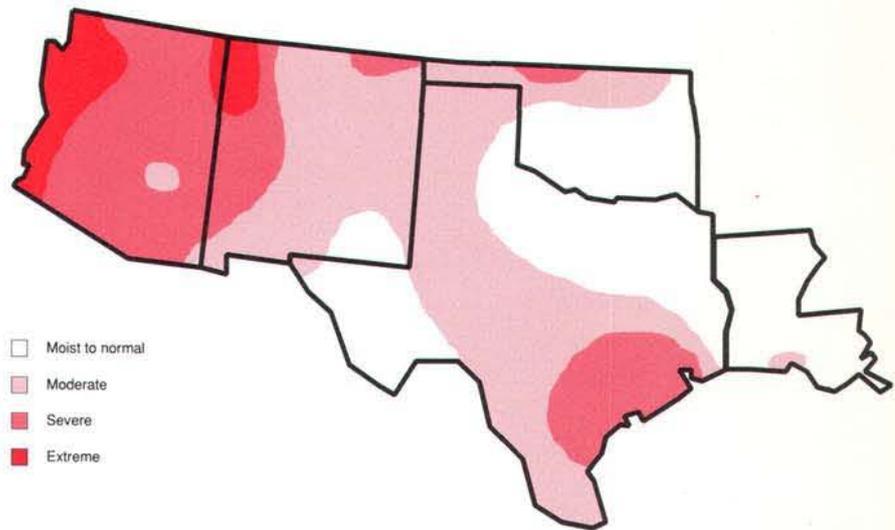
### Conclusion

Throughout most of the Southwest, economic growth accelerated in 1988. Although manufacturing slowed in that year, it remained a source of strength for most states in the Southwest. Energy, construction, and finance,

insurance, and real estate all remained drags on the Southwest in 1988, but their declines diminished.

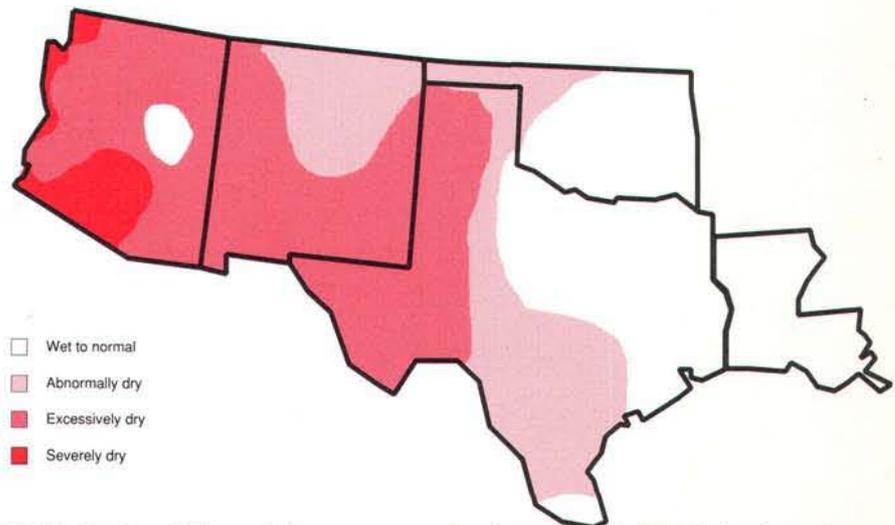
The Southwest should see stronger growth in 1989 and beyond. High capacity utilization elsewhere should benefit manufacturing in the Southwest.

Map 1  
Palmer Drought Severity Index  
May 6, 1989



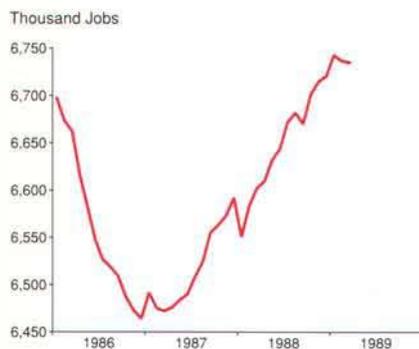
NOTE: The Palmer Index is used to monitor subsoil moisture conditions and is useful for longer range forecasting.

Map 2  
Crop Moisture Index  
May 6, 1989

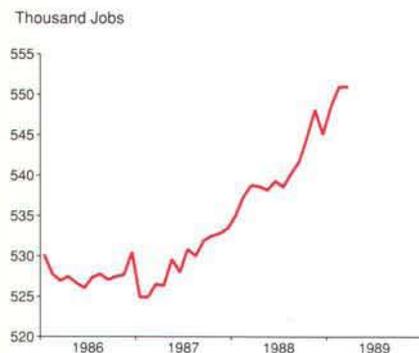


NOTE: The Crop Moisture Index measures soil moisture down to 5 feet below the surface and is used to monitor current soil moisture conditions.

**Chart 6**  
Total Nonagricultural Employment  
in Texas



**Chart 7**  
Total Nonagricultural Employment  
in New Mexico



In addition, the unexpected strength of the energy sector will give most of the region a boost. Growth in manufacturing and energy should further stimulate recovery in the service-producing industries. In most of the Southwest, continued declines in construction will hinder growth, but to a lesser extent.

Texas is leading the economic recovery in the Southwest (*Chart 6*). In 1988, non-farm employment in Texas grew by 2.9 percent. Growth in the service-producing sector was the main factor in the Texas expansion, but moderating declines in construction also helped boost the economy. With problems in the financial sector rapidly falling behind, Texas should see stronger growth in 1989 and 1990.

In New Mexico, the economic recovery accelerated last year (*Chart 7*). Total non-farm employment increased by 2.5 percent in 1988, boosted by a

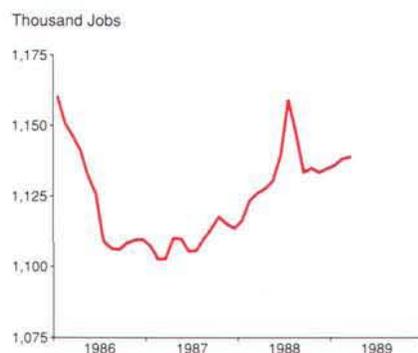
strong manufacturing sector. Industries manufacturing electronics and transportation equipment led the 3.5 percent increase in manufacturing employment. Unless defense spending in the state is dramatically cut, New Mexico should continue healthy expansion into 1990.

The Oklahoma economy grew only moderately in 1988 (*Chart 8*). But, the 1.7 percent increase in employment more than doubled 1987's growth rate. Recent strength in Oklahoma has come from manufacturing and services. As construction and construction-related industries improve, the Oklahoma economy should begin to see accelerating growth.

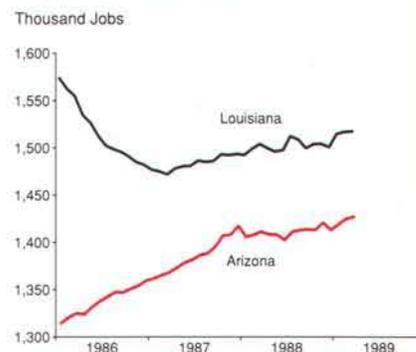
The Louisiana economy continues to expand slowly (*Chart 9*). A boom in petrochemicals has given the economy a boost. And unlike the situation in the rest of the Southwest, construction is contributing to economic growth. Construction employment, which began to rise last March, jumped nearly 5 percent in the first quarter of this year. In 1988, however, a stagnant service sector kept overall employment growth at 1.5 percent. In 1989 and 1990, an improving energy sector should contribute to increased economic expansion in Louisiana.

In 1988, employment in Arizona grew by less than 1 percent (*Chart 9*). A real estate slump led to three years of declining construction activity and still threatens the solvency of some financial institutions in the state. Growth of employment in services and manufacturing

**Chart 8**  
Total Nonagricultural Employment  
in Oklahoma



**Chart 9**  
Total Nonagricultural Employment  
in Louisiana and Arizona



was also weak in 1988. Nonetheless, the Arizona economy appears to have turned around. Growth will be slow in 1989, but it should strengthen by the end of the year. Somewhat stronger growth is likely in 1990.

Over the longer run, most states in the Southwest are poised for higher growth. The demographics, business climate, weather, and mix of industries should mean growth rates above the national average in the next decade.<sup>2</sup> In the meantime, the Southwest continues its steady expansion.

—Lea Anderson

<sup>1</sup> These estimates are based upon analysis by S.P.A. Brown and John K. Hill, "Lower Oil Prices and State Employment," *Contemporary Policy Issues*, July 1988.

<sup>2</sup> See Stephen P.A. Brown and Lea Anderson, "The Future of the Southwest Economy," Federal Reserve Bank of Dallas *The Southwest Economy*, November 1988.