

the Southwest ECONOMY

FEDERAL RESERVE BANK OF DALLAS

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Texas: *Demographically Different*

As the 21st century nears, demographic changes are reshaping the U.S. economy. The largest impact is coming from the maturing of baby boomers who began turning 50 this January. Just behind the boomers is the baby bust generation, which makes up a much smaller share of the total population. As the boomers and busters move through their life cycles, many elements of the economy—such as housing, unemployment, labor productivity and capital formation—will be affected.

Texas, like the nation, will be influenced as this demographic transition unfolds. Nevertheless, the Texas population historically has been somewhat different from that of the nation. In the past, the Texas population has grown faster than the national average. In addition, Texas is more ethnically diverse and younger than most other states. These differences may benefit Texas

in the years to come. The challenge is to make the differences work for Texas and not against it.

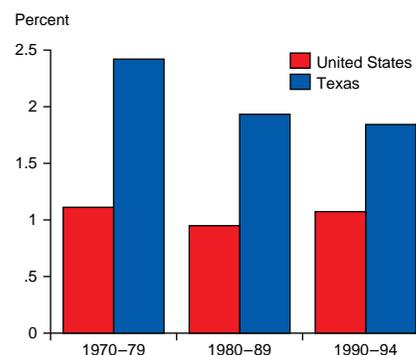
Texas: Big in Every Way

Historically, Texas' population has grown faster than the nation's. This was especially true during the boom days of the 1970s, when the state's population rose at more than two times the national rate (*Chart 1*). From 1980 to 1989, the state's average annual population growth of 1.9 percent was slower than in the preceding decade but still double that of the nation.

In the 1990s, Texas' population has continued to grow faster than the national average, and in 1994, Texas edged out New York as the second largest state in the country, behind California. Texas' population should continue to grow faster than its national counterpart, although it will follow a national trend of slower growth. Census projections indicate that through the year 2010, Texas' population will grow at an average annual rate of about 1.5 percent, while the U.S. population will grow at an annual rate of about 1 percent.¹

Two main factors explain why Texas' population growth historically has outpaced the nation's: higher than average birth rates and

Chart 1
Average Annual Population Growth Rate



SOURCE: U.S. Department of Commerce, Bureau of the Census.

high net migration—the number of people moving to Texas from other states or from other countries minus the number leaving.

While both national and Texas birth rates have fallen since the baby boom years, Texas' birth rate has stayed consistently higher than the national average. In 1992, for example, the Texas birth rate was 18.1 per thousand people, compared with the national average of 15.9 per thousand. The high Texas birth rate may be partly a result of the state's rich Hispanic heritage. High rates of immigration from Mexico and South America, where

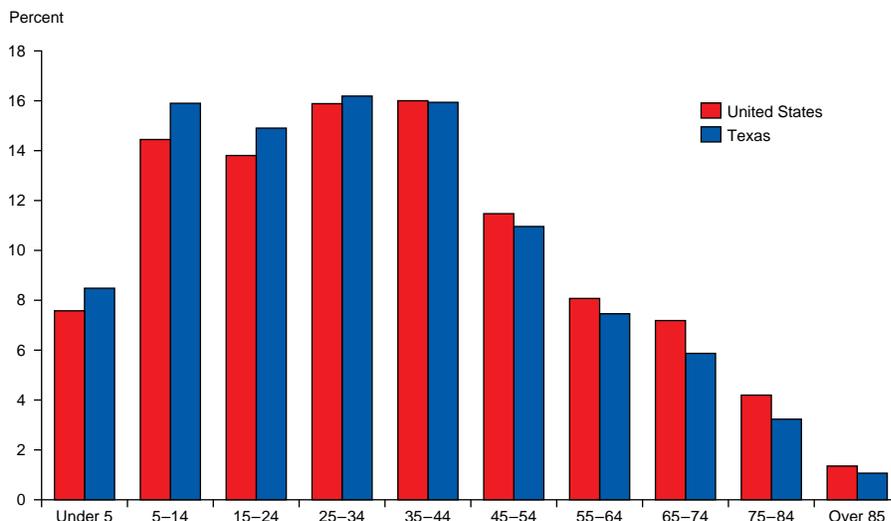
I N S I D E

Honest Money
Is the Best Policy

—
What's Behind Those
Yen-Dollar Swings?

“Not only is Texas’ population younger than average, it is also more diverse. The Texas population has a much higher share of racial and ethnic minorities than the U.S. population in general, mostly due to the state’s historical ties to Mexico.”

Chart 2
1994 Age Distribution: Texas and the United States



SOURCE: U.S. Department of Commerce, Bureau of the Census.

birth rates are higher than they are in the United States, have kept Texas’ birth rate higher than average. However, over the long run, U.S. Hispanic birth rates have been converging toward the rates for non-Hispanic whites.

In addition to high birth rates, net migration has played a large part in the state’s strong population growth. Historically, people have been drawn to Texas because of its abundant natural resources. In more recent years, people have been drawn to the state because of its healthy economy and other economic factors that make it an attractive place to live and do business.

During the oil boom of the 1970s and early 1980s, net migration accounted for an unusually large portion of the state’s population growth. In 1982—a year in which the Texas population grew a robust 4 percent—the total increase in the population was 586,000 people, and almost 70 percent of the increase resulted from net migration.² In the early 1980s, when the national economy turned downward, Texas drew more new residents than any other state.³ However, the statewide downturn that began in 1986 caused Texas to lose many of its new residents. From 1987 through 1989, 305,134 people left the state

to look for greener pastures elsewhere, resulting in anemic population growth.

In 1990 the exodus stopped and people began returning to the state, drawn by Texas’ improving economy. Since 1990, net migration has accounted for roughly 40 percent of the state’s population increase, a lower percentage than that of the 1970s but higher than the migration experienced in the 1980s overall. While net migration to the Lone Star State is expected to be positive, it may be less of a contributor to state population growth in coming years than it has been in the 1990s, according to forecasts by the Census Bureau and Texas Comptroller of Public Accounts. Census Bureau projections indicate that net migration will account for roughly 30 percent of Texas’ population increase through 2010, close to the historical state average since 1950.

Differences in Age Structure And Diversity

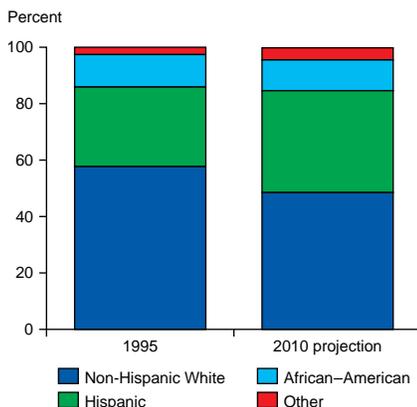
Both of the factors that contribute to Texas’ fast-growing population—a high birth rate and a high percentage of net migration—keep the Texas population younger than the national average. High birth rates boost the state’s share of

people in younger age brackets, and studies show that most people who move to Texas from other states or countries are young adults.

In 1994, Texas was the third youngest state in the country, behind Utah and Alaska. The median age in Texas was 31.9 years, compared with a national median of 34 years. Texas' younger population is especially evident when we look at the distribution of the population by age group. As Chart 2 shows, Texas has higher than average percentages of its population in the younger age brackets and smaller than average percentages in the age brackets 35 and above.⁴

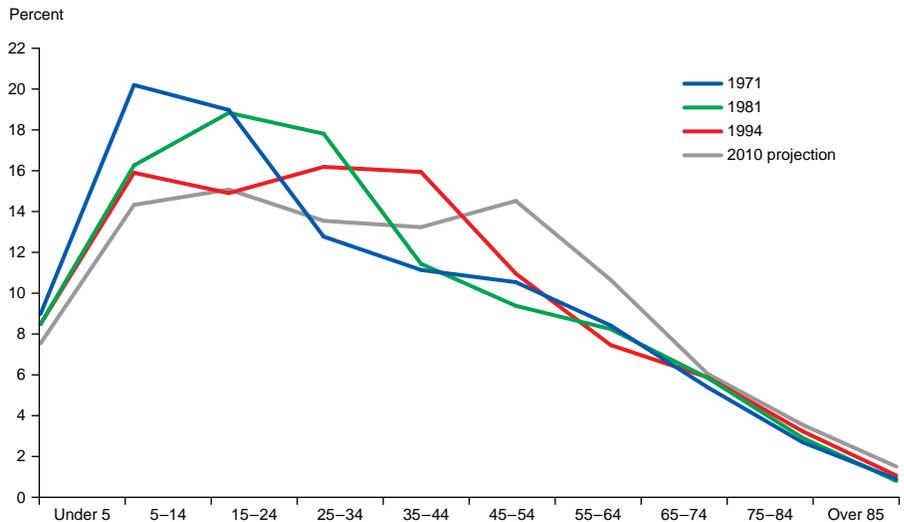
Not only is Texas' population younger than average, it is also more diverse. The Texas population has a much higher share of racial and ethnic minorities than the U.S. population in general, mostly due to the state's historical ties to Mexico. In 1995, 58 percent of Texans were non-Hispanic whites, which compares with 74 percent of the U.S. population. While the percentage of African-American Texans is about even with the national average of 13 percent, Texas' Hispanic population accounts for 28 percent of the total population, much larger than the national average of 10 percent. In fact, in 1995 Texas ranked second among the states in its share

Chart 3
Proportion of Texas Residents by Race and Ethnicity



SOURCE: Texas State Data Center, Texas A&M University.

Chart 4
Age Distribution of the Texas Population in Selected Years



SOURCE: U.S. Department of Commerce, Bureau of the Census.

of Hispanic population, behind New Mexico.

The trend toward diversity should continue into the next century. The Hispanic share of the population is expected to continue growing rapidly and by 2010 should reach 36 percent. In addition, the share of Asian-American Texans is expected to rise at a fast pace. In 15 years, the "minority" populations are expected to constitute the majority of Texans (*Chart 3*).⁵

Despite Its Differences, Texas Will Follow the Aging Trend

Despite being younger than the national average, Texas' overall population will age along with the national population. This "aging" of the population is a result of the maturing of the baby boom generation, which makes up the largest segment of the population. Chart 4 shows the movement of the baby boom generation through time and its effect on the age distribution in Texas. As the chart indicates, in 1971 the boomers were swelling the ranks of the 5-14 and 15-24 age brackets, causing the age distribution to be skewed toward those younger age groups. Ten years later, the baby boomers had caused an increase in the share of the

population aged 25-34, the ages most associated with household formation and entry-level home demand. By the mid-1990s, many of the boomers had moved into the 35-44 age bracket, and the share of the population in that age bracket rose substantially.

By 2010 a large share of Texans will be in their prime working years, and the age distribution will shift further to the right. As the first of the baby boomers come within an arm's reach of retirement that year, an estimated 22 percent of Texans will be 55 or older, compared with 17 percent today. Still, Texas' share of those 55 or older should be below the projected national average of 25 percent.

How Will U.S. Demographic Trends Shape the Future?

As the bulk of the population continues its move into the prime working years and then on into retirement, it will have a broad impact on the economy. Although it is difficult—and dangerous—to try to predict the future, the changes that will occur in the age distribution of the population have implications for some segments of the economy.

Housing. First, the demographic shift is expected to have a signifi-

cant impact on the U.S. homebuilding industry. In the coming years, a decline in the number of households headed by people ages 25 to 34 should cause a shift away from starter homes toward trade-up homes and specialized homes for older adults. As a result, residential construction will no longer be driven by the first-time buyer and builders will have to focus on “resizers.” In addition, prices of starter homes and homes for families with young children may weaken, while prices of homes that are popular with older adults, or empty-nesters, may increase.

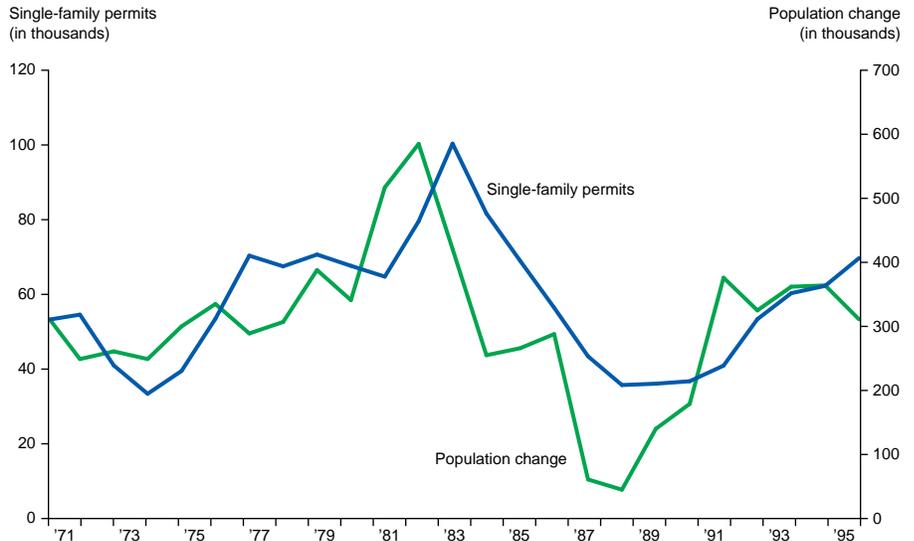
The purely demographic effect of the changing age distribution suggests a potential slowdown in the growth of the residential construction industry.⁶ Nevertheless, increases in immigration levels or a pickup in construction due to home remodeling by aging baby boomers could keep residential construction on its current path.⁷

Labor Market. When baby boomers entered the working world, their sheer numbers caused them to have a substantial impact on the U.S. labor market. The young-adult labor force grew rapidly during the late 1960s and 1970s, and because baby boomers were at the age when frequent entries into and exits from the labor force are more common, they exerted upward pressure on the national unemployment rate.

In the 1980s, the proportion of young people in the labor force shrank steadily, and eventually this reversal of demographic trends applied downward pressure on the unemployment rate (excluding increases during the 1980 and 1981–82 recessions). The 1980s closed with an unemployment rate of 5.3 percent, half a percentage point below its level a decade earlier.⁸

During the 1990s and beyond, much of the increase in the working-age population will be concentrated in the 35 to 64 age group. People in this group have exhibited high rates of labor force participation

Chart 5
Texas Population Growth and Housing Construction



SOURCE: U.S. Department of Commerce, Bureau of the Census.

and low rates of unemployment, implying continued downward pressure on the unemployment rate. Also, people in this age group are near their most productive years, which could boost labor force productivity.

In the coming years, labor force growth is expected to slow along with the rate of population growth. This could be good for the baby bust generation, those people now 20 to 31 years old. Because busters constitute a smaller than normal generation, employers may have to pay a premium for good, highly skilled entry-level workers. In addition, as labor becomes more scarce, businesses may become more innovative, creating labor saving technology that would boost productivity growth.

Other Implications. Demographic trends will affect many other segments of the economy as well. As the baby boomers near retirement, they may save more, thereby boosting the national savings rate. In fact, some researchers have suggested that the run-up in the stock market in the past few years may be due to the aging boomers’ rush to prepare for their golden years. The consensus on this view is mixed, and there is a downside as well.

As boomers begin retiring, the savings rate could begin to decline and stock values could fall.⁹ Other researchers predict that as the boomers retire, not only will savings rates decline, but the smaller workforce will mean less need for the accumulation of capital—such as factories and machines.¹⁰

While the baby boomers won’t begin retiring in large numbers until the year 2011, already there is growing concern about the financing of government spending programs for the elderly, like Medicare and Social Security. An aging population means that health care and retirement will consume a larger share of government spending. With a smaller proportion of working-age Americans supporting a larger number of elderly, this suggests higher tax burdens for future workers.¹¹

Do Texas’ Differences Matter?

Despite its different demographic characteristics, Texas will follow national trends for the most part in the coming years. Although the state has a younger and faster growing population than the nation, its rate of population growth will slow and its population will become older.

Nevertheless, there are some areas in which Texas may be affected differently from the nation because of its unique demographic trends. These areas include housing, retail sales and labor force growth.

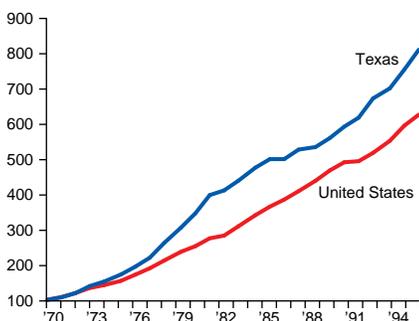
First, as Chart 5 shows, Texas housing construction follows changes in population to a large extent, but with a lag. The expectation that Texas' population growth will slow suggests slower growth in residential construction. However, the state's demographic characteristics suggest that the population-induced slowdown in housing demand will be less evident in Texas than in the nation as a whole.

Housing construction in Texas should be bolstered by the state's younger population. Through the year 2010, the number of people in the 25–34 age group is expected to fall more than 7 percent in the United States. In contrast, the number of Texans aged 25–34 is expected to increase by about 4 percent over the same period. It is precisely this age group that is responsible for start-up housing demand, the segment that will be most negatively affected at the national level.

Second, Texas' faster than average rate of population increase should draw retailers and other consumer-oriented businesses to the state. Chart 6 shows that retail sales have grown faster in Texas than in the nation since 1970, a trend that is likely to continue because of the

Chart 6
U.S. and Texas Retail Sales

Index, 1970 = 100



SOURCE: U.S. Department of Commerce, Bureau of the Census.

state's demographic characteristics.

Finally, Texas labor force growth should be affected as population growth slows and the population becomes older. With fewer workers entering the labor force and a larger share of Texans at their most productive working ages, we could see a slowdown in labor force growth coupled with an increase in productivity in the next 10 to 15 years. Still, Texas is likely to have a larger than average share of young workers to draw from because of its younger age distribution, meaning labor force growth should remain higher than the national average. This would be a positive factor for Texas businesses in areas with tight labor markets, making it less difficult to fill entry-level positions.

Because of Texas' growing diversity, minorities represent the largest segment of new entrants into the labor force, a trend that will continue. Unfortunately, minorities are more likely to drop out of school; therefore, they may lack some necessary skills for labor-market entry. While improving in recent years, the 1993–94 cumulative dropout rate for grades 7 through 12 was 21.1 percent for Hispanic students and 17.8 percent for African-American students, compared with a rate of about 9 percent for non-Hispanic whites and Asian-Americans.¹²

Because of the high dropout rates for minority Texans, they are less likely to obtain the necessary education for high-skill, high-wage positions. Thus, it may be harder for employers to recruit them into the technology-based entry-level positions of the future. And if the labor pool does not have the right job skills, the Texas economy will not be able to grow at its potential. A challenge for Texas will be to train and educate these young Texans and successfully assimilate them into the state's increasingly diverse labor force.

—D'Ann M. Petersen

Notes

- ¹ U.S. and Texas population estimates and forecasts are from the U.S. Department of Commerce, Bureau of the Census.
- ² Historical migration estimates were obtained from John Sharp, Texas Comptroller of Public Accounts.
- ³ Early 1980s refers to 1980 through 1983.
- ⁴ A big question mark in Texas' population picture is the number of undocumented immigrants not included in census statistics. A Census Bureau study estimates that in 1994, 300,000 to 427,000 undocumented immigrants lived in Texas. These undocumented immigrants not only add to the total population figures but are likely to have demographic characteristics similar to other immigrants that would contribute to a younger population.
- ⁵ Projections of the proportion of Texas residents by race and ethnicity are from the Texas State Data Center at Texas A&M University in College Station.
- ⁶ See Kent Hill and D'Ann Petersen, "Demographics and the Long-Term Outlook for Housing Investment," *Economic Review*, Federal Reserve Bank of Dallas, First Quarter 1994.
- ⁷ See Paul Emrath, "Immigration and Housing Demand," *Housing Economics*, March 1994, for an explanation of how future immigration is likely to affect U.S. housing demand.
- ⁸ The information regarding the baby boom's impact on the unemployment rate comes from "Population Changes, the Baby Boom, and the Unemployment Rate," *Monthly Labor Review*, August 1990.
- ⁹ See "The Year Is 2010. Do You Know Where Your Bull Is?" *New York Times*, March 10, 1996.
- ¹⁰ See Alan J. Auerbach and Laurence J. Kotlikoff, "The Impact of the Demographic Transition on Capital Formation," *Scandinavian Journal of Economics*, (94), 1992.
- ¹¹ For an explanation of how immigration might affect the U.S. age structure, thereby offsetting the increased fiscal burden of an aging population, see Kjetil Storesletten, "The Economics of Immigration," graduate dissertation, the Graduate School of Industrial Administration at Carnegie Mellon University, May 1995.
- ¹² Texas Education Agency, *1993–94 Texas Public School Dropout Report*, September 1995.

Honest Money Is the Best Policy

“When it comes to raising revenue, honesty is the best monetary policy. The best monetary policy imposes its own internal discipline, limiting the amount of currency printed.”

People the world over recognize the U.S. dollar. Above George Washington's portrait, the words “Federal Reserve Note” carry a promise in which many people trust. It's the promise of honest money that holds its value.

Some \$375 billion today circulates in the United States and abroad. Not only is the U.S. dollar held more widely worldwide than any other currency, estimates indicate that more American currency is held abroad than in the United States. What U.S. citizen touring abroad hasn't seen U.S. currency used in exchange for goods and services? American money circulates in Mexico, Israel, Russia, virtually every foreign country. Today, the U.S. dollar is the world's currency of choice, and it has been for several decades.

This popularity does not mean, however, that the dollar faces no competition from other currencies, or that an infinite supply of U.S. currency should be made available to the world. In fact, the dollar's widespread use in foreign countries raises several questions. Do foreign holdings of dollars help or hurt Americans? And what, if anything, should be done to safeguard the dollar's value? Understanding the answers to these questions lies in understanding how the government finances its spending and, in particular, the role of seignorage.

Seignorage is the volume of goods and services that governments buy with the fiat money they print. *Fiat money* is paper currency that's not backed by gold or other tangible assets. In effect, seignorage is an alternative to income taxation for financing government spending. The United States' seignorage opportunity has been somewhat unique. Because 50 percent or more of all U.S. dollars are held abroad, foreigners, as well as U.S. citizens, bear the burden of U.S. seignorage. So, seignorage not only substitutes for income taxation, it also represents a means of “taxing” foreigners. Seignorage amounts to a small gift

to U.S. citizens: the “taxes” paid by foreigners holding dollars reduces the amount of income taxes that must be collected from U.S. citizens.

If U.S. taxpayers benefit from seignorage, why doesn't the Federal Reserve make the dividend even larger by printing more currency and raising more seignorage from foreigners? The answer is because people worldwide seek honest money, an attribute the U.S. dollar would quickly lose if the Fed abandoned its pursuit of low inflation. By limiting the amount of currency in circulation, the Fed can provide a stable-valued currency and keep the dollar competitive against the numerous alternative currencies available to the public, such as the German mark, the Japanese yen and the Swiss franc. Inflationary policies would undermine the dollar's value and send dollar-holders to a more honest currency.

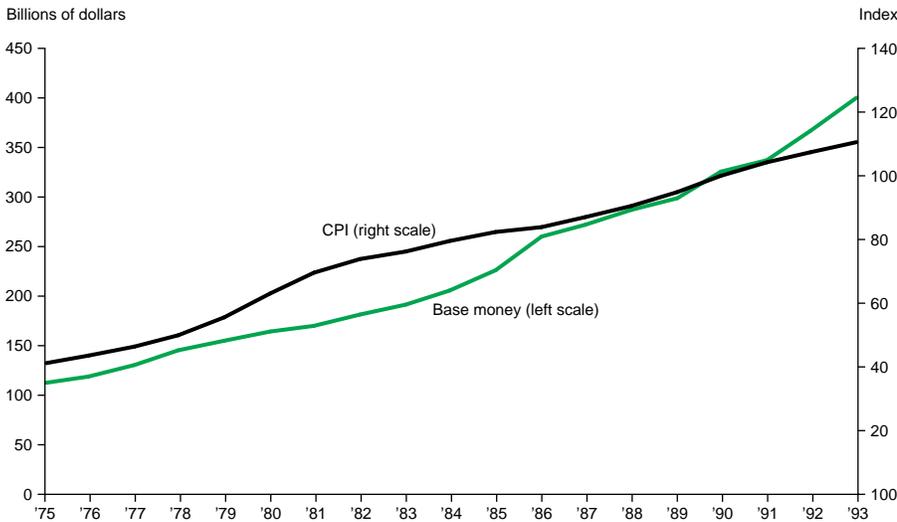
When it comes to raising revenue, honesty is the best monetary policy. The best monetary policy imposes its own internal discipline, limiting the amount of currency printed. From time to time, people call for a form of external discipline—a return to the gold standard. Americans taxpayers, however, can benefit more from a fiat money standard in which the value of currency is stable over time than from a return to the gold standard.

Fiat Money or Gold?

Until August 1971, the United States maintained the gold standard, a monetary policy that backed every bill in circulation with gold. Under the gold standard, the number of dollars circulating was determined solely by the quantity of gold held by the Fed. Consequently, a gold strike in Alaska, California or anywhere else that added to the Fed's gold reserves meant more money could be circulated. Conversely, a loss of gold reserves meant the Fed had to take an equal amount of currency out of circulation.

An attractive feature of the gold

Chart 1
Base Money and the Consumer Price Index



standard was that it imposed an external restraint on the Fed. Without additional gold, the Fed could not add money to the economy. Money was backed by gold reserves, so sustained episodes of inflation could not occur. If paper money was devalued by inflation, people traded currency for gold, which reduced the money supply and put the clamps on inflation. Hence, the value of money was dictated by the official dollar price of gold.

Today, the Fed does not back each bill with gold. Instead, the value of fiat money is maintained through the Fed's restraint in maintaining honest monetary policy. The reason a fiat money standard can make people better off than they would be under a gold standard is simple. Under the gold standard, huge quantities of precious metal had to sit in Fed warehouses to back the currency. A fiat standard lets people benefit from seignorage and releases the gold for people to enjoy, benefits that accrue as long as the Fed pursues a stable value of the dollar and refrains from excessive money creation.

Taxes or T-bills?

To understand the effects of seignorage, one needs to understand how government pays for its pur-

chases. Government can pay for goods and services by taxing, borrowing, or printing currency. Under today's fiat money standard, budget revenue is raised through seignorage when the Federal Reserve buys U.S. Treasury securities in the form of T-bonds or T-bills. Essentially, the Fed trades currency for Treasury debt, indirectly paying for the Treasury's purchases. (If the Treasury paid off its debt, the fiat money would effectively be backed by the Treasury's taxing authority. However, historically the Fed has written off the Treasury's obligations.¹⁾)

Seignorage is an alternative to income taxes or greater public indebtedness, not a free lunch. Overreliance on seignorage violates the honest money principle and amounts to an attempt to get something for nothing. But the economics of supply and demand prevent that from happening: if supply increases, the price falls. For money, the price is its value—how many goods and services it can buy—and the rate at which money's value falls is inflation.

Chart 1 provides evidence of the close correlation between changes in the money supply and the price level, which is used to gauge inflation. The chart plots the amount of currency in the hands of the public

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*“It is the commitment,
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plus bank reserves (base money) and the U.S. consumer price index for 1975–93. The two lines are nearly perfectly correlated, indicating that rapid growth of the supply of fiat money lowers the dollar’s value through inflation.

Between 1993 and 1994, the United States raised about \$31 billion through seignorage. This sum represents about 1.6 percent of federal spending. On the surface, it might appear that a higher level of seignorage would yield greater tax savings for the U.S. taxpayer because the Fed, in effect, could export some of the seignorage “tax” to foreign countries. That policy, however, could have unintended results.

The Temptation to Tax Foreigners

Researchers have coined the term “dollarization” to describe what happens when the dollar or other foreign currency circulates along with a local currency.² Estimates indicate that U.S. currency circulating abroad is between 50 percent and 78 percent of the total, or between \$187.5 billion to \$300 billion of the \$375 billion in circulation.³

A comparison with the German mark highlights U.S. dominance as a supplier of currency to the world. German marks in circulation today total about 250DM billion. Suppose, for example, that 33 percent of all marks were held outside Germany. Then roughly 83DM billion, or, at today’s exchange rate, the equivalent of about \$52 billion, would be held outside Germany. Even if *all* marks in circulation today were held outside Germany, they would be equivalent to only about \$167 billion, still smaller than the most conservative estimate of U.S. dollars circulating abroad.

The volume of U.S. dollars circulating abroad means that non-U.S. citizens bear part of the seignorage burden. And while a government that overtaxes its constituents may be ousted at election time, noncitizens holding dollars in foreign countries don’t vote—so why not

raise the seignorage “tax”?

Such a temptation is tempered by market competition. The more inflationary monetary policy becomes, the less attractive the currency becomes as a store of value. Dollarization occurs in some countries because the public doesn’t trust the local currency as a store of value, frequently because inflation in the country has been high in the past. So, the hint of inflation can cause people to exchange one foreign currency for another that seems more stable. In short, the dollar’s dominance could be lost quickly if the Fed suddenly increased seignorage and caused people to question the dollar’s future value.

And if the Fed reversed its monetary policy course, creating money at a much faster rate, then extensive foreign holdings of U.S. currency could exacerbate the effects of inflation fears. As foreign dollar-holders’ confidence in the dollar eroded, they would trade dollars for another currency they perceived as more honest, potentially en masse. In economic terms, demand for the dollar would fall sharply, pushing inflation up even faster. If the Fed failed to reduce the supply of currency to match the lower demand, the inflationary consequences would be made worse by the volume of U.S. currency being unloaded abroad. The ensuing mass reversal of currency flows—from foreigners to the United States—could prove overwhelming.

Incentives for Honest Money

The trust people around the world are willing to place in the U.S. dollar owes largely to the United States’ reputation for keeping its promises and its track record of monetary stability. Through seignorage, the dollar’s popularity abroad yields a dividend for American taxpayers that was not available under the gold standard.

Proponents of the gold standard cite its low-inflation record. These

days, money's stable value during the gold standard has come to be associated with gold per se. However, the gold standard ultimately worked because of restraint, the restraint to hold gold's dollar price constant rather than make periodic revaluations. In short, it is the commitment, not the commodity, that makes paper money hold its value—then and now. The real standard is honesty, not gold.

Thus, as long as the Fed can maintain its commitment to honest money, the nation can enjoy the benefits of a stable dollar. With so much U.S. currency in circulation, the government could be tempted to cash in through inflationary money creation. But excessive seignorage hurts everyone holding the currency. And while world markets have selected the U.S. dollar as the currency of choice, that status could disappear quickly if U.S. monetary policy stirred doubts about U.S. money.

Honest money is the right policy. For both U.S. citizens and the rest of the world, honest money makes good on the promise that a dollar today will be worth a dollar tomorrow, and honest money is what the Federal Reserve works to achieve by pursuing low inflation and practicing restraint.

—Joseph H. Haslag

Notes

- ¹ Technically, the Treasury does pay principal and interest on these debts, but historically the Fed has returned all principal and interest payments to the Treasury. See W. Michael Cox, "Two Types of Paper: The Case for Federal Reserve Independence," *Southwest Economy*, November/December 1992, for a description of the Treasury–Fed interaction.
- ² At minimum, the country's government can ensure some demand for its currency by requiring that taxes be paid in it.
- ³ See Richard D. Porter and Ruth A. Judson, "The Location of U.S. Currency: How Much Is Abroad?" unpublished mimeo, 1995. In addition, see Robert D. Laurent, "Currency in Circulation and the Real Value of Notes," *Journal of Money, Credit, and Banking* 6 (2 1974): 213–26. Laurent estimated that at most 2 percent of currency is lost, for example, by being at the bottom of rivers or privately destroyed.

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Beyond the Border

What's Behind Those Yen–Dollar Swings?

Recent movements in the yen–dollar exchange rate largely reflect relative business cycle movements and expectations of near-term growth in the United States and Japan. The yen–dollar exchange rate has been subject to wide swings as Japan has struggled with financial-sector difficulties and policy uncertainty.

The real value of the dollar relative to the yen has been extremely volatile over the past year. In fact, on a monthly basis, the real value of the dollar has been even more volatile against the yen than against the Mexican peso. From February to April 1995, the real value of the dollar fell by 15 percent against the yen; since then, the dollar's value against the yen has appreciated a dramatic 29 percent (Chart 1).

Since 1992, the U.S. economy has been growing steadily, while Japan's economy has been extremely sluggish, with average growth of less than 1 percent a year. Japan's unemployment rate has reached new highs.

Some of Japan's sluggishness is the result of banking difficulties. Japan's banking problems have not been unlike those of the U.S. savings and loan crisis during the late 1980s. Both had their seeds in overvalued asset prices. The value of many assets on financial institutions' books have plunged since late 1989 when the Japanese stock market declined nearly 40 percent. Overall, Japan has had to contend with declining prices. Japan experienced 0.1 percent deflation in 1995. Deflation continued in January and February 1996 as well. As asset prices have fallen, lending has declined.

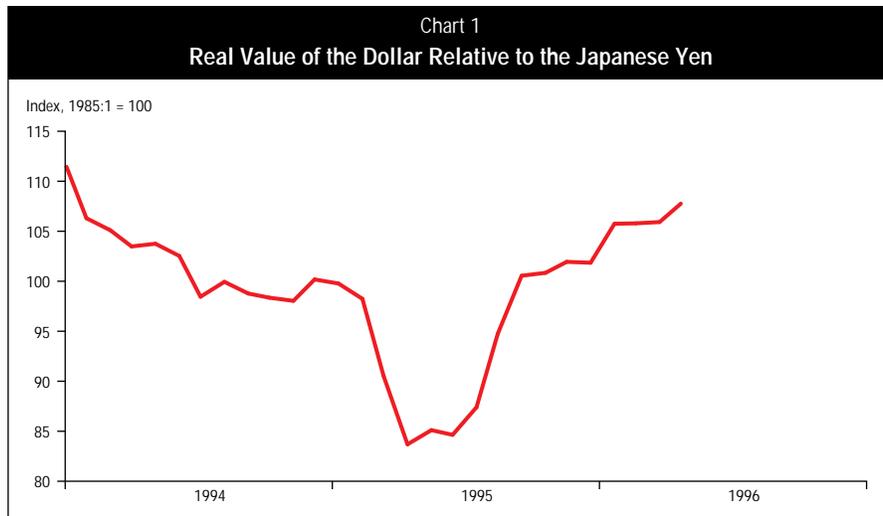
Japan's government has attempted to bail out several financial institutions that have large amounts of unrecoverable debt. A recent proposal to bail out mortgage lenders drew strong opposition and resulted in a federal

budget impasse. On March 26, 1996, the legislature passed a short-term budget that kept the government operational and gave both sides 50 more days to resolve the impasse. By mid-April, a budget compromise was reached, but it excluded the proposal to bail out mortgage lenders.

Although Japan's economy has been sluggish over the past few years, signs of a recovery have emerged recently. While U.S. real gross domestic product (GDP) grew by an annualized 0.5 percent in the fourth quarter of 1995, Japan's real GDP grew by 3.6 percent. Capacity utilization and new machinery orders increased in 1995, with orders currently at their highest level in the past three years. Housing starts have increased dramatically since August, growing 7 percent in January 1996 compared with year-earlier numbers. Dun and Bradstreet's latest

survey of business expectations reveals that business confidence has improved sharply in the past few months. Finally, real household spending grew 3.4 percent in January, compared with January 1995.

Japan's financial markets also are sending some



positive signals. The yen has appreciated about 4 percent against the dollar since the end of 1995. The Japanese stock market index, the Nikkei, has hit the 22,000 mark, the highest level so far in 1996. Since April 1995, the Nikkei has grown about 27 percent.

If these conditions continue, a sustained recovery is possible. A poll conducted by *The Economist* magazine indicates expectations of GDP growth of 2.3 percent in 1996 and 1997. A 2-percent growth rate would have seemed sluggish by 1970s standards, but in 1996 it would signal a welcomed economic recovery.

—Michelle Burchfiel
David Gould

Regional Update

The Eleventh District economy continued to grow in the first quarter of 1996 but not as robustly as in 1995. Recent movements in economic indicators and an improving Mexican economy suggest moderate expansion in second-quarter 1996 that could gain momentum in the second half of the year.

District job growth improved in February and March after a sluggish January. The District finished the first quarter with an employment increase of 2.1 percent (at an annual rate), compared with 2.9-percent

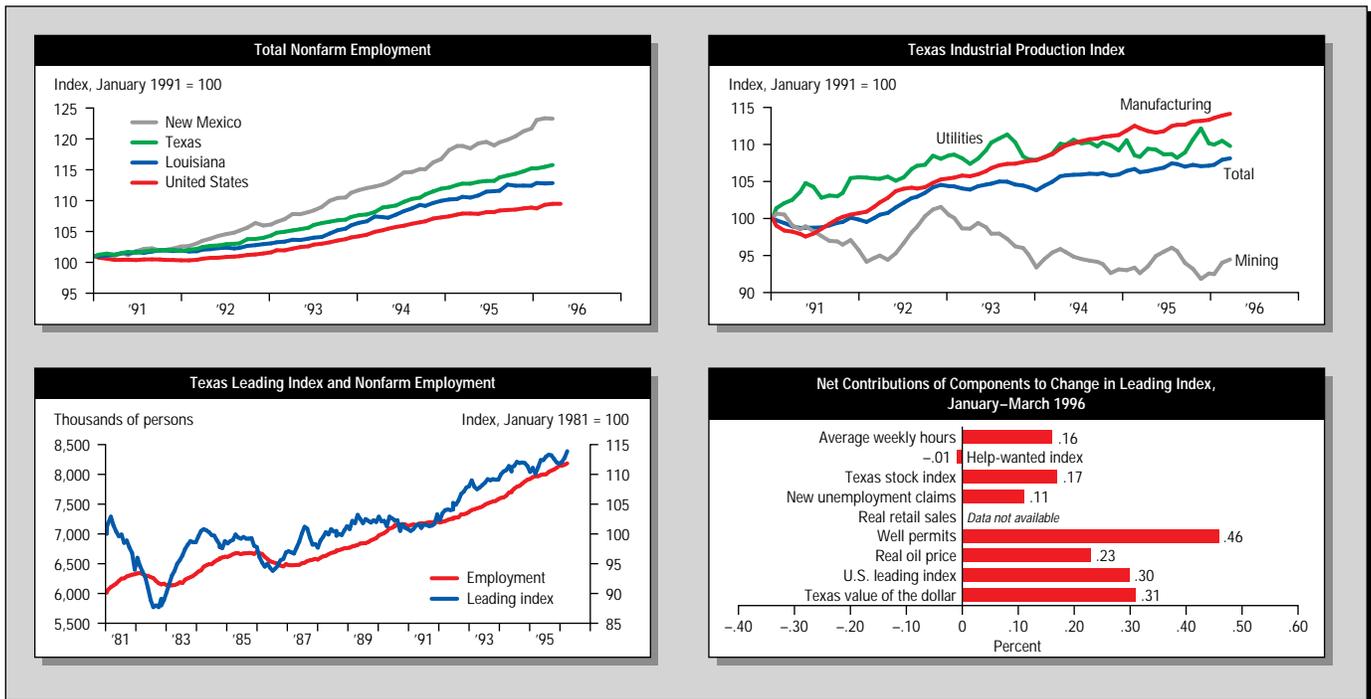
job growth in 1995. Rapidly expanding high-tech industries continued to stimulate growth in business services and construction, while higher energy prices gave energy-related industries slight job gains. Growth in manufacturing jobs was sluggish, but anecdotal reports suggest orders picked up in April, which could boost employment in coming months.

Mexico's continued improvement could mean more Eleventh District exports to Mexico and stronger retail sales along the border. After

bottoming out in 1995, the Mexican economy has been improving slowly. The stabilization of the Mexican economy helped boost Texas exports to Mexico in fourth-quarter 1995 after declines in the first three quarters.

The Texas Leading Index strengthened in the first quarter of 1996, following declines in late 1995. March's increase was the largest since April 1995, and six of the eight index components contributed gains. Recent movements in the Texas Leading Index suggest continued expansion in coming months, and perhaps even more vigorous growth in the third and fourth quarters.

—D'Ann M. Petersen



REGIONAL ECONOMIC INDICATORS

| Texas Leading Index | Texas Employment | | | | | | Total Nonfarm Employment | | |
|---------------------|------------------|--------|--------------|---------------|------------|---------------------------|--------------------------|-----------|------------|
| | TIPI total | Mining | Construction | Manufacturing | Government | Private service-producing | Texas | Louisiana | New Mexico |
| 3/96 | 113.9 | 120.7 | 153.8 | 425.7 | 1,036.3 | 1,467.0 | 8,184.5 | 1,795.0 | 711.4 |
| 2/96 | 112.8 | 120.5 | 154.5 | 425.6 | 1,037.3 | 1,464.9 | 8,162.6 | 1,794.0 | 711.8 |
| 1/96 | 112.1 | 119.8 | 152.6 | 425.5 | 1,040.2 | 1,462.0 | 8,144.9 | 1,795.3 | 710.1 |
| 12/95 | 111.8 | 119.6 | 154.5 | 421.4 | 1,035.3 | 1,461.9 | 8,145.1 | 1,788.1 | 702.1 |
| 11/95 | 112.0 | 117.1 | 154.4 | 418.4 | 1,032.4 | 1,459.6 | 8,110.8 | 1,788.4 | 699.5 |
| 10/95 | 112.6 | 119.8 | 154.8 | 415.8 | 1,030.7 | 1,455.3 | 8,082.5 | 1,788.2 | 694.8 |
| 9/95 | 113.2 | 119.5 | 155.3 | 411.7 | 1,031.3 | 1,453.0 | 8,063.0 | 1,791.1 | 691.5 |
| 8/95 | 113.3 | 119.9 | 155.4 | 408.0 | 1,029.3 | 1,458.9 | 8,041.1 | 1,775.1 | 689.1 |
| 7/95 | 113.0 | 120.0 | 155.1 | 405.0 | 1,026.2 | 1,449.4 | 8,001.0 | 1,774.1 | 686.2 |
| 6/95 | 112.4 | 119.3 | 156.7 | 407.3 | 1,028.0 | 1,445.1 | 7,999.7 | 1,772.7 | 689.5 |
| 5/95 | 112.4 | 119.1 | 156.9 | 406.1 | 1,027.2 | 1,441.8 | 7,989.5 | 1,762.8 | 688.1 |
| 4/95 | 111.2 | 118.8 | 156.0 | 401.7 | 1,029.4 | 1,440.2 | 7,968.4 | 1,757.3 | 683.4 |

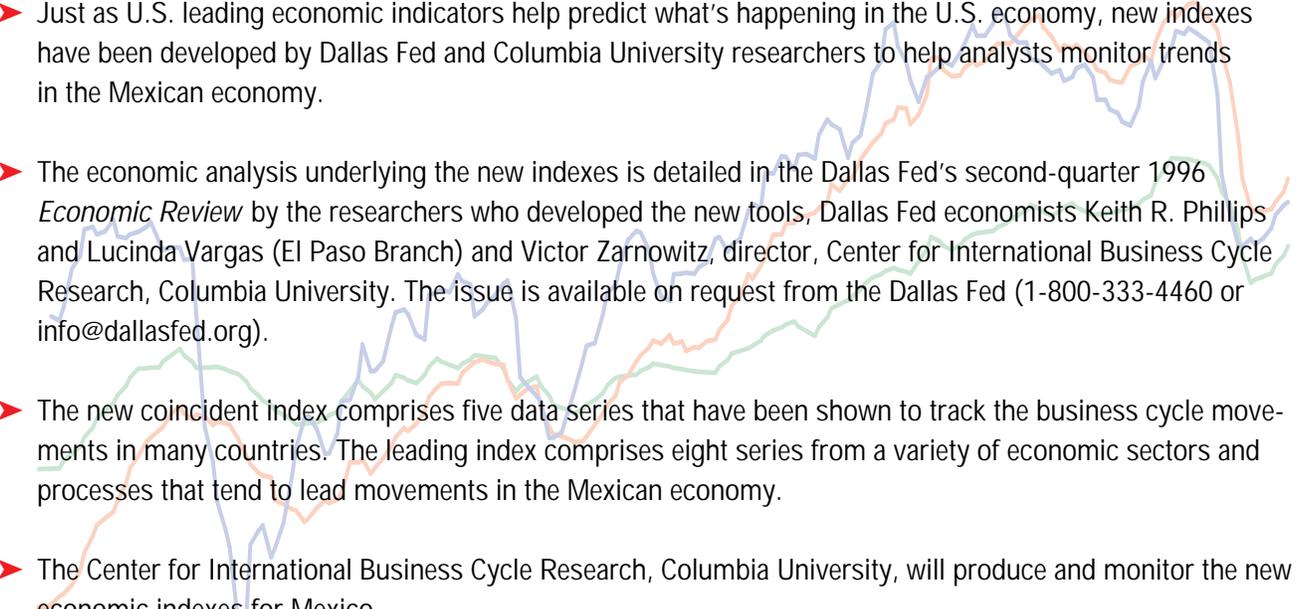
FURTHER INFORMATION ON THE DATA

For more information on employment data, see "Reassessing Texas Employment Growth" (*Southwest Economy*, July/August 1993). For TIPI, see "The Texas Industrial Production Index" (*Dallas Fed Economic Review*, November 1989). For the Texas Leading Index and its components, see "The Texas Index of Leading Indicators: A Revision and Further Evaluation" (*Dallas Fed Economic Review*, July 1990).

Online economic data and articles are available on the Dallas Fed's BBS, Fed Flash (214) 922-5199 or (800) 333-1953, and WWW home page: www.dallasfed.org

New Tools for Analyzing the Mexican Economy

Indexes of Coincident and Leading Economic Indicators

- 
- ▶ Just as U.S. leading economic indicators help predict what's happening in the U.S. economy, new indexes have been developed by Dallas Fed and Columbia University researchers to help analysts monitor trends in the Mexican economy.
 - ▶ The economic analysis underlying the new indexes is detailed in the Dallas Fed's second-quarter 1996 *Economic Review* by the researchers who developed the new tools, Dallas Fed economists Keith R. Phillips and Lucinda Vargas (El Paso Branch) and Victor Zarnowitz, director, Center for International Business Cycle Research, Columbia University. The issue is available on request from the Dallas Fed (1-800-333-4460 or info@dallasfed.org).
 - ▶ The new coincident index comprises five data series that have been shown to track the business cycle movements in many countries. The leading index comprises eight series from a variety of economic sectors and processes that tend to lead movements in the Mexican economy.
 - ▶ The Center for International Business Cycle Research, Columbia University, will produce and monitor the new economic indexes for Mexico.

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