SOUTH PADRE ISLAND ECONOMIC INDEX 1994-2005

Prepared for the

South Padre Island Economic Development Corporation

By

Rafael Otero, Ph.D.

May, 2006

SOUTH PADRE ISLAND ECONOMIC INDEX

Methodology

Selection of Variables

The variables included in the composite economic index were selected taking into account the reliability and availability of the data, and recommendations by the South Padre Island Economic Development Corporation. The four variables included were Hotel/Motel Occupancy Tax, Sales Tax, Bank Deposits, and Building Permits Valuation.

Data

The South Padre Island Economic Development Corporation provided the data. It covers the period January 1994 - December 2004. For the annual index, the monthly data were added in a yearly total for all variables except for Bank Deposits, where a monthly average was calculated to represent the year.

Index Calculations and Interpretation

The weights for the four variables that make up the composite index are the following:

Hotel/Motel Occupancy Tax	40%
Sales Tax	30
Bank Deposits	20
Building Permits Valuation	10

The data for the variables, which involve money, were adjusted for inflation in both the annual and monthly indexes using the consumer price index (CPI). For the monthly index, all variables except Building Permits Valuation were further adjusted for seasonal variations. The Buildings Permits Valuation variable was not adjusted because it did not show a seasonal pattern.

The index was then calculated using 1994 as the base year (or benchmark) with an index value of 100. Therefore, the interpretation of an index number of 110 in any given year is that economic activity increased by 10% relative to 1994. An index number of 95 would imply that economic activity decreased by 5% relative to 1994.

SPI ECONOMIC INDEXES

Using long periods for trend analysis allows us to learn about periods of economic recession and expansion and their possible causes. The year 1994 was used as the benchmark year.

SPI Composite Index

The effects of the Mexican economic crisis of 1995 on the SPI economy are evident on the composite index. The U.S. economy was growing at a healthy pace at that time, so the SPI slump cannot be attributed to the U.S. economy. This is clear evidence that economic activity in South Padre Island is highly dependent not only on the U.S. economy, but also on the Mexican economy.

1994-2000. The SPI economic activity declined 11% (index of 89) in 1995 relative to 1994. It was not until 1998 that the economic activity in SPI recuperated the 1994 levels. After a local recession during 1995-1997, the SPI economy (composite index) showed a healthy 8% average annual growth for the period 1998-2000, reflecting the combined growth of both the U.S. and Mexican economies during that period.

2001. The SPI economy grew at 1.6% in 2001 in spite of the slowdown of the U.S. economy and the collapse of the Port Isabel-SPI causeway, which by itself caused a drop of 40-50% in occupancy and sales taxes in September and October of that year, according to the seasonally adjusted monthly indexes.

2002. As projected in early 2002, the SPI economic activity grew at a strong pace. It grew 15% in 2002, the highest economic growth since 1994. This growth was primarily driven by large investments in construction (building permits), indicative of the confidence investors have on the future of SPI. Stability of the Mexican peso for most of the year also contributed to maintain a healthy growth in occupancy and sales in SPI.

2003. My projection for 2003 in February, 2003 was that 2003 would probably not be as good as 2002, but that it would probably be a good year for SPI. According to the composite index, 2003 (index of 134.29) was not as good as 2002 (140.17), but it was better that 2001 (121.84) and all the previous years. The overall SPI economy declined 4.2% in 2003 relative to 2002, a bit more than I had originally expected. This was primarily due to a large decline in building permits. Construction expanded dramatically in 2002 and probably saturated the market for 2003.

2004. I forecasted that 2004 (index of 142.03) would be better that 2003 (index of 134.29), but I was uncertain whether it would be better than 2002 (index of 140.27). It ended up being the best year up until then, primarily due to a large increase in building permits at the end of 2004.

2005. In 2005, I forecasted that 2005 would be a better year that 2004 for SPI. The annual composite index shows that 2004 had an index of 142.03 and 2005 had an index of 144.27, an increase of 1.6% in real terms (after inflation). Although the main activity of SPI (hotel/motel occupancy) actually declined, the real estate sector had an important increase (building permits grew almost 15%). This makes 2005 the best year so far.

Building Permits Index

1994-2000. The building sector was the most drastically affected by the 1995 SPI recession. Valuation of building permits declined 64% in 1995 relative to 1994. This sector only began growing again until 1998, after a three-year recession. The under-use of the room capacity at SPI due to the local 1995-1997 recession did not require new construction until 1998, the year the SPI economy recovered the 1994 levels. In 1998 and 1999, building permits valuation grew at a rapid pace, recuperating the 1994 building levels in 1999.

2001. The deterioration of the U.S. economy in 2001 led to a 4% reduction of building permits. This confirms that the construction sector is the most sensitive to changes in overall economic activity.

2002. In 2002, building permits valuation grew at the stunning pace of 69%, offering a clear indication that investors have confidence in the future of SPI.

2003. The large construction expansion in 2002 probably saturated the market for 2003, so building permits declined 51%.

2004. The 2004 building permits increased 99% relative to 2003, primarily in December, taking the year to almost the 2002 level.

2005. This year the index achieved its historical maximum (203.13) to date. Valuation of building permits increased 14.7% relative to 2004.

Occupancy and Sales Tax Indexes

1994-2000. As would be expected, occupancy and sales tax revenue also experienced a decline in 1995, although not as dramatic as the building sector. Both tax revenues declined by close to 8% in 1995 relative to 1994. The occupancy tax revenue recuperated the 1994 level in 1997, but sales tax revenue did not reach the 1994 level until 2000. Occupancy tax revenues experienced a healthy growth of about 5.6% in 2000, while the sales taxes increased by about 4.5% that year.

2001. Occupancy taxes grew at 2.2% in 2001, while sales taxes actually declined by almost 3.2% as a result of the weakening U.S. economy and the collapse of the Port Isabel-SPI causeway.

2002. Sales taxes grew at 8.3% in 2002, while occupancy taxes grew at 7.7%. This healthy growth in occupancy and sales were largely due to the stability of the Mexican peso last year.

2003. Occupancy taxes declined 7.1% in 2003, while sales taxes declined 1.3%. This decline was probably due to the uncertainty in the U.S. economy and the 10% devaluation in the Mexican peso between November, 2002 and February, 2003.

2004. Sales taxes only grew 1.5% in 2004, while occupancy taxes grew 4.4%.

2005. Sales levels were practically the same as in 2004 in real terms, while motel/hotel occupancy actually declined by 1.5% during the year.

Bank Deposits Index

1994-2002. Bank deposits grew continuously during the period 1994-2000 at an average rate of about 8% annually. Bank deposits grew at 14% in 2002.

2003. Bank deposits grew 18.5% in 2003, the largest growth since 1994. This is the only index component that increased continuously since 1994. A possible explanation for the continuous growth in bank deposits even when occupancy and sales declined may be that new SPI residents are bringing large amounts of cash to SPI.

2004. Bank deposits declined 7.6%, the first decline since 1994. With the new construction expected in 2005, this index should regain its growth pattern in 2005.

2005. Bank deposits increased less than one percent (.7%) and has not achieved the 2003 levels yet. This index, though, is the least certain because of the lack of cooperation in the reporting of the figures from at least one of the banks.

ECONOMIC TRENDS AND FORECAST FOR SOUTH PADRE ISLAND

The geographical location of South Padre Island (SPI) makes its economy dependent on tourism from the Rio Grande Valley, other parts of the United States, and Mexico. Therefore, an economic forecast for SPI has to include expectations on these areas.

After a long period of economic expansion (1992-2001) when the economy grew at an average of about 4%, the U.S. economy entered in a recession at the end of 2001 as a consequence of the unforeseen events of September 11, 2001. The economy had experienced a slowdown during the first half of 2001, but the economy was still growing and was expected to grow again at higher levels by the end of 2001 if the events of September had not occurred. The U.S. economy continued to struggle in 2002 with very low levels of economic growth, and, unfortunately, expectations of a war with Iraq maintained great uncertainty in the U.S. economy for 2003, at least for the first half of the year. The huge deficits incurred by the federal government in 2003-2004 because of the wars in Afghanistan and Iraq and the “war on terror” will have an effect in the future.

The Mexican economy had a period of relative prosperity during 1996-2000 after the 1995 recession brought about by the 55% peso devaluation of that year. The devaluation in turn was caused by the 1994 deficit of 30 billion dollars in the Mexican Current Account (importing more goods and services than it is exporting) without sufficient dollars flowing in as investment because of the political uncertainty of that year. Up until 1993, the trade deficit had been financed by foreign investment dollars, but the political instability of 1994 brought about by the rebellion in Chiapas and the assassination of the would-be president led investors to lose confidence in Mexico, forcing the brisk devaluation of 1995. The depreciation of the peso made Mexican products competitive in the international market and stimulated the expansion of exports. The exporting sector in Mexico helped pull the economy out of the recession into a period of relative stability and economic growth from 1996 to 2000. The importance of the exporting sector in Mexico is reflected in the fact that Mexico has become the second trading partner of the United States, having surpassed Japan in 2000.

Mexico’s trade deficit is becoming again a topic of concern for the future of the Mexican economy. It has been steadily increasing since 1995, although it is not yet at the levels of 1994. Inflation in Mexico has been traditionally higher than in the U.S., making Mexican products uncompetitive on the international markets if the currency does not depreciate to compensate for the increase in inflation. The Mexican government wanted to lower inflation under 5% by 2004, a rate that could only be achieved by maintaining an overvalued peso. They were apparently willing to try to achieve the lower inflation goals even at the expense of running large trade deficits, which may ultimately require a brisk devaluation in the future if for whatever reason investors lose confidence in Mexico and stop sending dollars to Mexico. Fortunately for Mexico, Mexican immigrant workers in the United States are sending more and more money to their relatives in Mexico, helping balance the flow of dollars. For as long as Mexico can continue to receive new investment and immigrant worker money, enough dollars will flow in to pay for the trade deficit and avoid the need for a devaluation of the peso.

2002. The overvalued peso during the 2000-2002 made it cheaper for Mexicans to travel and spend in the United States, including the Rio Grande Valley and South Padre Island. And as forecasted that year, 2002 turned out to be a good year for SPI due to the stability of the peso and the addition of new attractions such as Schlitterbhan.

2003. By February 2003, the large Mexican trade deficit, coupled with a reduction in foreign investment in Mexico forced a 10% devaluation of the peso. This had a small negative effect in the number of Mexican tourists coming to SPI. The peso did not devalue further relative to the U.S. dollar because the dollar also weakened against the major currencies of the world, so both currencies lost value against the euro, British pound, and yen. By 2003, after three years of the new government in Mexico, Mexicans and foreigners had lost confidence in President Fox because he did not deliver on many of his campaign promises. This led to a reduction in the dollars flowing into Mexico in the form of new investments, which were helping finance the trade deficit before. Nevertheless, Mexican workers in the U.S. were still sending more money to relatives in Mexico which helped offset the decline in investment dollars.

2004. As forecasted for 2004, since the implementation of the visitor program to keep track of Mexican nationals when they come into the U.S. as well as when they leave the country was postponed and the peso did not depreciate considerably, there was not a major negative effect in the number of Mexican visitors and the SPI economy performed better than in 2003. In fact 2004 was the best year so far.

2005. In my forecast for 2005, I said the "barring unforeseen events, the peso is not expected to depreciate dramatically in 2005, the visitor program will not be implemented yet, and the United States economy is expected to grow. Therefore, it can be expected that economic activity in SPI will probably be better than 2004."

As predicted, the peso did not depreciate dramatically, the visitor program was not implemented, the US economy grew at a healthy pace, and as a consequence economic activity in SPI was better that 2004.

Forecast for 2006 and beyond. My concerns last year for 2006 and beyond are still valid since Mexico will have an election this summer. Last year I said that:

> An issue of concern in the longer term that we must keep abreast of in the near future is that Mexico will have a presidential election in 2006, and a strong possible candidate may be Andres Manuel Lopez Obrador, currently the mayor of Mexico City. He represents the extreme political left and has been involved in many actions of corruption. He has gained much support primarily from the impoverished people who unfortunately do not understand how the economy works and only see the short term benefits of massive government spending without comprehending the long term

> negative effects. The long term damage that someone like him can do to Mexico should be a major concern to all of us who in one way or another can be affected by what happens in Mexico. His policies would undoubtedly lead to instability and economic chaos in Mexico and the region. Immigration to the U.S. would increase, trade between Mexico and the U.S. would decline, and, the worst fear of all, Mexico can end with a communist revolution with all its implications for the United States.

The economy of SPI, and the entire US-Mexico border will depend on the outcome of this election of a new Mexican President this year. There are three candidates that have a chance to win: Felipe Calderon of the party PAN, Carlos Madrazo of the PRI, and Andres Manuel Lopez Obrador of the PRD.

The PAN represents the political views of the center and right of the political spectrum in Mexico. If Calderon wins, we can expect a continuation of pro free-market policies and relative economic stability. These policies combined with the increase in oil prices could bring a period of mayor prosperity for Mexico, with all the positive implications for the economy in SPI and the rest of the US border. As we know, Mexican nationals can tend to travel and buy in the US when they have the means.

The PRI represents the center of the political spectrum. As would be the case with Calderon, if Madrazo wins coupled with high oil prices, we can only expect relative political stability and economic growth. So a win of either the PAN or PRI would be positive for SPI and the Valley.

A major fear of mine is that the PRD has possibilities of winning. This party represents the left in Mexico. We must understand that the left in Mexico, as in many developing countries, is not the same as in Europe, for example. The left in Mexico is violent and extremely corrupt. I can only forecast a bleak future for Mexico and the US border if Lopez Obrador wins. Mexico would return to the economic crisis of the 1970's and 1980's with all its implications for the US border. We would very likely experience peso devaluations, large increases in illegal immigration, and political problems for the US government. Those of us who remember the effects of the 1980's devaluations of the Mexican peso can see the effect on the border economy of another cycle of devaluations. If many people think the US currently has a problem of illegal immigration from Mexico, current levels would be small compared to the level of illegal immigration that a government led by Lopez Obrador would generate. People would try to escape the crisis, which can also turn violent, by coming to the US.

In summary, my forecast for 2006 is good because there is relative stability in Mexico, high oil prices are bringing additional money into the Mexican economy, and Mexican workers in the US are sending even more money to their relatives in Mexico. This trend can continue and even improve if either the PAN or PRI win this summer's election in Mexico. But if Lopez Obrador wins, we will start seeing problems within a few years in Mexico. Maybe not so much within the first year because he would ride the current economic stability and there is a lag of time for changes to be felt in the economy, but within three to four years Mexico would be back to the 1970’s again.