Houston Business

A Perspective on the Houston Economy

Is Houston's Expansion in the Slow Lane or the Breakdown Lane?

Houston's economy has spent much of its history in the passing lane, with one recent, prolonged visit to the breakdown lane. However, the city sought diversification away from energy, and the current slowdown is the first real test of just how far we have come in our ability to handle energy adversity.

From January 1987 until early 1991, Houston's economy was in high gear, averaging wage and salary growth of 4.8 percent per year. Over this same period, the nation averaged only 2.6 percent annual employment gains. But as the year progressed, this momentum slowed to a halt. Now, Houston may be fortunate to finish 1991 with any job growth at all.

Since the holiday peak in late 1990, Houston's economy has added only 5,800 jobs, and seasonally adjusted job growth in the second quarter of 1991 was slightly negative. Newspaper headlines have dramatized the slowdown, with numerous layoffs and other cutbacks announced by the city's largest corporations.

What happened? Several problems are at work to cause the slowdown. First, disappointing prices for natural gas caused retrenchment in the upstream energy sector. Second, the national economic recovery proved weaker and slower to materialize than anticipated, bringing the effects of recession to Houston. Finally, many large corporations continue to struggle with a large burden of debt assumed in the 1980s. Debt restructuring and downsizing have become a key part of the bad news heard from many big companies, including several in Houston.

CUTS IN UPSTREAM OIL

In the summer of 1990, if asked where the price of natural gas was going, forecasters might answer that gas prices would rise rapidly, driven by the end of the so-called natural gas bubble and by huge new markets opened up by the Clean Air Act. Analysts predicted that 1991 prices would reach $2.50 to $3 per thousand cubic feet and that 1992 prices would approach $5. Instead, the price dipped below $1.20 this year. Although the price will rise seasonally over the winter, the futures market puts it at only $1.40 by April 1992.

The high expectations for natural gas prices led to a modest build-up in oil and gas mining employment in Houston for the first time since the downturn in 1982. Oil prices that rose to $35 per barrel after the invasion of Kuwait helped finance larger drilling budgets in 1990 and 1991. Between January 1990 and July 1991, Houston added 8,100 new jobs in oil and gas exploration. Many of these jobs are at risk because natural gas prices failed to meet expectations and because the rig count tumbled from 1,068 in January to 775 in September.

Prices are affecting many of the backward linkages from oil exploration to Houston's manufacturing base as well. These oil service firms are highly dependent on the level of upstream activity. The domestic rig count partially reflects the level of drilling activity, but the rig count does not tell the complete story. For example, the loss of a significant portion of offshore drilling in the Gulf of Mexico, which is primarily a natural gas region, works heavily to the detriment of service firms because offshore drilling is very service intensive. On the brighter side, many of these companies report much stronger overseas sales, although not strong enough to offset domestic losses.

THE NATIONAL ECONOMY

The recovery of the national economy from recession was not expected to be strong by historical standards. Analysts based their expectations on the rubber band analogy: because the recession was mild by historical standards and the downward pull was modest, the snapback would be modest as well. Unfortunately, the recovery has been disappointing by even the modest expectations set for it. By April 1991, the recession had cost 1.5 million jobs; since April, job gains have been slow, averaging only 25,000 per month through September.

Data clearly indicate that the recovery began in the manufacturing sector, and growth in manufacturing production began to accelerate early this year. New factory orders have surged, and the National Association of Purchasing Manager's Index rose to 55 in September, its highest level since late 1988.

Any spreading of the recovery from manufacturing is slow and uneven. The latest Federal Reserve Beige Book survey highlighted the disparity between manufacturing and other sectors, particularly retailing. Housing starts, often an important stimulus to past recoveries, rose only modestly to about one million on an annualized pace, and has since fallen back.

The recovery, while still under way, is an uphill struggle. Layoffs continue by state and local governments unable to balance their budgets, as well as by many of this nation's largest corporations that are struggling under a load of debt. Credit problems continue in several parts of the country as financial institutions grapple with declining real estate prices. The consumer is looking at mixed employment prospects and real income increases that only begin to recoup the losses of the recession.

WHAT ABOUT HOUSTON?

What about Houston? We too are struggling, but conditions are *not* a repeat of the oil-price-induced busts of 1982 and 1986. The speculative forces that took the rig count higher than 4,500—and back to 775 today—are not present now. The energy adjustment under way is taking place at the margin, and is not an extensive structural realignment.

Table 1 lists five conclusions about the Houston economy that are helpful in interpreting current events. These conclusions, published in the March 1990 *Economic Review* from the Federal Reserve Bank of Dallas, provide what is now a timely look at the cyclical role of mining and manufacturing in the local economy.

The study examined the effect of the national economy, the international value of the dollar and oil prices on the Texas and Houston economies from 1975 to 1989. Although *oil* prices were considered explicitly, many of the conclusions should carry over to the current problems in natural gas markets.

The first conclusion tells us that—other things being equal—the Houston economy is as sensitive to the national economy as the rest of Texas is. The difference between Houston and the rest of Texas is that other factors, such as oil prices, can more easily and quickly move the city off the national growth path. Hence, Houston has, in fact, felt the national recession over the past year and will similarly benefit as the recovery proceeds.

Houston continues to be more sensitive than the rest of the state to oil and gas price changes

Table 1
Five Conclusions about the Houston Economy

1. **Houston's economic base is no less sensitive than that of the rest of Texas to the national business cycle, other things being equal.**

2. **Houston's economic base is more sensitive than the Texas economic base to changes in the price of oil. The difference is the large share of oil-related manufacturing in Houston.**

3. **The response of mining (oil exploration and development) jobs in Houston to changes in the price of oil is now 40 percent smaller than before the Houston recovery began in 1987. The response of Houston manufacturing remains unchanged.**

4. **Houston's economic base is much more sensitive than the state's economic base to the international value of the dollar.**

5. **Oil maintains a significant presence in Houston. Although Houston's oil-related economic base is now less responsive to oil-price increases, more stable and higher oil prices still promise big employment gains for the Houston area.**

SOURCE: R.W. Gilmer (1990), "Oil Prices and Manufacturing Growth: Their Contribution to Houston's Economic Recovery," Federal Reserve Bank of Dallas *Economic Review*, March, 13–22.

(conclusion 2). The big difference seems to be in the backward linkages to Houston's manufacturing base—that is, to oil service goods such as specialized machineries, valves, tubing and other goods for exploration.

Jobs associated with oil exploration and production in Houston are now about 40 percent less sensitive to changes in oil prices than they were before 1987 (conclusion 3). This change should reflect the stability that signaled the end of the speculative bubble that took hold of the industry in the early 1980s, and it should reflect the continued consolidation of headquarters jobs back to the largest energy centers, such as Houston and Dallas. Houston's oil- and gas-based manufacturing sectors do not seem to have stabilized in a similar manner.

Houston is much more sensitive to the trade-weighted value of the dollar than is the rest of the state, and the tremendous appreciation of the dollar added to the economic problems of the city in the 1980s (conclusion 4). Houston's port, the world-scale chemical operations that line the ship channel and the big international construction firms that are based in Houston are among the obvious examples that help explain this sensitivity. With the dollar up approximately 4 percent over the course of 1991, this factor is only a modest negative influence in the city's current slowdown.

Conclusion 5 in Table 1 is stated from an optimistic perspective, but even a reduced energy sector remains a potent force in Houston. Although the role of the national economy is enhanced by diversification, the current national recovery still must work strongly and positively to offset energy losses.

ECONOMIC OUTLOOK

The recent headlines in Houston appear worse than the underlying situation they describe. Low natural gas prices seem likely to persist into 1992. Oil prices, currently at favorable levels, seem unlikely to move much higher and could decline over the coming year. Houston could use help from a healthy expansion in the U.S. economy.

However, other key components of the Houston economy seem stable. Medical services, funding for NASA and very strong billings by the international construction firms all seem to be in place for the coming year. A modest boost from the national economy should put Houston back on a positive growth path, even if growth will fall short of the performance of the past four years.

Houston's economy has spent much of its history in the passing lane, with one recent, prolonged visit to the breakdown lane. Life in the slow lane may seem scary, largely because it is unfamiliar. However, the city sought diversification away from energy, and the current slowdown is the first real test of just how far we have come in our ability to handle energy adversity.

Recent headlines have spotlighted a string of corporate layoffs and retrenchments in Houston. Reasons for the layoffs vary: low energy prices, efforts to relieve the corporate balance sheet of debt, and stringencies imposed by weak national and international markets.

Underlying economic conditions in Houston remain very slow; any stimulus from the national recovery has been weak and centered in manufacturing. With continued cutbacks in upstream oil and gas operations, resumption of stronger growth in Houston increasingly depends on the national economy's course.

RETAIL AND AUTO SALES

Beige Book survey respondents describe retail sales in Houston as being on trend going into October, but retailers are showing some caution in the wake of bad headlines. Local consumers have yet to cut back spending, but retailers are carefully monitoring inventories, watching expenses and reconsidering hiring plans. Retail buying decisions for the holiday shopping season are complete. Any sign of consumer restraint will prompt heavy promotion. September, always a weak month for auto sales, was no different in 1991. September sales fell to the same range recorded for the month in each of the past four years.

PAPER AND WOOD PRODUCTS

Demand for containerboard used in corrugated boxes has improved steadily and is now strong. Suppliers have raised prices. Demand for bleachboard continues to be strong, helped by food-service trends that favor paper and by the product's price advantage over plastic.

Lumber prices continue to fall, reversing the effects of panic buying that ran the price up 50 percent in June. Respondents indicated that, given the cutting restrictions in the Northwest, Houston lumber prices are weak. Demand for lumber is improved but not strong.

CHEMICALS AND REFINING

Petrochemical demand is described as stable or up only slightly, and the margins are weak. The outlook is increasingly pessimistic because capacity continues to come on-line in a weak market. Margins for refiners are eroding as crude prices rise and gasoline prices remain weak. Demand for refined products remains below year-ago levels.

UPSTREAM OIL

Oil prices have risen since early September, but the support for these prices is not apparent. With Kuwait resuming oil production faster than anticipated and Iraq completely out of the market, lower prices in 1992 are highly likely. Natural gas prices have begun their normal seasonal rise, with September spot prices at the wellhead at $1.35 per thousand cubic feet and January futures at $2.32. April futures fell back to $1.45. Storage is below levels of a year ago.

The rig count is showing a seasonal rise and may have stabilized. The low domestic rig count continues to hurt demand for oil services, and stronger international demand is not sufficient to offset domestic losses. Cuts in service-intensive activity, such as offshore operations and horizontal drilling, are exacerbating the problem. Inventories are fluctuating for service firms, and sales are very competitive.

REAL ESTATE

Leasing activity for office, industrial and retail space showed little or no improvement in the third quarter. The office market is very uneven across Houston, however, with Clear Lake and Greenspoint strongest and the downtown area very weak. There is little construction activity in these markets, except some build-to-suit industrial space.

New home sales continue at a pace even with last year. Starts, however, are down 6 percent, and inventories of completed housing are very thin. Sales of existing homes continued to be strong through September, with first-time buyers reported to be the most active.

For more information, call Bill Gilmer at (713) 652-1546.
For a copy of this publication, write to
Bill Gilmer • Houston Branch • Federal Reserve Bank of Dallas
P.O. Box 2578 • Houston, Texas 77252