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Houston Business

A Perspective on the Houston Economy

Houston's Economy Continues to Improve

Increasingly, the problems that held back Houston's economy in 1991–93 are receding, and recent growth looks sustainable. Upstream energy is stable, the space station project continues, and petrochemicals have unexpectedly improved.

During the first seven months of 1994, Houston's economy has shown clear signs of ending a prolonged hibernation. Seasonally adjusted growth in nonfarm employment through July 1994 ran at a moderate annual rate of 1.8 percent, but the rate of growth of goods production in mining, manufacturing and construction (2.1 percent) moved ahead of growth in private services (2 percent) and government (1.3 percent). This marks a turnaround from the very weak job growth of the 1991–93 period, which saw goods employment decline and service jobs created mostly in low-wage and local government services. (*See Figure 1.*)

Increasingly, the problems that held back Houston's economy in 1991–93 are receding, and recent growth looks sustainable. Upstream energy is stable, the space station project continues, and petrochemicals have unexpectedly improved. Indeed, while growth in the rest of Texas and the nation will slow in coming months due to higher interest rates, Houston's economy has reverted to its old, countercyclical habits. When the numbers are in, local growth should show acceleration in the second half of 1994 that should continue into 1995.

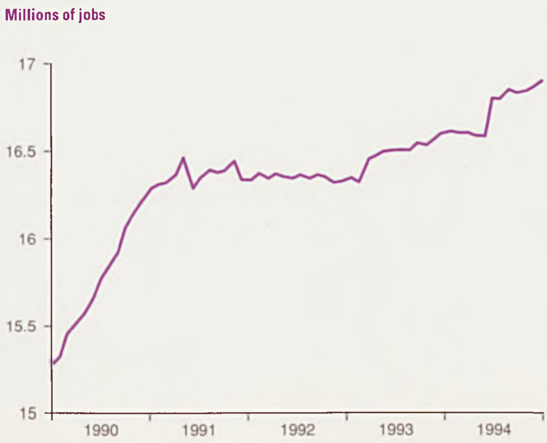
WHY SLOW GROWTH?

Houston's slowdown after 1991 can be broken down into two phases. The first phase resulted from a collapse of energy prices—the city's continuing nemesis—that cost Houston more than 6,000 oil and gas jobs by early 1993. In 1990, local oil service and machinery companies welcomed the burst of drilling activity brought on by the Persian Gulf War and used the revenues as an opportunity to beef up staff for a prospective boom in natural gas exploration. By July 1991, the momentum gained from the Persian Gulf War came to a halt, but the predicted expansion in gas drilling did not materialize. Instead, natural gas prices plunged to near $1 per thousand cubic feet in 1992, resulting in widespread layoffs among Houston oil service and machinery companies. These companies depend on delivering equipment and services to the wellhead, and even in the 1985–87 downturn, the Baker Hughes rig count never moved under a seasonally adjusted monthly figure of 735 working rigs. In 1991–92, the domestic rig count fell below 735 for 11 consecutive months.

Energy-related losses were aggravated by the decisions of major companies to turn away from oil exploration in the United States. The onshore United States is widely perceived as fully explored and drilled out, and offshore drilling is subject to congressional bans except in the western Gulf of Mexico. Suddenly, thousands of domestic oil fields were on the market, and local staff devoted to domestic operations were surplus. In addition, as the 1990–91 national recession spread, U.S. companies undertook widespread corporate restructuring to make operations leaner and more responsive. Houston-based energy headquarters were full participants in this process.

Phase two of the slowdown came in 1993 with deficit reduction proposals from the new Clinton administration. Whatever the broader policy merits of these proposals, three hit very close to home in Houston. A Btu tax would have levied a double tax rate on oil and posed a special threat to refinery profits; proposed health care reform froze hiring and construction at the Texas Medical Center; and a complete review of the space station program slowed investment in the Clear Lake area. Three of Houston's major growth centers were in limbo until policy issues could be resolved.

Figure 1
Total Houston Employment, 1989–94



MOVING FORWARD

Past issues of *Houston Business* discussed how the city's growth increasingly depends on the national economy (July 1993) and on four key centers of self-sustaining growth within the city: upstream oil, downstream oil, the Texas Medical Center and the Johnson Space Center (April 1993). Houston's struggles, therefore, can be explained by the energy and policy issues above, especially once they combined with a national recession and a prolonged jobless recovery. Strong growth in Houston requires that these growth centers pull together, and recent growth has accelerated only as energy conditions improved, the national economy tightened up and deficit reduction issues were favorably resolved.

The national expansion has become a positive force in Houston as labor markets and industrial capacity have tightened up this year. Houston's business cycle has often run counter to that of the nation because of the influence of oil markets. However, if we set the role of energy aside, the national economy affects Houston much the same way it influences other Texas cities. National recovery from a mild recession began in 1991 but proceeded at a pace slow enough to leave excess capacity in labor markets and industrial capacity until early this year. Slow growth and recession in Europe and Japan also left slack capacity among our trading partners. With the national economy on a 4-percent growth rate since mid-1993, and with economic recovery abroad, excess capacity disappeared in 1994. Oil prices have benefited from stronger national and global growth, and petrochemical markets have staged a complete and unanticipated recovery.

Stability in Houston's upstream operations has been the product of a steady market for natural gas drilling. Some employment losses continue among Houston's biggest companies, but oil service companies are hiring again. The best news for Houston comes from the Gulf of Mexico, primarily a natural gas-bearing region, now restored to robust health by a combination of good gas prices, oil production from deep waters and new technology that has opened new and unexplored "subsalt" areas. Oil prices have rebounded from the low levels of early this year and should foreshadow increased oil-directed drilling at home and abroad. Natural gas prices weakened this past summer, but normal winter weather should see them strengthen again. A definite short-run risk to this sector is an unusually warm fall or winter, which could cause gas prices to decline further.

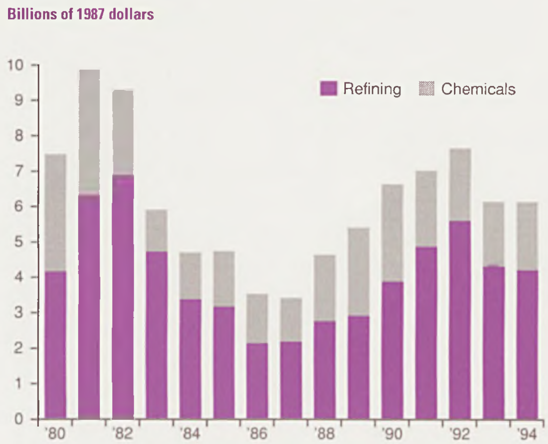
The space station project continues at Clear Lake, and after years of controversy it now has enough congressional support to make its future secure. This year, lower budget ceilings and a partnership with the Russians resulted in a net loss of 750 jobs at the Johnson Space Center and among its contractors, and a similar loss is possible next year. But the numbers are small compared with the 4,400 jobs that would have been cut with the death of the project. The best news is simply that the project's future is on secure ground, and the local business community can make plans with more certainty.

Health care reform is still unresolved, and the Texas Medical Center is a likely source of continued weakness. Health care provided 26,000 new jobs in Houston in the five years following January 1988, but employment peaked in mid-1993 and has slowly declined with intensive cost cutting at many hospitals. With or without a government mandate, pressure from employers to reduce health care costs will continue. The chief tool will be a primary care physician placed between patients and specialists, diverting patients from specialized care if possible. The Texas Medical Center disproportionately provides specialized services, and it will suffer disproportionately under reform. Also, reform will reduce cross-subsidies from patient care to support research and education.

GOOD NEWS FROM PETROCHEMICALS

A strong negative factor six months ago, the petrochemical construction cycle has unexpectedly become a positive force for Houston. As Figure 2 shows, annual spending for refining and chemical projects in the United States has ranged from $3.5 billion to $10 billion since 1980. Texas and Louisiana get a large share of this spending, with 200 to 250 projects consistently under way along the Gulf Coast since 1988.

Figure 2
Domestic Capital Spending
On Refining and Petrochemicals, 1980–94



Refining construction picked up in Houston with the demise of the proposed Btu tax, as several capacity expansions and Clean Air Act projects moved forward. Even a modest push in additional chemical construction could be a powerful plus for Houston.

Six months ago, the petrochemical industry was mired in overcapacity and widespread restructuring, with no relief expected before 1997–98. But spare capacity and inventories evaporated in recent months in a dramatic turnaround, and prices and profits have jumped sharply. This raises the immediate prospect of increased maintenance at these plants and many small projects to remove production bottlenecks in existing facilities. Over the longer term, new facilities are again a possibility. This expansion will be limited because we are *still* completing and bringing online commodity chemical capacity begun during the 1988–92 Gulf Coast construction boom; for example, 4 billion pounds per year of new ethylene capacity will relieve current shortages in early 1995. For resins and other products, however, the strong demand of recent months has accelerated the schedule for future construction.

This shift in chemicals from the debit to the credit side of Houston's economic ledger is important, as healthier downstream industries combine with a strong national economy, stability upstream and an ongoing space station program. Health care reform becomes the only source of lingering weakness. Job growth in Houston should continue to gain ground, perhaps accelerating to 2 percent or more through the second half of this year, with solid growth continuing into 1995.

Results of the Houston Beige Book survey in August point to continued improvement in the local economy. The recent strength of regional chemical markets indicates possible longer-term gains through downstream construction activity.

RETAIL AND AUTO SALES

Houston's retail and auto sales in 1994 have been on a roller coaster from one month to the next. After a good spring, retail sales weakened in early summer but were reported to have improved in late summer. The retail market is extremely competitive in Houston, and continued construction of new malls and large discount stores is raising concerns about overexpansion. Auto and truck sales in August just matched those of August 1993, following a very strong June and a very weak July. Year-to-date auto and truck sales are 1 percent ahead of those in 1993.

UPSTREAM ACTIVITY

Demand for oil field goods and services has been sluggish in recent weeks. Drilling has entered its usual year-end acceleration, but the seasonal pickup is slower than normal. Current domestic drilling activity lags behind 1993 by more than 10 percent. Natural gas continues to drive drilling activity, but higher oil prices in recent months could increase oil-directed drilling through the rest of this year. Foreign drilling has also been slow because of weak oil prices, and better results are anticipated overseas as well.

Since late July, oil prices have fallen from $19 to $17 per barrel, largely due to news of the oil field strike in Nigeria. Global and domestic oil demand remains strong, but reports of increased oil supplies also weighed on prices. Natural gas prices slipped under $2 per thousand cubic feet, depressed by cool weather on the East Coast, high electricity production from nuclear generators, high gas storage levels and strong gas imports from Canada. A few producers have shut-in capacity in anticipation of higher prices this winter, but survey respondents were generally more concerned that a mild heating season could see gas prices slide further.

DOWNSTREAM REFINING AND CHEMICALS

Refineries along the Gulf Coast operated at near 100 percent capacity in recent weeks. Product prices and profit margins were strong through mid-August, but profits have since narrowed as wholesale gasoline prices have fallen steadily. Refineries with pipeline connections to the Midwest benefited from refinery outages and strong demand from that region.

Chemical demand is outstripping available capacity in ethylene and propylene markets. Inventories are low and described as completely earmarked for contract customers under plant allocation programs. Little product is flowing into spot markets, and prices are rising sharply. Price increases for ethylene and propylene are now driving further price increases for downstream resins such as polystyrene, polyethylene, polypropylene and polyvinyl chloride. Prices of these resins are 30–40 percent higher than they were 12 months ago.

REAL ESTATE

Capital continues to flow into local real estate, providing fuel for the construction of luxury apartments and retail space. Apartment construction is near 6,000 units this year, up from 3,000 last year. Apartment occupancy has not moved from around 88 percent in three years, but some rents have recently softened. The office market has made small positive gains in reported rents and occupancy. New-home sales have slowed, and inventories of completed homes on the ground are higher than they have been in several years. Despite higher interest rates, sales of existing homes picked back up in August and exceeded the August 1993 sales level by 3 percent.

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