

# Houston Business

A Perspective on the Houston Economy

## Houston's 1997 Growth Matches Strong National Pattern

Houston had a banner year in 1997, following a good one in 1996. Once all the data are collected and revised, we should find that Houston employment grew at a rate between 4 and 5 percent in 1997. This is an improvement over the 3 percent job growth Houston enjoyed in 1996, and it will mark the city's best percentage growth since 1990.

The local unemployment rate also fell to 4.4 percent in November, the lowest rate of the 1990s. But good news in Houston stemmed from many sources beyond the labor market, with new home sales, existing home sales and housing starts up at double-digit rates over 1996. Harris County autos had their second consecutive year of record sales. And strong demand and growing lead times pushed local manufacturing production sharply higher, as the Houston Purchasing Managers Index averaged 61.6 percent for the year, 6 percentage points higher than strong readings registered by the U.S. Purchasing Managers Index.

Nor was good economic news confined to Houston in 1997, as the United States and Texas both turned in solid economic performances. The last two years have seen a break in the pattern of "rolling recessions" across regions of the United States, and, for the first time since the late 1970s, economic growth was shared by most states and cities. This article takes a brief look at the U.S. and Texas economies last year, their relationship to the Houston economy and prospects for further growth in 1998.

### UNITED STATES REDEFINES BOUNDARIES OF GROWTH

The expansion now underway in the United States began in April 1991, and after 81 months it

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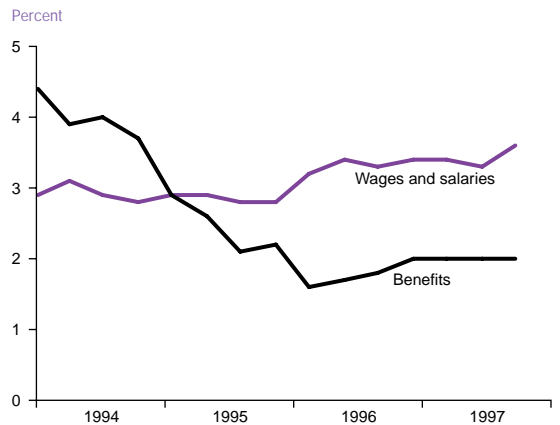
is the third longest period of uninterrupted U.S. growth since World War II. Growth began slowly in 1991 as New England and California struggled with real estate and banking problems, and the early phases of this business cycle were tagged “the jobless recovery.” The growth pace picked up smartly in 1994, however, as GDP grew at 3.5 percent and generated an average of 287,000 new jobs per month nationwide. Since 1994, and continuing through the third quarter of 1997, growth has remained strong; the U.S. economy has averaged 3 percent increases in GDP, pushed the factory system to the limits of capacity utilization and kept the labor market at or near full employment. In contrast to its “jobless” beginnings, this expansion has averaged more than 3 million new wage and salary jobs per year since 1994.

Since the emergence of stronger growth in 1994, this expansion has consistently pressed the limits beyond which inflationary pressures might appear. Growth in 1997 tested these boundaries severely, but they held with remarkable success. GDP growth from third quarter 1996 to third quarter 1997 averaged 3.9 percent. Meanwhile, the unemployment rate fell from 5.4 percent in January 1997—near the conventional definition of full employment—to 4.6 percent by November. Unexpectedly, and in the face of strong growth, the 12-month rate of consumer price inflation fell from 3 percent in January to 1.8 percent by November. Producer prices over the same period fell 0.6 percent, while the GDP deflator rose only 1.9 percent.

Subdued inflation was the product of a series of favorable factors. Despite a tight labor market, wage and salary growth rose only slightly during the year, with the employment cost index for the third quarter of 1997 showing a 3.6 percent gain, compared with a 3.2 percent gain for the third quarter of 1996. Benefit costs rose at only a 2 percent annual rate during this same period, primarily due to smaller increases in medical costs (*Figure 1*). And at the same time, preliminary data show that productivity surged in 1997. After averaging a 0.9 percent growth rate from 1988 to 1996, productivity for the nonfarm business sector rose at a 2.1 percent annual rate in the first three quarters of 1997. This kept the increase in unit labor costs under 1 percent.

A strong dollar also worked to keep prices

*Figure 1*  
Employment Cost Index for Private Industry  
(Percent change from 12 months earlier)



low, as the appreciation of the dollar meant that foreign goods were cheaper in dollar terms. As imports rose, domestic producers held prices down to stay competitive. The best example might be U.S. auto makers, which started the new model year with large rebates to avoid losing market share to Japanese producers because of a weak yen.

The U.S. economy entered 1998 with significant momentum. Consumer confidence remains at the highest levels of the past 28 years, buoyed by strong labor markets and solid income growth. High technology remains a major force in unusually high levels of investment for this advanced stage of the business cycle. Producer durable equipment investment was up 8 percent from third quarter 1996 to third quarter 1997, led by a 27 percent increase in investment in computers and peripheral equipment.

Government spending and the dollar remain a moderate drag on growth, as they have throughout the expansion. The currency crisis in Asia might take 0.5 percent off U.S. GDP growth in the coming 12 months, and unexpected shocks to the economy are always possible. But by this time next year, the current expansion should have passed 92 months of continuous growth, surpassing the 1982–89 Reagan expansion to become the second longest growth period of the past 50 years.

#### TEXAS OUTPERFORMS THE UNITED STATES

The strong national expansion has been an important source of growth for Houston over the past several years. It has helped local com-

panies such as Compaq, American General, Continental Airlines and others that operate in national markets; it has helped keep the price of energy and chemical products strong. Somewhat ironically, the major trends that have shaped growth in other major Texas metropolitan areas in recent years—high technology, defense cuts and the Mexican currency crisis—have had a peripheral, less direct effect on Houston.

Texas has outperformed the nation each year since 1990, and 1997 was no exception. Comparison of the 12-month growth rates for wage and salary employment show Texas outperforming the United States by 1 to 2 percentage points throughout the year (*Figure 2*). By November the U.S. growth rate was 2.5 percent over the prior 12 months, and Texas was up 3.5 percent. The surprise is simply that Texas entered 1997 with labor markets that were tighter than in many other parts of the United States, but still managed better job growth than the nation.

Where did Texas workers come from? Texas has for many years attracted business and labor from other states, based on the Sun Belt advantages of low taxes, low cost of living and pleasant places to live. Also, among Texas metropolitan areas the fastest growth was registered in South Texas and in the state's biggest cities. By late in the year, the state's fastest growing metropolitan areas were McAllen and Laredo, followed by Houston, Dallas, San Antonio and Fort Worth—all adding jobs faster than the state average. South Texas, of course, has significant pockets of unemployment and underemployment, a young and inexperienced

work force and a significant potential for illegal employment—problems that are often shared by Texas' largest metro areas. Further, welfare reform and welfare benefit cuts would have been felt first and most strongly in these same areas. In short, Texas job growth in 1997 seemed to be reaching to the back of the employment line, to the least skilled and to the last chosen in less heated labor markets.

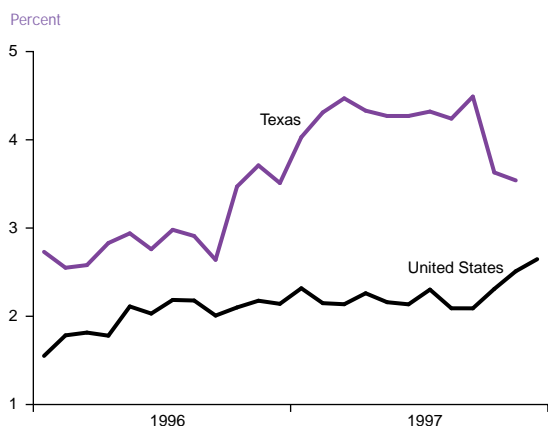
Industrial growth was broadly based in Texas, with 1997 growth rates exceeding the decade average for all private major industry groupings. Strong oil and natural gas prices helped push the state's oil and gas employment to a 6 percent gain, as well as helping push Houston—the state's largest metropolitan area—to the forefront of Texas growth. Construction was a surprising source of strength, with robust residential, industrial and office markets across the state. The transportation sector was helped by high levels of economic activity and by NAFTA. New high-tech manufacturing jobs came to a standstill in Texas in 1997, although the smaller software and computer-related services sectors grew at 12.5 percent.

The economy should slow in Texas this year, with job growth slipping under 3 percent in 1998. The U.S. economy will provide less impetus to the state, with GDP growth forecast to slow from near 4 percent in 1997 to 2 percent to 2.5 percent in 1998. Mexican GDP growth should slow from a strong 7 percent growth rate in 1997 to 4 percent to 5 percent in 1998. A healthy Mexico is important to the state's border regions and to the state as a whole, since Mexico absorbs 40 percent of Texas exports.

Finally, the outlook for energy prices is far less positive in 1998 than it has been for the past two years. Late in 1997, both oil and natural gas prices fell sharply for a variety of reasons—more Iraqi oil, higher OPEC production quotas, warm winter weather and slower growth in Asia. Oil prices near \$17 per barrel and natural gas prices near \$1.70 per thousand cubic feet may not precipitate a downturn in this sector, but they won't provide the economic momentum of the last two years.

—Robert W. Gilmer

*Figure 2*  
Twelve-Month Growth Rate: Texas vs. United States  
(Nonagricultural wage and salary jobs)



NOTE: I would like to thank Mine Yücel of the Federal Reserve Bank of Dallas for her input on the Texas outlook.

**H**ouston entered 1998 with substantial momentum from a strong economic performance in 1997. Lower energy prices have not yet had a significant effect on the order books of local oil service and machinery companies, and probably won't unless we experience an extended period of oil prices under \$17 per barrel. Chemicals provided a positive surprise with stronger prices and margins than anticipated.

#### RETAIL TRADE AND AUTO SALES

Holiday sales proved disappointing compared with expectations built up by a strong economy. Department stores mostly met their plan, running a percentage point or two above last year. Upscale stores did particularly well, as did stores in younger suburbs. Home furnishings did well, while sporting goods sales were generally lackluster.

Houston auto sales in November were down 15 percent from the extremely positive results of a year ago, but still well above the November level of most recent years. On a year-to-date basis, auto sales through November were 6 percent ahead of those of 1996—high enough to set a new annual record for Harris County even before December sales were added to the total.

#### OIL AND NATURAL GAS PRICES

Crude oil prices were hit hard by a triple dose of bad news: the resumption of Iraqi oil sales, the Asian currency crisis and warm weather. Also, OPEC voted in late November to increase its quotas, a fact that only legitimized existing cheating but dealt another negative blow to the market. Prices tumbled from \$21 per barrel in October to \$17 per barrel by early January.

Warm weather slowed sales of both heating oil and natural gas, and inventories of both fuels are 5 percent to 7 percent higher than this time last year. Natural gas prices dropped from \$3.50 per thousand cubic feet to \$2.20 by early January. Gasoline demand has been seasonally strong, but supplies are adequate, and pump prices have fallen to the

lowest levels since early 1996.

Oil services and machinery continue to report very strong demand and shortages of personnel and materials. The rig count held steady near 1,000, with two-thirds of the rigs directed toward natural gas deposits.

#### CHEMICALS AND REFINING

Commodity petrochemical prices remained stronger than expected, given several large additions to capacity in recent weeks. Prices were held up by strong demand and depleted inventories attributed to strong U.S. economic expansion in 1997. Declining natural gas prices further helped profit margins. Downstream plastic prices generally were unchanged, except for small declines for polyethylene.

Refining profits typically rise as crude prices fall, since oil product prices lag and fall more slowly. However, both gasoline and heating oil prices fell along with crude in December, leaving margins unchanged and at the low levels of recent months. December refinery output was high, with capacity close to 100 percent in Texas and Louisiana.

#### REAL ESTATE AND CONSTRUCTION

Real estate respondents continue to report very high interest in Houston by both real estate investment trusts and institutional investors. Industrial activity remains strong, fueled by substantial levels of speculation. The office market continues to improve, and ground has broken on new office buildings in Sugar Land and The Woodlands. Retail activity is flat. Some concern was expressed about the large number of apartments—more than double the number typical of recent years—coming on-line in 1998.

A shortage of construction workers constrains current building activity. Framing crews, carpenters, estimators and project managers were all cited as difficult to find. These skills can't be produced quickly through training programs, and there is no region of the nation whose economy is weak enough to provide a surplus of workers.

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