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Houston Business
A Perspective on the Houston Economy

Asian Flu and Oil Glut Weaken Outlook for Houston

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The financial problems in Asia are yet one more chapter of a very old story: too many dollars chasing too few deals—or, in this case, dollars, marks and yen, drawn to East Asia by the region's stellar economic performance, slow growth in Europe and Japan, and low interest rates in the United States. Banking systems in Asia's newly industrialized countries (NICs) and developing economies were responsible for directing this avalanche of new capital to its best uses, but they proved poorly developed, inadequately regulated and sometimes corrupt. The result was loans to political insiders, friends or politicians, followed by a rash of defaults and bankruptcies. The financial crisis occurred after a loss of confidence in the banking systems of several Asian countries and the collapse of local currencies as foreign capital fled the region.

The financial crisis, which began in Thailand in May 1997, has since spread to Malaysia, Indonesia, the Philippines and South Korea. Countries throughout Asia, Latin America and Eastern Europe have felt its destabilizing effects. Table 1 shows how estimates of real GDP growth have been slashed throughout Asia in the wake of the crisis. The International Monetary Fund (IMF), for example, has revised its estimate for 1998 Thai growth twice in seven months, cutting it from 7 percent to zero.

The Texas Gulf Coast, as well as the United States as a whole, will be affected as the fastest growing region of the world falters. A commodity-driven economy like Houston's may be more adversely affected than other parts of the country, especially when combined with separate, ongoing problems in oil and chemical markets. It is too early to offer a definitive bottom line but not too early to suggest caution, as slower growth probably lies ahead for Houston in 1998.

SLOWER ECONOMIC GROWTH

The consensus is that an Asian slowdown will exert only a modest braking effect on the world's developed economies, reducing GDP growth by 0.5 percent to 1 percent. This assumes that the transmission mechanism for a slowdown is existing trade patterns with the Asian NICs and developing economies and that the crisis remains confined to the five countries already deeply involved. Table 2 shows developed nations' share of trade directly tied to Asian NICs and developing countries (in column 1) and the importance of trade to these economies, as measured by the percentage of trade in GDP (column 2). The product of these two figures (column 3) shows the portion of each nation's GDP linked to Asian countries. For the developed world as a whole, it is about 3 percent of GDP, with the U.S. economy a typical example at 2.9 percent. Not surprisingly, Japan is more closely linked, with 4.9 percent of GDP tied to other Asian countries, and Italy the least linked at 1.5 percent.

To illustrate the limited impact of an Asian slowdown on the developed world, the IMF's *World Economic Outlook* offers a hypothetical scenario that assumes the crisis is contained to the five countries already involved and that they buy 10 percent less from developed countries. Under this scenario, other NICs and developing countries in the region buy 5 percent less. As a result, exports by developed countries fall 1 percent, or 0.2 percent of GDP. Since the currency devaluations have made Asia more competitive, these countries export more to the developed world in 1998 and the amount sold equals half the decline in their purchase of goods from developed countries. Developed nations lose another 0.5 percent of trade, or 0.1 percent of GDP. Finally, add in a second round of effects as deterioration in external positions and domestic demand reduces income and profits. Using a multiplier of 1.5, the bottom line under the IMF scenario is GDP losses of 0.4 percent to 0.5 percent for developed economies.

These projections for a modest developed-country slowdown are based on existing channels of trade that change in levels of activity but not in pattern. Manufactured goods best fit this picture, with the most affected goods being those heavily traded between the United States and Asia, such as electrical and industrial machinery, rubber and plastic products, or aerospace equipment. However, for commodities like oil and petrochemicals, it is more likely that excess production will spill into world markets with less regard for past trade patterns as cargoes float around the world until they find a home.

OIL AND PETROCHEMICALS

This year was already shaping up as a poor one for oil markets because of a warm winter, ongoing humanitarian oil sales by Iraq and an increase in OPEC's quotas. Oil sales by Iraq have become an on-again, off-again proposition, but they could add 350,000–700,000 barrels per day to the world market. OPEC's new quotas simply ratified cheating by its members, but OPEC countries are now operating 740,000 barrels per day over the new ceiling. Slower economic growth in Asia may already have added an unexpected 400,000 barrels a day to the market.

Asia accounts for about 25 percent of the world's oil consumption, with Japan, China, Korea and India the continent's largest consumers. More impressive, however, is Asia's contribution to the growth in the demand for oil. Between 1990 and 1996, annual world demand grew 920,000 barrels a day, with Asia accounting for 848,000 barrels a day, or 92 percent. The five countries already mired in the financial crisis contributed 309,000 barrels a day annually, or 34 percent of world growth.

Estimates of the effects of the crisis are for reduced growth in oil consumption in Asia in 1998, not reduced levels of consumption. The U.S. Department of Energy recently cut its 1998

Table 1
Asian GDP Growth Projections Are a Moving Target

IMF estimates (percent), by date of forecast

Country	May 1997	October 1997	December 1997
Thailand	7	3.3	0
Indonesia	7.5	6.2	2
Malaysia	7.9	6.5	2.5
Philippines	6.4	5	3.8
Hong Kong	5	5	4.1
Japan	2.9	2.1	1.1
Korea	6.3	6	2.5

SOURCE: International Monetary Fund, *World Economic Outlook* (interim assessment), December 1997.

Table 2
Developed-Nation Trade Ties to East Asia
(Percent)

Country	Asian share of trade	Trade share of GDP	Asian share of GDP
United States	21.8	13.2	2.9
Japan	40.9	12	4.9
Germany	8.6	27	2.3
France	7.4	29.7	2.2
Italy	6.7	22.6	1.5
United Kingdom	10.3	30.3	3.1
Canada	5.9	43.0	2.5
G–7	17	19.9	3.4
All developed	14.5	20.7	3

NOTE: The East Asian countries included are China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.

SOURCE: See Table 1.

growth estimate for Asia by 300,000 barrels a day, but most private forecasters are more pessimistic, predicting cuts of 400,000–500,000 barrels a day.

This witch's brew of warm weather, high production and diminished Asian demand has created worldwide dislocations in markets for crude oil and refined products. Despite a strong U.S. economy, U.S. and Caribbean oil inventories are rising sharply.

Established trade channels are also being ignored in chemical markets as the demand for petrochemicals plunges in Korea and East Asia. As spot prices have fallen throughout the region, Asian producers have begun exporting primarily to China, India, Vietnam and other neighbors less seriously affected by the crisis. Imports from the United States, Europe and the Middle East are now less competitive in these glutted Asian markets.

The major damage to European and U.S. markets, however, will come from the diversion of low-cost product from the Middle East and Canada. For some products, as much as 60 percent of Saudi Arabian output and 40 percent of Canadian production now go to Asia. Sales lost in Asia will head for Europe or the United States.

This year was already expected to be a relatively poor one for U.S. chemical profits, primarily because of recent large expansions in domestic capacity. The U.S. economy should provide strong demand for petrochemicals, and falling energy prices could preserve margins for several months. By midyear, however, chemical margins will narrow as Asia makes 1998 bleaker than expected.

INTERNATIONAL CONSTRUCTION

Asia's financial crisis has inflicted short- and medium-term damage to oil and petrochemical construction markets in Asia. Every energy-related project planned for the region is being reconsidered, but the bulk of cancellations and delays thus far have been in Thailand and South Korea.

Energy companies from outside the region see this crisis as an opportunity to aggressively expand or to acquire cash-strapped Asian competitors. However, the red-hot Asian construction market is unquestionably cooling off. In 1997 the top 10 engineering and construction companies in Houston provided 26,300 jobs, 3,200 of them for licensed engineers. Some of the companies are headquartered here (Brown & Root, M. W. Kellogg), while others have a Houston presence to take advantage of the deep market in energy engineers (Bechtel, Fluor Daniel). The top 10 companies together average half of their work tied to international contracts.

Asia has grown in importance to the global construction market in the 1990s. In 1989 Asian contracts made up 21.8 percent of the worldwide awards to foreign operators; by the mid-1990s Asian contracts accounted for one-third of international awards and revenue. For U.S. companies, Asia is slightly less important, making up 24.4 percent of international revenue in 1996, down from 28.6 percent in 1995. In 1996 Japan dominated the list of countries doing work in the rest of Asia, with $16.9 billion in revenue. The United States was second, with 34 companies earning $5.5 billion, followed by South Korea ($4.1 billion) and Germany ($3.5 billion).

Even before the crisis, U.S. companies were being hurt by both a strong dollar and the emergence in recent years of strong competition from Korea and China. By 1996 Korea and China combined were absorbing 16 percent of the Asian market. And the strong dollar will continue to force operational changes by American companies. In 1994–95, the Japanese response to a strong yen was to move every possible piece of the project to the region where it was to be built; the Japanese engineer, in particular, was seen as too expensive to be competitive. U.S. companies now face similar pressures.

Very strong economic expansion continues through the early part of 1998, with few signs that lower oil prices have yet slowed the local economy. Oil prices began to slide in November, when they were at $21 per barrel, and have since fallen to under $15. Although local oil companies are registering concern and caution, only scattered signs of slower energy activity have emerged.

RETAIL AND AUTO SALES

Local retailers report they easily cleared out their winter merchandise and, given the current strength in the retail market, are concerned they may have been too conservative in ordering for the spring season. Sales continue to exceed annual plans, prompting retailers to expect a great first quarter. The winter also saw a surge in auto sales. For December and January combined, Harris County auto sales were up 26 percent over the same period a year ago. Early reports, however, show February auto sales cooling somewhat from this strong pace.

OIL AND NATURAL GAS PRICES

Possible military action in Iraq was the only thing that distracted oil markets from steadily pushing down crude prices. The warm winter and the Asian crisis have limited demand, while OPEC continues to overproduce. Natural gas prices have done better, holding at over $2 per thousand cubic feet. Respondents were unclear as to why gas prices have held up so well but cited flat natural gas production levels over the past 18 months as a possible explanation. New technology allows gas wells to be drained within two or three years, and timing the delivery from the next generation of wells is critical. Poor planning—or perhaps the crunch in the oil service industry—has left several companies struggling to replace production.

Oil service and machinery companies continue to report healthy demand, big backlogs and critical labor shortages. Some producers, in contrast, felt it was easier to schedule work with these companies and noted some price concessions unavailable just a few weeks ago. The rig count continues at well over 900 working units.

PETROCHEMICALS AND REFINING

Prices slipped for ethylene and propylene, mostly on the basis of overcapacity for these basic petrochemicals. Declining prices for oil and natural gas feedstocks provided some cushion for profit margins, however. Sharp declines in Asian market demand and prices for several plastic resins—including polyvinyl chloride, butadiene and acrylonitrile—have put downward pressure on domestic prices. Rail shipping problems on the Ship Channel continue to rival those of last summer.

Refiners' profit margins remain lackluster. Refining margins often improve as crude prices decline, since oil product prices may fall more slowly than crude prices. However, a warm winter meant that falling heating oil prices were largely responsible for pulling down crude prices. Margins have been relatively poor all winter.

LOCAL REAL ESTATE AND CONSTRUCTION

Local construction activity remains robust, with one respondent describing it as "exploding" after the first of the year. Announced bid activity in the public sector and on the Ship Channel is expected to bolster construction through the first half of 1998.

New and existing home sales started the year with a bang, with both segments recording the best January sales of the decade. Heightened interest in housing is driven by the strong local economy and by interest rates that have dipped as low as 6.8 percent for a 30-year fixed mortgage.

Big plans continue to be drawn up for expanding Houston's office space, with 20 to 30 buildings in various phases of architectural design, financing or construction. One consequence of lower oil prices, however, has been caution from local energy companies in committing to new space. Several of these companies have scaled back or canceled such plans.

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