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FEDERAL RESERVE BANK OF DALLAS HOUSTON BRANCH

Houston Business

A Perspective on the Houston Economy

Higher oil prices could put Houston back on the fast track in 2000. For this growth to materialize, however, higher oil prices will have to combine with continued strength in the national economy and a dollar exchange rate that remains stable or declines.

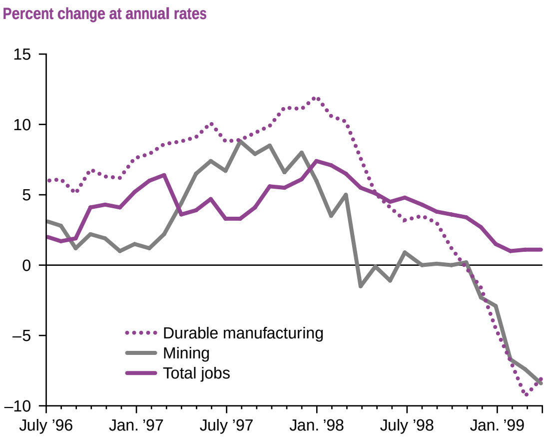
Higher Oil Prices and Houston's Economic Outlook

In recent months, the price of West Texas Intermediate (WTI) has moved sharply higher on world oil markets. On March 1, the spot price of WTI was $12.23 per barrel—low even by the previous year's standard of weak oil markets—but crude oil prices then began to rise steadily on news of an agreement among OPEC and non-OPEC producers to remove from world markets 2 million barrels of oil per day. By April 16, WTI had moved above $17 per barrel. It briefly traded as high as $19 in early May, but in recent weeks has fallen back to the $17 range. The price of natural gas followed crude upward, rising from $1.64 per thousand cubic feet on March 1 to near $2.20 over the past six weeks.

It is unclear whether OPEC's latest agreement will hold together, and it is probably the only factor keeping oil prices as high as they are now. Without the agreement, prices can easily come down as fast as they have gone up. But for now, higher oil and natural gas prices offer a ray of hope to Houston oil producers and oil service companies, who have suffered through a serious slump for the past year.

This article examines the implications of this upturn in world oil markets for job growth in Houston. The oil slump has already pulled the annual job growth rate in Houston down to 1.1 percent over the six months ending in April. Sharp declines in oil and gas mining and durable goods production have played a major role in the slowdown (*Figure 1*). Our conclusion will be that the turnaround comes too late to restore a healthy rate of job growth in Houston in 1999, and there

Figure 1
Houston Job Growth Over Prior Six Months



will be little or no net job creation this year. Higher oil prices, however, could put Houston back on the fast track in 2000, with job growth running 3 percent to 5 percent next year. For this growth to materialize, however, higher oil prices will have to combine with continued strength in the national economy and a dollar exchange rate that remains stable or declines.

DRILLING AND OIL SERVICES

If prices for oil and natural gas have improved, oil-field activity remains extremely depressed. For four weeks in April and early May, the domestic rig count fell below 500 working rigs, the lowest levels ever recorded in the 55-year history of the Baker Hughes rig count, leaving fewer than half the number of rigs that were working just 12 months earlier. Similar depressed conditions are found around the world, with every region except the Middle East recording all-time low levels of drilling activity. The result has been tremendous pressure on producers and oil-service companies to downsize their operations to match a rapidly shrinking market. Oil-related employment in the United States has shrunk by 56,400 jobs since peaking in October 1997, a reduction of 19.8 percent. In contrast, Houston's oil and gas mining sector peaked nearly a year later, and, through April, job losses total only 4,200, or –5.9 percent.

By late May, two months after OPEC's formal announcement of a cut in oil production, drilling and oil service markets seemed to have bottomed out and to be poised for a turnaround. The rig count has slowly moved back above 500, but there has been no rush to the oil fields. Producers have taken a wait-and-see attitude with respect to the OPEC cuts, paying down debt and repairing their balance sheets before going back to their boards of directors with new drilling programs.

THE HOUSTON ECONOMY

The Houston business cycle has been the subject of several feature articles in this newsletter over the past year (March 1998, June 1998 and January 1999), as weak oil markets and the global financial crisis have slowly eroded local job growth. The three key variables considered in these articles have been the U.S. economy, oil markets and the dollar exchange rate. After three years of strong job growth, averaging 3.6 percent per year from 1996 through 1998, weak oil markets and a strong dollar have pulled job growth down to a 1.1-percent annual growth rate since last October.

The two positives for Houston through much of 1998 and early 1999 have been a strong U.S. economy and the local economy's own past momentum. A 4.8-percent growth in jobs in 1997 carried over into 1998 with continued expansion in construction, retail and a variety of personal services. The best example is a red-hot market for single-family housing—both existing homes and new starts—driven by a combination of past strong job growth and low and declining mortgage rates. The housing market has been an important element keeping growth in construction jobs at rates above 4 percent in recent months. Construction and retail trade employment are the only two major sectors in Houston with growth rates above 2.5 percent for the six months ending in April.

The surprising strength of the U.S. economy has helped Houston. GDP growth was close to 4 percent for all of 1998, with a stunning 6-percent annual growth rate announced for the fourth quarter. The first quarter of 1999 started this year off strongly as well, with GDP registering a 4.1-percent annualized growth. The consumer was the big driver in the first quarter, as GDP would have grown at a 4.6-percent annual rate if nothing had changed except personal consumption. Similarly, investment alone —if nothing else had changed—would have added nearly 2 percent to GDP, led by additions of computer and technology-related equipment. However, net exports resurfaced as a

Table 1
Houston Employment Growth Under Two Scenarios for 1999 and 2000

Sector/Scenario	1997	1998	1999	2000
Total employment				
1	5.1	4.4	.1	4.9
2	5.1	4.4	–1.0	3.6
Goods employment				
1	5.5	3.1	–1.8	8.5
2	5.5	3.1	–4.2	4.8
Services employment				
1	5.0	4.8	1.4	4.8
2	5.0	4.8	.7	3.2

NOTE: Private employment only, government excluded. Growth rates computed fourth quarter to fourth quarter.

huge drag on growth in the first quarter, as trade losses subtracted 3.1 percentage points from first quarter GDP. Labor markets remain extremely tight, and apart from oil-related price increases there are still few signs of inflation in the U.S. economy. The GDP deflator, the best and broadest gauge of inflation, was running at only a 1.1-percent annual rate in the first three months of the year.

As discussed above, the biggest recent negative for the Houston economy has been oil markets, but exacerbating the oil problem has been the strength of the dollar. The dollar rose sharply with the onset of global financial problems in mid-1997, and the Dallas Fed's calculation of the trade-weighted value of the dollar still has it trading 8 percent to 10 percent above these 1997 levels. This strength poses problems for Houston, a city with annual merchandise exports of $18 billion per year. The problem is particularly visible at the Port of Houston, where operating revenues were down 19 percent this April compared with last April and are down 6.7 percent year-to-date. A recent article in the *Houston Chronicle* quoted a local longshoreman as saying, "You can fire a cannon through the city docks and not hit anything."

TWO SCENARIOS

What does the possible turnaround in oil markets mean for Houston? Let's consider two scenarios. First, let's assume in both scenarios that the U.S. economy continues to grow strongly and that U.S. labor markets remain tight with an unemployment rate near 4.5 percent. The current U.S. expansion is already the second longest since 1854 and has far too much momentum to bet against continued growth through 2000.

In both scenarios, we assume a turnaround in drilling activity in the second half of 1999. In the stronger Scenario 1, we assume the domestic Baker Hughes rig count rises to 850 by the end of 1999 and stays there through 2000. In the weaker Scenario 2, the rig count rises to only 725 by the end of 1999 and also stays there through 2000. In Scenario 1 we also assume the international financial crisis continues to cool down and the dollar exchange rate slowly falls back to mid-1997 levels by the end of 1999. In Scenario 2, however, we assume the dollar remains at its current level through 2000.

Tables 1 and 2 display the results. Scenario 1 shows total employment growth of only 0.1 percent in 1999, and Scenario 2 shows a possible decline of 1 percent. The difference in the results is not statistically significant, and the main message of these figures is simple: even a strong turnaround in drilling comes too late to help Houston job growth in 1999. Next year, however, is a different story, with job growth turning healthy at rates of 4.9 percent or 3.6 percent in 2000. And why not? Both scenarios are based on optimistic assumptions—strength in the U.S. economy, growing drilling markets and a stable or declining dollar exchange rate. If the turn in oil markets does not materialize or does not hold well into 2000, job growth could quickly become sluggish.

Table 2
Houston Employment Growth Under Two Scenarios in Selected Industries

Sector/Scenario	1997	1998	1999	2000
Construction				
1	3.9	7.1	1.9	1.7
2	3.9	7.1	.6	–1.1
Oil and gas mining				
1	7.0	0	–8.1	10.7
2	7.0	0	–10.1	5.1
Manufacturing				
1	6.0	1.7	–2.1	12.1
2	6.0	1.7	–5.3	8.4
Retailing				
1	2.8	3.1	1.7	3.9
2	2.8	3.1	1.4	2.8
Personal and business services				
1	7.3	5.3	2.1	5.8
2	7.3	5.3	1.3	4.5

The important durable manufacturing and mining sectors in Houston show signs of bottoming out, but no rebound is apparent yet. Overall job growth in Houston has slowed to 1 percent over the past six months, and a turnaround in oil and natural gas drilling is needed to keep more air from coming out of the balloon.

RETAIL AND AUTO SALES

Retailers report sales running at levels comparable to last year's, but in some cases sales are not meeting their expectations for this year. Sales and promotions have prevented an inventory buildup, but margins have been hurt.

In contrast, car and truck sales are going through the roof. April sales ran 25 percent ahead of the record set a year ago, and sales for the first four months of this year are up 15 percent. Dealers credit a strong economy, widespread incentive programs, low interest rates and new truck and sport utility vehicle models.

OIL SERVICES AND MACHINERY

Oil prices began to rise in early March, peaked near $19 per barrel in April and have since settled near $17 per barrel. Despite higher oil prices, business conditions have not improved at all for the oil services and machinery industries. One respondent said his company met with customers early this year to assess their 1999 drilling plans, but so far drillers are not even spending at rates projected for before the oil price increase. He felt there is potential for a big upward bounce in drilling activity once it gets started. Another respondent thought July board of directors meetings might be the key to renewed drilling activity. All respondents emphasized the critical need for OPEC production cuts to hold or prices will fall quickly.

PETROCHEMICALS

A series of planned and unplanned outages hit the ethylene chain of petrochemical products in April and May, leading to opportunistic price increases for a number of products. For example, low inventory levels and higher ethylene prices have already triggered two rounds of price increases for polyethylene, with another proposed for June. It may take the summer or longer to rebuild ethylene inventories and bring prices down; prices might be propped up even longer if companies try to build year-end inventories in anticipation of the Y2K rollover.

The rest of the petrochemical chain has seen little in the way of price increases despite sharp rises in the price of oil and natural gas feedstocks. Overcapacity is the dominant factor in pricing.

REFINING

Refiners' profit margins fell back in recent weeks as inventories filled and production moved into high gear. Gulf Coast refineries operated at 105 percent to 110 percent of capacity in May. The wholesale price of gasoline peaked in early May and has fallen by 5 to 7 cents in various parts of the United States. A solid improvement in profit margins in March and April was reversed in May, with talk that poor profitability could shut down some refineries.

REAL ESTATE

Homebuilders find themselves with enough of a backlog to keep busy for the rest of the year, but they face shortages of wallboard, concrete and labor as they try to get product on the ground. The lack of new home inventory and the long wait to get into new construction continue to keep the existing home market sizzling.

The one weak spot in Houston real estate is best illustrated by the man in the chicken suit spotted in front of a West Houston apartment complex waving free rent and no deposit signs at motorists. Such signs are springing up all over town as the glut of class A apartments continues to grow. The class B market is also expected to be hurt as the class A price incentives spill over into that market.

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