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FEDERAL RESERVE BANK OF DALLAS HOUSTON BRANCH

Houston Business

A Perspective on the Houston Economy

National Slowdown Hits Texas

Growth continues across the state, but it is slow. The widespread slowdown has created a state economy increasingly vulnerable to a negative external shock, whether from energy, Mexico or bad news from the national economy.

The Texas economy has benefited tremendously from several long-term trends over the past decade: employment gains as manufacturing moved from the Rust Belt to the Sun Belt, a shift in technology-related employment away from Silicon Valley and increased trade with Mexico. And certainly, Texas has benefited from more traditional sources of growth as well, such as oil and natural gas. But in the past 12 months, state economic growth has shifted into a lower gear, moving from 2.8 percent employment growth last year to a 0.9 percent annualized rate in the second quarter of 2001.

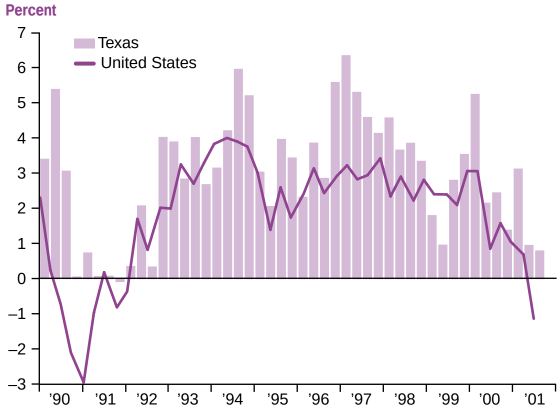
In recent years, the big news on the Texas economy—whether good or bad—has come from energy, technology and our relationship with Mexico. This article briefly looks at statewide conditions and then focuses on these three areas.

MACRO CONDITIONS

To find indications of slower growth, it's unnecessary to look further than total state employment. Growth rates have retreated dramatically since the second quarter. Job growth is slow in virtually every industrial sector and every major metro area. Continued layoffs are pushing the unemployment rate up, and help-wanted advertising is down sharply statewide. Employment growth rates have not turned negative, as in the U.S. economy. However, statewide growth has slowed to less than an annualized 1 percent (*Figure 1*).

In the second quarter, every major metro area stepped down to a slower rate of growth: Austin (–1.3 percent), Dallas (2.2), El Paso (–0.2), Fort Worth (0.4), Houston (2.5) and San Antonio (2.7). Throughout the 1990s, at least one economic sector or geographic region was strong enough to

Figure 1
Texas Job Growth Slows in the Second Quarter
(Private Nonfarm Payrolls)



NOTE: Data are seasonally adjusted annual rates, quarter over quarter.
SOURCE: Texas Workforce Commission.

keep the statewide average up, but this is not the case today.

Just as in the national economy, weakness in Texas begins in the manufacturing sector. In March the Texas industrial production index turned negative, and a month later manufacturing job growth began to decline. By the end of June, manufacturing weakness began to spread to the other major sectors of the economy, most notably, business and personal services. Even retail employment, an indicator of the consumer's ability to keep the economy afloat in a business and investment slowdown, is now showing signs of weakness.

Weakness is seen in other labor market indicators as well. The state unemployment rate has risen for six consecutive months, and it moved above the U.S. rate in June and July. Mass layoffs continue to rise, reaching a rate of more than 9,000 per month, and initial unemployment claims are at their highest since 1992. Additionally, if the help-wanted index is any indication, employers will not be looking for new hires in the near term. The state help-wanted index fell nearly 14 percent over the second quarter and 31 percent for the year, more than matching the decline in the national index of just over 14 percent and 22 percent, respectively. In Texas, Dallas and Austin saw the steepest declines in help-wanted advertising in the second quarter, with both over 20 percent.

THE BORDER ECONOMY

Trade with Mexico has become a major contributor to Texas economic growth. Trade liberalization in Mexico began in the mid-1980s and culminated with the implementation of the North American Free Trade Agreement in 1994. The Mexican manufacturing belt has steadily shifted to the north from Mexico City, as transportation links to the large U.S. market have become more important for Mexican factories. The chief industrial cities in Mexico are now Juarez, Tijuana, Monterrey and others along the U.S.–Mexico border. The lever for this shift has been direct foreign investment in Mexican maquiladoras, with manufacturing jobs created rapidly in plants throughout the country but especially in northern Mexico.

Over the past year, however, slowing U.S. and Mexican economies have meant a downsizing of manufacturing employment across Mexico, especially in the four states that border Texas, where maquiladora employment has fallen by 9.5 percent since September 2000. Annualized growth rates for maquila employment fell from over 20 percent in summer 2000 to –15 percent this past summer.

Texas border cities are very dependent on the health of the U.S. and Mexican industrial sector, supplying parts to the maquiladoras or moving goods across the border. So it's not surprisingly that growth has also slowed on the Texas side of the border. Like the rest of the state, the border saw employment growth abruptly slow in the second quarter. Unemployment rates have ticked up in all major border cities, with Brownsville seeing the largest increase. The help-wanted index for the border region has also declined, albeit by less than for the rest of the state. Retail sales growth remains positive but has been cut in half since last year, as Mexican shoppers become more cautious. While the border cities have slowed less than the rest of Texas, they have not been immune to the industrial slowdown taking place in both the United States and Mexico.

ENERGY

The energy sector has been a bright star in the state economy this entire year, but it, too, is rapidly losing momentum. The U.S. rig count topped 1,275 for five weeks in late June and July but has stagnated near 1,250 since then. There is a growing consensus that domestic drilling may have peaked for now, and additional stimulus will have to come from oil-directed drilling tied to international projects.

Natural-gas-directed drilling is the primary source of U.S. drilling activity, accounting for 80 percent of it for the past several years. The price of natural gas, however, steadily weakened through the summer. Spot prices slipped under $4 per thousand cubic feet in late May, then settled near $3 in early July before moving to $2.50 in late August.

The extraordinary pace of storage injections over the summer has driven the decline in the price of natural gas. Gas is normally produced, moved near consuming regions and put into storage over the summer to prepare for peak heating periods in the winter. In each of the months May through July of this year, more than 400 billion cubic feet of gas was moved into storage, a pace 68 percent faster than last year. Whether high inventories are caused by a slowdown in demand from the national economy or result from 1,000 rigs searching for gas, a 35 percent fall in the price of natural gas has caused producers to reassess both their cash flows and their drilling programs for the second half of this year.

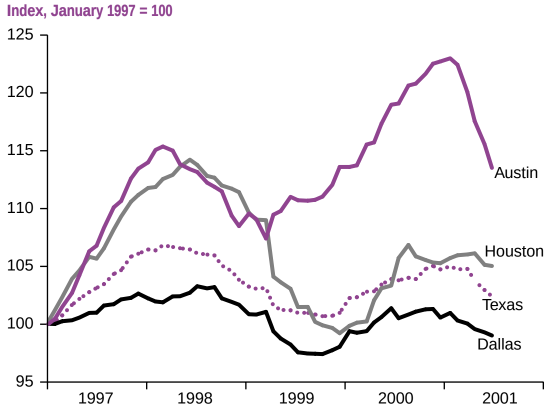
The view downstream is also very weak. Lower natural gas prices have helped petrochemical producers with lower feedstock costs, but weak demand and excess capacity have kept product prices low and profits weak. Refining margins have narrowed significantly in recent weeks as the price of gasoline retreated from springtime highs.

TECHNOLOGY

Technology is the weakest sector of the state economy. The two hardest hit areas are North Dallas/Richardson and Austin, where overall job growth and manufacturing employment are down, with a spillover to the office and industrial space markets.

While some technology industries see a bottoming of negative sales growth and inventory buildups, others continue to lower price and profit projections and announce job layoffs. The semiconductor book-to-bill ratio, which measures the ratio of new orders to shipments, hit an all-time low of 0.44 in April, indicating that demand for new product was not materializing. New orders remain 25 percent below last year's levels in this industry. Although the numbers remain quite low, the book-to-bill ratio has been moving in the right direction since April, and the industry buzz from this part of the technology sector is more positive than from any of the others.

Figure 2
Metro Tech Employment



NOTE: Data are seasonally adjusted.
SOURCE: Texas Workforce Commission.

Employment growth in technology has been central to economic strength in Texas over the past several years, but it is now one of the core reasons for weakness, especially in the state's manufacturing base (*Figure 2*). It is unlikely technology will again provide a stimulus to the state's economy in the near term.

CONCLUSION

The national slowdown, particularly in technology, has not spared the state. As the industrial malaise spread to Mexico, it has slowed a border region that until recently had been an important source of strength for Texas. Energy, while not weak, has lost momentum, and its ability to eliminate slack elsewhere in Texas is diminished. And construction and real estate, which have benefited from a strong Texas economy in the past, probably won't maintain their current strength without a solid economic expansion to support them. Construction permits and contract values have leveled off, and vacancy rates, especially in the North Dallas and Austin office markets, have risen.

Growth continues across the state, but it is slow. The widespread slowdown has created a state economy increasingly vulnerable to a negative external shock, whether from energy, Mexico or bad news from the national economy. In the same sense, without good news from one of these same sources, job growth in Texas will remain weak or nonexistent for the rest of this year.

—Robert W. Gilmer
Timothy K. Hopper

The vital signs for the Houston economy continue to look very respectable, with job growth running 2.7 percent in the second quarter, the unemployment rate at 4.5 percent and the Houston Purchasing Managers Index still pointing to continued expansion. Construction and oil and gas led job growth in the second quarter, although the retail and services sectors registered solid gains as well.

RETAIL AND AUTO SALES

Clothing, home furnishings and department stores continue to report good sales locally, even as the effects of Tropical Storm Allison have waned. Sales are strong enough to match plan, leaving no inventory problems, and respondents with stores in other parts of the state say sales are generally better in Houston than elsewhere.

Flood damage in Houston gave auto sales a big boost, with July sales running 12 percent ahead of last July's. Sales continued to do well in August, helped by substantial rebates and other incentives.

OIL AND NATURAL GAS PRICES

Oil prices have remained in a narrow band of $26 to $28 per barrel for light sweet crude, with support for prices coming from OPEC's decision to remove 1 million barrels per day from the market beginning September 1. Working against higher prices is the return of Iraqi oil to world markets and the slowest global growth since the aftermath of the Asian financial crisis.

Natural gas inventories have continued to build rapidly, pushing down the price from $3 per thousand cubic feet in late July to $2.30 by Labor Day. Cool weather and weak industrial demand are behind the large gains of gas in storage. Prices have not been this low since December 1999, and they are likely to remain under pressure until the heating season begins in a couple months.

OIL SERVICES AND MACHINERY

The domestic rig count, which spent five weeks in late June and July at levels above 1,275 working rigs, has retreated to about 1,250 rigs. Most of the decline has come in gas-directed drilling, and half of that offshore. Rigs are coming back on the market, and day rates for rigs have softened. According to respondents, the decline has not been severe enough to negatively affect day rates for supply boats or most oil service prices.

REFINING

Gasoline prices turned around and began to rise again in late August, mostly due to a series of problems in the refinery system. In the Houston area, prices are up about 12 cents since August 1. Refiners' profit margins per barrel have improved from the very low levels of a few weeks ago but are still about half of the good margins generated last spring.

PETROCHEMICALS

Falling natural gas prices are good news for chemical producers. Lower gas prices pull feedstock prices down and restore the traditional advantage of cheap gas over oil that Gulf Coast chemical producers have long enjoyed relative to the rest of the world. However, weak demand and industry overcapacity have prevented any improvement in chemical profits; declining feedstock prices have simply been passed through in falling product prices. Ethylene contract prices took the biggest one-month hit ever in July. Polyethylene, polyvinylchloride and polystyrene have been among the plastics with falling prices.

FINANCIAL INSTITUTIONS

Respondents continue to report a slowdown in loan demand due to slower economic conditions. Deposit growth has slowed as well, partly because of declining interest rates. Most banks report that money is available to lend, however, and their margins are falling because there are fewer good deals to be banked.

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