



HoustonBusiness

A Perspective on the Houston Economy

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Houston's Near-Term Outlook: Slow Growth, Downward Risk

If Houston avoids the worst and the U.S. economy and drilling activity suffer no significant reverses, the local economy could see 2 percent job growth next year.

If a significant reversal of some kind postpones expansion, the current lack of job growth in Houston could linger for much of the year.

Economic forecasting may be deskbound statistical work, but at times it presents its own risks. Admittedly, the risk is not physical; rather, it is to personal and professional reputations, and it occurs partly because forecasters are often deficient in explaining the uncertainty that accompanies their facts and figures.

Last year offers an excellent example of a moment when economic forecasters repeatedly found themselves a step behind the headlines: The expected soft landing turned into a hard one, then into a recession and finally into a recession made worse by the events of September 11.

Perhaps we have arrived at another moment when current events can overcome the strongest statistical trends, as war, weather and growing questions about the strength of the U.S. economy all figure

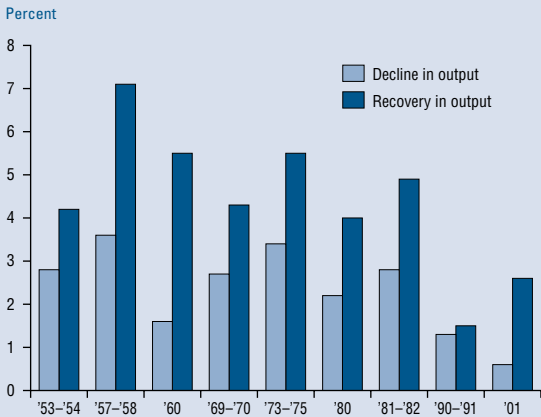
into Houston's prospects for renewed job growth. This article summarizes Houston's current economic conditions and near-term outlook for job growth, with an emphasis on the many uncertainties that accompany the outlook.

The U.S. and Global Economies

If you want to foresee growth in the Houston metro area, you only need to know the outlook for the U.S. economy, the global economy and energy. In 2001, we began the year with forecasts of bright prospects ahead on all fronts and found ourselves disappointed by all three. The U.S. economy moved into recession by March, the rig count was falling by July and world economic growth fell short of its 2001 forecast by half. Houston's prospects of 3 percent or better job growth in 2001 slowly evaporated month after month, and the year ended with only a 0.2 percent increase in employment, measured from December to December.

Now we find ourselves on the other side of the cycle. The U.S. economy resumed growth

Figure 1
Recovery Often Proportional to Decline,
with Current Recovery Similar to Past Declines



in fourth quarter 2001, led by strong consumer spending despite dire predictions of a recession extended by September 11. Output, as measured by gross domestic product, grew at 2.7 percent in the fourth quarter, followed by 5 percent and 1.3 percent growth the first and second quarters of this year. **Figure 1** shows that output growth after three quarters of recovery is normal for a mild recession. Like a rubber ball, the bounce-back is often proportional to the height from which the ball is dropped, and the figure shows both the decline and the rebound of past recessions. If the last two recessions have not bounced back like the others, it is because the ball did not drop as far.

Figure 2 shows that the same rule of proportional rebound usually holds for employment as well. But the last two recessions have been different. The 1990–91 recession had a jobless recovery, with growth so weak that it did not spur employers to add new workers. The current recovery from an even milder recession seems to be following the same jobless pattern.

Although the recovery appears to have fallen into place late last year, a definite

period of high oil prices no doubt caused part of the brake on growth. However, the best guess is more sluggish growth ahead; leading indicators have remained flat in recent months, financial markets are sending mixed messages about the business cycle and forecasting models tell us the probability of recession ahead remains small. War, further oil shock or a sour response by consumers to continued stock market declines could throw all these models and indicators out the window.

Growth in the global economy similarly picked up in late 2001 and continued through the first quarter of 2002. Then, in tandem with the slowing growth in the United States and Europe, global financial markets began to deteriorate, particularly in South America and Turkey. Like the forecasts for U.S. growth, the global outlook has ratcheted down a notch, with growing recognition that

period of renewed weakness has emerged since July. Total hours worked fell, and measures of industrial production turned particularly weak, raising concerns about a double-dip recession. The uncertainty of a prospective war in Iraq and a prolonged

the risks have moved mostly to the downside. The International Monetary Fund, for example, estimates world growth at 2.8 percent in 2002, up from 2.2 percent in 2001, and forecasts acceleration to 3.7 percent in 2003.

For a port city and export center like Houston, perhaps the best news from international events has been the dollar's decline against a basket of world currencies. Since early this year, the dollar has lost about 3 percent of its value, making U.S. exports cheaper abroad and foreign competitors' products more expensive at home. This is particularly important to key Houston industries such as chemicals and industrial machinery. The decline so far is only about one-third of the dollar's run-up since early 2000, but it is very welcome news for Houston.

Oil and Natural Gas Drilling

After bottoming out at record low levels after the Asian financial crisis in April 1999, the number of U.S. working rigs climbed rapidly to nearly 1,300, the highest level since 1986. Last July, however, the rig count began to fall again and

Figure 2
Bounce-Back in Jobs Proportional to Recovery
Except in Last Two Recessions



reached 738 before turning and climbing again in April. After quickly adding 100 rigs, the count has moved sideways near 850 for six months.

In recent years, 80 to 85 percent of the drilling in the United States has been directed to natural gas, not oil, and swings in the inventory and price of natural gas mostly explain the rig count gyrations. During the 2001 recession, inventories built rapidly because natural gas was not being used under boilers or in industrial processes; then, as the economy entered recovery late last year, a warm winter kept inventories full.

Now we find ourselves headed toward the 2002–03 heating season with record high inventories. Gas prices have been relatively high in recent months, but the downward price risk posed by these bloated inventories has kept drilling subdued. For many producers, the memories are still fresh of the damage their balance sheets sustained in the 1998–99 downturn.

The current high inventories are sufficient to carry the United States through a normal winter without a shock to gas prices. But a normal winter (at least) is probably required to support the price of natural gas and keep it high. In other words, the near-term prospects for a significant piece of Houston's economy depend on the weather, especially on how cold it is in the Middle West and Northeast. A decline in drilling poses a major risk to a near-term renewal of job growth in Houston.

Houston's Prospects

The best bet is that conditions are slowly falling into place to assure Houston some

measure of renewed employment growth next year, as the U.S. and global economies improve. However, the uncertainties are almost palpable—war, weather, the stock market, consumer sentiment—and almost all point to a significant risk of falling short.

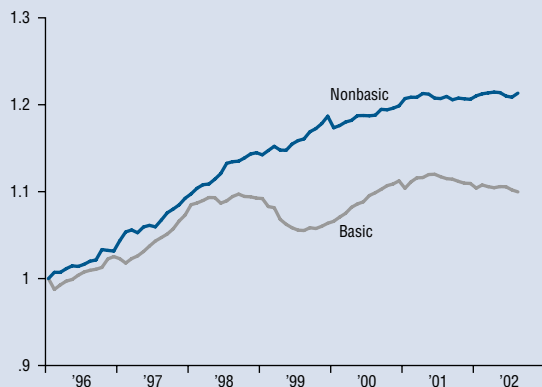
Houston entered 2001 with close to 3 percent employment growth, but growth slowed by midyear as the national recession and the drilling downturn caught up with it. Job growth was slightly negative in the second half of 2001 as September 11, layoffs at Continental Airlines, the Compaq merger and the Enron meltdown all took their toll. Throughout 2002, job growth has been near zero.

Figure 3 presents another way to look at Houston's employment. This approach is particularly useful for considering the prospects of a relatively small economy caught in the greater forces of national and global expansion. Employment is divided into two parts: basic and nonbasic. Basic jobs are those associated with export activity, which simply entails shipments out of the metropolitan area to other regions of the United States as well as to foreign countries. Oil and gas machinery and chemicals are important examples of these local exports. Exports are important because they pay for imports (autos from Detroit, financial services from New York), as well as nonbasic, inherently local activity such as food stores and dry cleaners.

Figure 3

Basic and Nonbasic Employment in Houston, 1996 to Present

Index, January 1996 = 1



SOURCES: Texas Workforce Commission; author's calculations.

During the latest recession the important basic jobs—the ones that drive growth—have weakened in Houston, but not nearly as much as during the 1998–99 downturn. Many Houstonians outside the oil and gas sector or petrochemicals did not even notice the 1998–99 downturn because nonbasic activity, such as retail trade and construction, continued to expand so rapidly, largely because of pent-up demand generated by the previous five years of strong economic growth. Now, however, nonbasic activity, having caught up with the needs of the city, has flattened out; moreover, slow growth and the decline in export activity are not providing any push to these secondary sectors through job and income growth.

If Houston avoids the worst and the U.S. economy and drilling activity suffer no significant reverses, the local economy could see 2 percent job growth next year. If a significant reversal of some kind postpones expansion, the current lack of job growth could linger for much of the year. Many of the current uncertainties should have worked themselves out by early 2003.

Recent data have not been kind to Houston's prospects for recovery from the current slowdown. Employment remains in neutral, stuck at roughly 2.12 million total jobs since June 2001. After four months of data showing weak expansion, the Houston Purchasing Managers Index slipped back in September, indicating slight contraction. Domestic drilling activity, which should be rising seasonally, has been near 850 working rigs since April. All indicators point to an economy making little progress as we approach year-end.

Retail Sales

Local retailers are finding sales harder to come by. They are having trouble even matching last year's post-September 11 sales. Everyone now seems to be sharing the pain, even discount stores that had previously seemed immune and furniture stores that had been buoyed by strong home sales. Given the current sluggish economy, achieving last year's holiday totals will be difficult. But this year retailers face the added problem of a holiday season six days shorter than last year's.

Real Estate

Apartment occupancy has been rising seasonally, but Class A occupancy remains down compared with last year. Leasing incentives are on the rise. Occupancy is under pressure as low interest rates make homebuying attractive and more difficult economic times

force singles and families to double up.

Low interest rates are still supporting new home sales; August 2002 sales were well above those of a year earlier. Starts, inventory and traffic were all up by double digits over the previous August. Existing home sales continue to hover just below last year's sales totals, but inventory has grown to one-third higher than its 1999 low point.

Energy Prices and Oil Services

Crude oil prices have been supported by talk of war with Iraq, OPEC's decision not to raise its quotas and low inventories. Hurricanes Isidore and Lili both closed the Louisiana Offshore Oil Port, cutting deliveries to Gulf Coast refineries and pushing prices higher. Crude rose over \$30 per barrel as the hurricanes approached but has since fallen back to \$28 per barrel.

Although the hurricanes briefly shut down some gas production, natural gas inventories continue to head toward record levels as the heating storage season ends. Gas prices surged over \$4 per thousand cubic feet during Isidore and Lili but fell back to \$3.75 afterward.

Growing natural gas inventories have kept drilling activity stalled since April at about 850

working rigs, with no indication of a significant fourth-quarter pickup. With the slowdown lasting longer than anticipated, talk of renewed layoffs is surfacing.

Refining and Chemicals

Poor profit margins induced refiners to cut production in September. Then Isidore and Lili briefly closed some refineries and halted crude deliveries to the Gulf Coast. Heating oil inventories that looked comfortable six weeks ago are suddenly much tighter, and the prices of both heating oil and highway diesel fuel have surged.

Petrochemical demand has flattened out, and the series of price increases for plastics products has ended. Purchases made to restock inventory or beat price increases worked their way out of the system in September, leaving only industrial demand to fuel growth. As a result, sales turned weak to nonexistent. Even for products such as polyvinyl chloride and polyethylene, whose prices had moved up steadily all year, the price increases ended. In some cases, customers are now asking that producers reverse previous increases.



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