HoustonBusiness

A Perspective on the Houston Economy

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1982–90: When Times Were Bad in Houston

This article looks back at the 1980s and the speculative fever that bred the bust—in oil, real estate, banking, and savings and loans. The experience of the '80s reminds us that while the Houston economy could be healthier today, it has certainly seen much worse in the not-too-distant past.

In the last issue of *Houston Business*, we introduced a new coincident index of economic activity for Houston based on employment, the unemployment rate, real wages and real retail sales. The index optimally weights and combines the data to best portray the Houston economy. It is most useful as a tool to gauge current economic conditions. The index shows Houston slogging through a mild but prolonged decline. Economic activity peaked in April 2001, followed first by a decline of less than 1 percent and then by a long period of no growth that extends to the present.

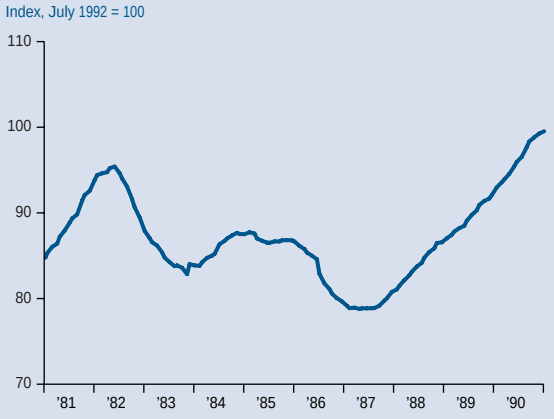
The same data, however, can be used to document the past. Figure 1 shows the coincident economic index from 1981 to 1990, a period of very bad times in Houston. The Houston economy peaked in March 1982 and did not revisit that level until February 1990. The initial decline of 13.2 percent ended in August 1983. It was followed by an expansion of 5.9 percent that ended in November 1984 and another decline of 10.2 percent before Houston finally touched bottom in January 1987. Houston returned to the March 1982 level of economic activity in February 1990 after a rapid 21.1 percent climb from the bottom. The entire cycle of bust and recovery took seven years and 11 months.

This article looks back at the 1980s and the speculative fever that bred the bust—in oil, real estate, banking, and savings and loans. Houston was at the center of the oil boom and the ensuing bust and led the state into and out of recession. The experience of the '80s reminds us that while the Houston economy could be healthier today, it has certainly seen much worse in the not-too-distant past.

Boom and Bust in Oil

The earliest roots of many of the problems of the 1980s—inflation, the 1981–82 recession, the bust in both oil and real estate—can be traced to the mile-long gas lines of 1973.

Figure 1
Coincident Index of Houston Economic Activity, 1981–90



SOURCE: Authors' calculations.

The Israeli–Arab October War began Oct. 6, 1973, and a week later the Organization of the Petroleum Exporting Countries (OPEC) announced an immediate 5 percent production cut, to be followed by continued monthly cuts until Israel withdrew to its 1967 borders. The cartel also announced an embargo on oil shipments to the United States and the Netherlands.

Although the gasoline lines were real, the production cuts were never fully implemented, and oil easily slipped through non-embargoed countries such as Great Britain and France. The gas lines were largely the product of panic buying by U.S. consumers and businesses, and—along with domestic price controls on energy—gave rise to the myth of resource scarcity that prevailed for the rest of the decade.

The primary oil weapon became an excise tax—a price increase per barrel levied by a cartel experimenting with a new and aggressive pricing policy throughout the 1970s. Each time a new disruption occurred in world oil markets, from pipeline breaks to the Iranian revolution, OPEC used the event to ratchet up the price and then maintain it. OPEC's pricing became more aggressive after it implemented a formal quota system among members in 1978 to support prices. OPEC's Long-Term Price Policy Committee saw the ultimate target as just under the price of synthetic oil—the only possible substitute, as they saw it—or near $60 per barrel.

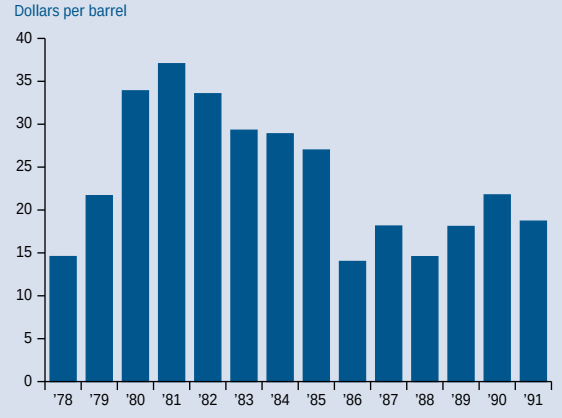
OPEC was wrong, of course. Figure 2 shows the upward push in oil prices during the late 1970s and the collapse in the 1980s. One substitute turned out to be conservation and alternative fuels, a response that had been delayed by price controls on oil and natural gas in the United States. Another was cheating on quotas by OPEC members unable to control their domestic budgets or comply with their quotas due to spending pressures at home. Most important, high oil prices stirred substantial exploration in relatively high-cost areas outside the Middle East, such as the North Sea, Alaska and Mexico. Non-OPEC production rose from 3.8 million to 7 million barrels per day between 1981 and 1992. After a failed attempt to ratchet the price upward after the start of the Iran–Iraq War in 1980, the OPEC price began to retreat. In 1986, the cartel briefly disintegrated in a squabble over quotas, then reformed in 1987 with more realistic monopoly targets for oil prices.

The myth of resource scarcity and the inevitable upward spiral of oil prices kicked off an unprecedented boom in oil exploration in the United States. As Figure 3 shows, the domestic rig count rose from 1,242 in January 1973 to a peak of 4,530 in December 1981. On the downside, the rig count fell to 663 in July 1986, an 85 percent decline.

The fact that the boom was based in oil inevitably put Texas, and especially Houston, at the epicenter of events. World War II had seen Persian Gulf pricing replace "Texas-plus" as the world oil standard, but Texas and surrounding states remained important producers on global standards. Houston was home to the state's oil service and machinery industry. Between 1970 and 1980, the Texas population grew 27 percent, adding nearly 1.8 million new people. One demographer estimated that based on the trends of the 1970s, Houston would be as large as Mexico City—in excess of 20 million population—by 2000. U-Haul trailers leaving Michigan for Texas exceeded those making the return trip by a ratio of 100 to 1.

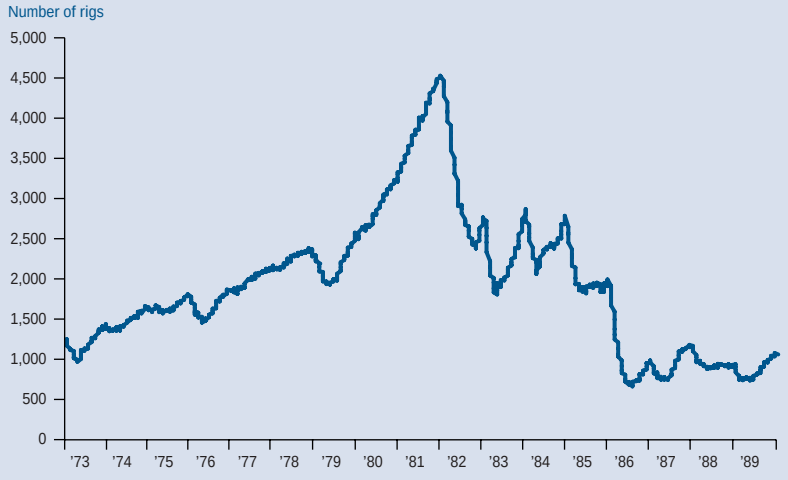
The companies most closely tied to domestic drilling also had close linkages to Houston's oil and manufacturing sector. They were drillers and oil serv-

Figure 2
Price of Foreign Crude Oil to U.S. Refiners, 1978–91



SOURCE: Energy Information Administration, U.S. Department of Energy.

Figure 3
Working Rigs in the United States, 1973–89



SOURCE: Baker Hughes Inc.

ice companies, such as Schlumberger, Dresser, Halliburton, Cameron Iron Works and SEDCO. Sales of drill pipe, tools, rigs and services grew to $40 billion in 1982 but fell to just $9 billion by 1986. The number of industry workers fell from 100,000 in 1982 to fewer than 25,000 in 1986.

The collapse of oil prices and drilling activity in 1986 brought the period of greatest distress for these companies, and virtually all became candidates for merger. Combinations could increase scale economies in operations, cut corporate overhead and reduce the number of field locations. The 1986 merger of Baker International and Hughes Tool, long and bitter rivals in the drill bit market, came to symbolize the desperation of the times. Between March 1982 and March 1987, more then 225,000 jobs—approximately one in eight—disappeared in Houston.

Real Estate and S&Ls

The rapid growth of Houston and Texas fed a boom in real estate development. You didn't have to know the oil industry to capitalize on the oil boom. You could simply buy and sell real estate in Houston or Dallas. Single-family homes, apartments, retail centers, offices and industrial space were brought to the market at a frenzied pace. The initial shock of declining oil prices in 1981–82 slowed development, especially in oil cities like Houston and Midland–Odessa. But just as the oil boom began to fade, real estate got an important new lease on life from an unexpected source—the savings and loan industry.

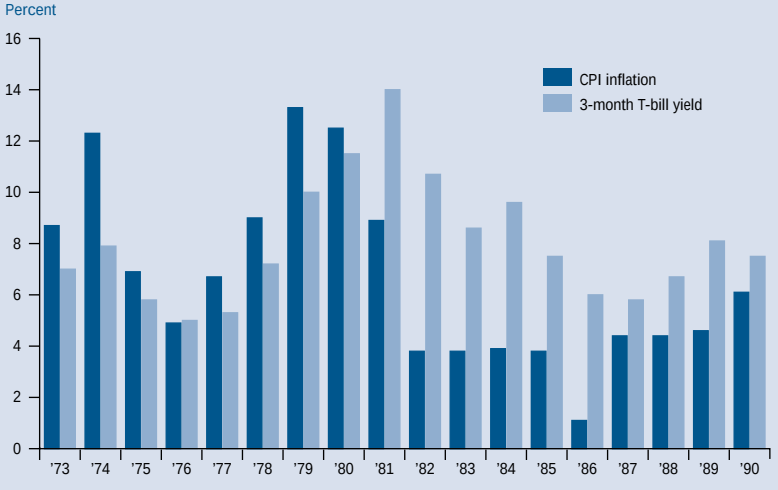
S&Ls had long been conservative, local lenders, filling a niche in the market for small mortgages. Their fatal flaw, however, was borrowing short to lend for long periods at fixed rates. In the 1970s, as inflation heated up after the Vietnam War and two oil-price spikes, short-term interest rates rose sharply, and S&Ls found themselves paying much more for funds as deposit ceilings were lifted (*Figure 4*). Caught holding long-term mortgages paying only 3 to 4 percent with short-term rates briefly spiking to near 20 percent, three-fourths of the industry was insolvent by the late 1970s. Regulators began to organize combinations of insolvent S&Ls into new "phoenix" institutions whose primary asset was regulatory goodwill, an accounting trick to turn the negative capital position into an asset. The institutions were sold to investors for tax advantages and spreads guaranteed by regulators and up to 40 years to write down the goodwill.

In 1982, the Garn–St. Germain bill converted the stodgy S&Ls into high-flying investment vehicles, allowing them to not only invest their deposits in commercial real estate but also invest in their own development projects. Texas, California and Arizona liberalized the investment rules even more, and S&Ls were sucked into the Southwestern real estate boom with a vengeance. S&Ls began to bid up the yields they paid on their deposits to attract hot, federally insured funds in blocks of $99,999—just under the insurance limit—and invest the money in real estate. Rust Belt thrifts were not left out; they freely invested in loan participations originated by S&Ls from Arizona to Texas to Florida.

The Texas real estate boom ended badly, of course. The oil market fundamentals that fed the initial expansion continued to deteriorate through 1987, as did the job market statewide. Then the Tax Reform Act of 1986 eliminated tax shelters for passive real estate development, even wiping them out retroactively. Suddenly, deals done years earlier were worth much less, and the impact on the value of existing real estate was devastating.

In 1989, the S&L crisis ended with the Financial Reform, Recovery and Enforcement Act, which imposed rigid capital standards for S&Ls and a more rapid write-off of regulatory goodwill. Of the 279 S&Ls in

Figure 4
U.S. Inflation and Interest Rates, 1973–90



SOURCES: Board of Governors, Federal Reserve System; Bureau of Labor Statistics.

existence at year-end 1987, 225 failed or were forced into involuntary mergers, two merged voluntarily and two were liquidated voluntarily by their directors (*Table 1*).

By 1986, not just Houston but Dallas, Fort Worth, Austin and San Antonio had a four- to six-year supply of office buildings, apartments and retail space. Houston had 200,000 vacant homes, twice the normal level for a city its size (*Figure 5*). Postings and foreclosures in Harris County peaked in mid-1987 at 50,000 postings and 30,000 foreclosures per year. Properties repossessed by the Federal Housing Administration, the Federal Deposit Insurance Corp., the Veterans Administration, the Federal Home Loan Bank Board, Fannie Mae and other agencies all had to be disposed of, leading to a vicious cycle of property prices that were depressed further by disposal, more worthless loans, weakened financial institutions and even more repossessions.

Texas Banks

Banks are more diversified lenders than S&Ls, which originally specialized in mortgage lending and later broadened to commercial real estate. Unfortunately, in the 1980s when everything went wrong, diversification simply offered banks more ways to get into trouble.

Early problems emerged in the international arena. Several of Texas' largest banks, mostly in Dallas, had actively begun lending to developing countries in Latin America and Southeast Asia and Iron Curtain countries. Global recession and the decline in oil revenues after 1981 left many of these countries unable to service their bank debt. In September 1982, both Mexico and Brazil announced they could no longer meet bank obligations. Texas bankers found that sovereign loans could also be nonperforming loans.

The initial 1981 decline in oil prices also quickly had consequences at home. July 1982 brought the failure of Penn Square Bank of Oklahoma City, one of the most aggressive U.S. oil and gas lenders. Further, Continental Illinois National Bank of Chicago had purchased more than $1 billion in loan participations from Penn Square. In July 1984, the FDIC injected $15 billion in capital in return for a controlling interest in the Chicago bank in what would become the first modern "open bank" transaction.

Other energy lenders failed on the heels of Penn Square: Abilene National Bank in August 1982 and three Midland–Odessa banks in 1983. Lenders to drillers and the oil service industry were hit hard early as the rig count began its collapse and repossessed drilling equipment drew little more than 10 cents on the dollar at auction. By the end of 1987, all four independent banks in Midland and three of the four in Odessa had closed.

The second shoe dropped in 1986 with a double dose of bad news: First, the capitulation of the rig count and oil prices redoubled the pressure on energy lenders. Second, after banks fled from energy lending to real estate, overinvestment in all segments of real estate emerged in every major market in the state. Even a strategy of geographic diversification into Austin, El Paso, Dallas, Fort Worth, Houston and San Antonio did not protect Texas banks from the

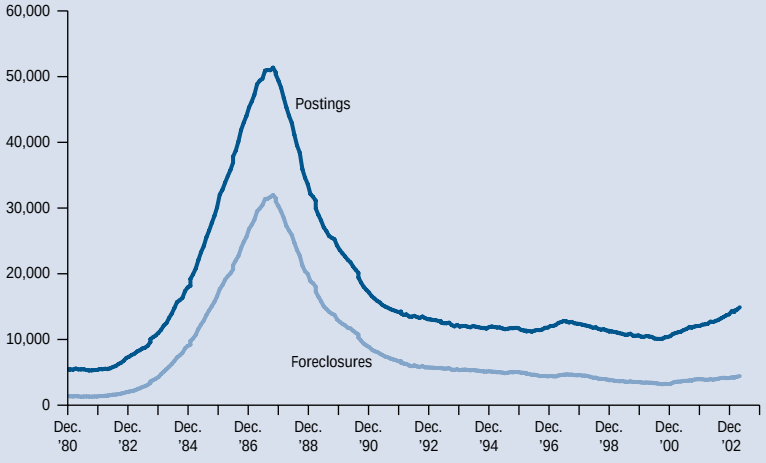
Table 1
Texas Thrift and Bank Failures, 1983–92

	S&L failures	Texas as percentage of U.S.	Bank failures	Texas as percentage of U.S.
1983	1	2.8	3	6.3
1984	2	9.1	6	7.6
1985	1	3.2	12	10.0
1986	2	4.3	26	18.8
1987	4	8.5	50	27.2
1988	90	43.9	113	56.5
1989	8	17.0	133	64.6
1990	72	22.9	103	61.3
1991	55	23.7	31	25.0
1992	7	10.1	29	24.2

SOURCE: Joseph M. Grant, *The Great Texas Banking Crash: An Insider's Account* (Austin: University of Texas Press, 1996), pp. 27, 40.

Figure 5
Harris County Postings and Foreclosures, 1980 to Present

Index, July 1992 = 100



SOURCE: Foreclosure Listing Service.

have a glut of office space. But the scale of overinvestment pales in comparison with the 1980s, and the state's mild recession is more a pause in growth than a massive write-off of past errors. Like the rest of the nation, growth will resume in Houston and Texas with the revival of business confidence and renewed investment.

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decline in real estate values.

The Tax Reform Act of 1986 may have put the final nail in the coffin of many of these banks, retroactively wrecking the economics of what initially were sound credits and putting downward pressure on property prices statewide. The dilemma for many banks became whether to sell real estate that was rapidly declining in value or to hold onto it. Selling meant realizing losses that would further damage already weak capital positions. Holding on meant waiting for a turnaround in real estate markets, a turnaround that would not come in time for many institutions.

Table 1 summarizes the number and timing of Texas bank failures. Table 2 traces the fate of the state's largest bank holding companies in the early 1980s. Of the 10 largest at the beginning of the decade, only one survived—Cullen/Frost Bankers. The others merged with out-of-state interests or failed.

Conclusion

Recessions are often described as the result of speculative excesses—the product of overinvestment and miscalculations during the prior expansion. Perhaps the 1980s bust was an inevitable reaction to the Southwest's enormous excesses, in both oil and real estate, in the 1970s. The reaction, in terms of the extraordinary depth and length of the following downturn, seems to have been proportional to the excesses on the upside.

Today we are working our way through the speculative excesses of the last decade—overinvestment in high tech in Austin and Dallas, for example, and in energy trading in Houston. Austin has too many high-end homes and apartments, and Dallas and Houston

Table 2
Largest Texas Bank Holding Companies in the Early 1980s: Status by 1990

Allied Bancshares Inc.—Acquired by First Interstate Bancorp, Los Angeles, in January 1988 without federal assistance.

Cullen/Frost Bankers Inc.—Operating profitably without federal assistance.

First City Bancorporation of Texas—Received $1 billion infusion from Federal Deposit Insurance Corp. (FDIC) in September 1987; reorganized under management of outside group that raised $500 million in new capital.

InterFirst Corp.—Federally assisted takeover by NCNB Corp. in July 1988; assisted by the FDIC with a $1 billion cash infusion in March 1988; merged with RepublicBank in March 1987 to become First RepublicBank Corp.

Mercantile Texas Corp.—Federally assisted takeover of most banks by Bank One Corp., Columbus, Ohio, in June 1989; taken over by the FDIC in March 1989; merged with Southwest Bancshares Inc. in October 1984 to become MCorp.

RepublicBank Corp.—Merged with InterFirst in March 1987 to become First RepublicBank Corp.

Southwest Bancshares Inc.—Merged with Mercantile Texas in October 1984 to form MCorp.

Texas Commerce Bancshares—Acquired by Chemical Banking Corp., New York, in May 1987 without federal assistance.

SOURCE: *Houston Business*, February 1992.

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There is some good news for the Houston economy. Confidence is growing that high natural gas prices will fuel more exploration in coming months, boosting Houston employment in mining and manufacturing by the third quarter of this year.

U.S. economic data, in contrast, remain disappointing, although it will be at least a couple of months before we understand how well the U.S. economy is performing following the Iraq war. Preliminary data from Houston's Purchasing Managers Index for April indicate a fourth consecutive month of local expansion, although the job market has yet to reflect any significant improvement.

Retail and Auto Sales

Retailers remain disappointed with current sales, which are running behind last year's levels by high single digits. The only way to improve store traffic is through sales and promotions. Sales of big-ticket items are particularly difficult. The slow sales are widely shared by all classes of retailers.

Auto sales in April were down 11 percent from last year and are off 4 percent year to date. Incentives and price reductions remain an important ingredient of auto and truck sales as well.

Real Estate

Existing home sales have leveled off in Houston, with sales gaining slightly in March compared with last year and then slipping back by 4 percent in April. The local apartment market remains sluggish, with both occupancy and rents falling. A weak job market, continued apartment construction and the affordability of home ownership have cooled apartment rentals.

Houston's office market continues to struggle after the 2002 slump but finally seems to be stabilizing. Industrial occupancy is stable, but only thanks to a drop in construction and substantial incentives offered by warehouse owners.

Oil Services and Machinery

Optimism is clearly growing in this sector, with the outlook having swung in favor of a pickup in drilling activity that could last a couple of years. High natural gas prices, driven by inventories 50 percent below normal, have changed the outlook for drilling. The domestic rig count has pushed over 1,000 in recent weeks, and respondents seemed optimistic that 1,200 or more rigs could be working by the third quarter. That level of activity would soak up excess capacity in oil services; spill over into Houston's manufacturing sector for pipes, valves and machinery; and begin to add to local job totals.

Refining

Margins for refiners continued to decline from the high levels of this winter but remained very profitable. Demand is flat for gasoline, down for jet fuel and very strong for residual fuel oils that can substitute for natural gas. Inventories are at the bottom of the normal range for both gasoline and distillates, and despite high levels of production by refineries, there has been limited progress in refilling gasoline inventories before the summer driving season begins.

Petrochemicals

Demand for petrochemicals was very strong in April but definitely cooled off in May for a number of products—propylene, styrene, PVC and MTBE. The weakening has not been dramatic—more of a speed bump than a fall off a cliff. Reasons vary from a softer housing market and excess inventory from buying ahead of the Iraq war to weaker demand from Asia.

Natural gas prices at $5–$6 per thousand cubic feet have been the primary drivers in price increases for PVC, nylon and polypropylene. Prices and revenues for many products are near record levels, but only because of high feedstock prices. The industry's profit margins remain near levels usually associated with a recession trough.

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