



HoustonBusiness

A Perspective on the Houston Economy

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Tide Turns Texas Toward Recovery

Momentum in the Texas and U.S. economies has turned, indicating positive growth this year and likely stronger growth next year.

According to the Texas Coincident Index, the state's economy has been in recovery since the first quarter of this year. However, like the jobless recovery of the last recession after the 1990–91 Gulf War, continuing job losses, centered primarily in manufacturing, in both Texas and the United States have pulled the employment statistics down, even as overall output climbed. The difference between the past two years and the current one is the momentum building in the U.S. economy that will eventually turn the tide on employment losses. Texas is participating in this buildup and, for the first time since 2000, will end the year with positive job growth.

Other indications also point to a turnaround this year. Job losses in the state's high-tech sector—a major source of layoffs during this contraction—are slowing. Rising oil and natural gas prices have boosted the rig count, although this has yet to show up in energy employment because of continuing

industry consolidation. Finally, employment statistics, which are collected through two surveys—one of businesses and one of households—have been diverging because of strength in the latter's employment measure. In the past this divergence has foreshadowed a resurgence in the business survey.

This article examines the state's current economic performance and concludes that the momentum has indeed turned, indicating positive growth this year and likely stronger growth next year.

Job Growth in 2003

Total employment growth this year was positive through August, compared with a net loss for the same period in 2002. While employment losses remain concentrated in manufacturing, transportation and utilities, they are less severe than last year's. Growth has continued in the service sector and in government employment, with particularly strong gains in private education and health services and in leisure and hospitality services.

This pattern of total job growth has not yet emerged

among the state's five major metropolitan areas, however. In fact, only Austin and San Antonio, with the largest concentrations of service and government jobs, saw positive employment growth through August. Houston experienced a quarter percent job loss. The statewide concentration of job losses in manufacturing, transportation and utilities appears to affect the major metro areas disproportionately relative to the rest of the state. However, contrary to last year at this time, the rate of job decline is slowing rather than accelerating (*Figure 1*).

Although statewide manufacturing employment has suffered most during this contraction, losses through August were just under half those experienced during the same period in 2002 and less than 40 percent of those in 2001. On the other hand, weakness in transportation and utilities continues to mount. A turnaround in business services and continued strength in the rest of the service sector are gradually shifting the momentum toward positive employment growth.

The U.S. Recovery

In November, the U.S. recovery will be two years in the making. What could have been a relatively quick turnaround after the 2001 recession was waylaid by increased uncertainty due to rising global tensions, corporate accounting scandals and poor stock market performance. Under these conditions, surveys of consumer and business confidence sank even as overall economic output began to rise. The industrial sector weakened as sales slowed, which led to lower business investment and eventually layoffs. Ultimately, employment losses began to mount and continued through the first eight months of this year. A cumulative 2.8 million jobs have gone

away since employment peaked in first quarter 2001.

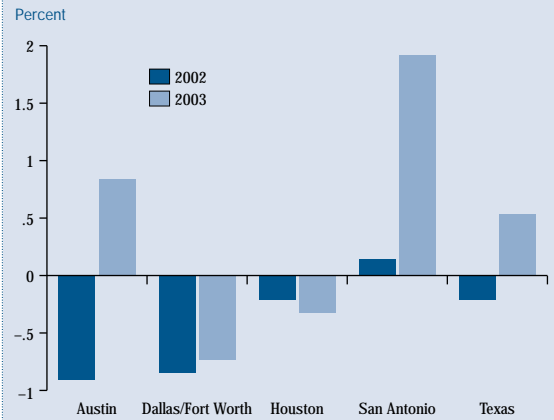
Throughout this period, however, the consumer has been an unwavering source of strength to the U.S. economy. Consumer spending both mitigated the depth of the recession and ensured continuation of the fledgling recovery. At the end of 1999, U.S. stock markets had experienced nearly 18 years of almost uninterrupted growth; between 1995 and 1999, the Standard and Poor's 500 stock index averaged a near 30 percent annual rate of return. For two decades, the rising stock market created wealth that fueled consumer spending even after the bubble burst.

In addition, interest rates began a rapid descent in January 2001, taking mortgage rates to levels not seen in 40 years. Housing starts ballooned, helping offset construction jobs lost in other areas of the economy, and refinancings soared. The spillover effects from the increase in first-time homeowners as well as the equity drawdowns kept consumers spending.

Productivity growth has also been significant over the past two years, averaging nearly 5 percent. This has been another major stimulus for consumer spending because a large portion of these productivity gains has been passed to employees through wage and benefit increases. Total compensation climbed nearly 4 percent over the past year. Ironically, productivity gains also contribute to a slow recovery. When employers can increase output and profits without hiring, aggregate job growth suffers.

This year began with a high level of uncertainty, continued weakness in the industrial sec-

Figure 1
Annualized Employment Growth in Texas Metros



SOURCE: Bureau of Labor Statistics.

NOTES: Seasonal adjustment by Federal Reserve Bank of Dallas; calculations by authors; Dallas and Fort Worth combined.

tor and a relatively stronger consumer sector. As the year progressed, however, the nation's industrial sector improved steadily. U.S. business investment was up 0.9 percent in the first two quarters, the first solid gain since third quarter 2000. Measures such as the purchasing managers index and industrial production have increased, especially since the beginning of summer. This trend has been matched at the state level, with Texas industrial production up 1.6 percent since last December. Even the manufacturing component is up 1.5 percent since last year. Finally, government spending has contributed significantly to GDP growth this year. Military spending has increased nearly 22 percent over 2002, and the July income tax rebates gave the average family an estimated tax saving of just over \$1,000.

High Tech

Throughout the 1990s, high technology was one of the Texas economy's growth engines. At the industry's peak, nearly 12 percent of all U.S. employees in computer, semiconductor and communications equipment manufacturing were located in Texas, mostly in Austin and Dallas. At the outset of the 2001 recession, high tech bore the brunt of the Nasdaq implosion. Texas' high-

tech employment shrank by 16 percent during the first year following the recession's onset. The drop in overall state employment—1.4 percent during the same period—was compounded by the state's concentration of communications and semiconductor equipment manufacturers, high tech's worst-hit segment. Consequently, whereas Texas typically experiences above-average growth immediately after a recession, this time around the state has struggled under the weight of mounting high-tech job losses.

While the U.S. economy will provide the needed boost to Texas this year, high-tech employment in the state will come close to hitting bottom. This is not yet a turnaround, but it does mean Texas will no longer hemorrhage jobs in this sector (*Figure 2*). Since the peak of the business cycle, Texas has lost 80,800 high-tech jobs, nearly 70,000 of them before the end of 2002. While semiconductor employment and output are not likely to bounce back much because of production shifts to Asia, computer manufacturers have seen promising sales growth.

Nationally, in spite of continued weakness in some high-tech segments, overall investment in equipment and software increased at an annual rate of 5.8 percent during the first two quarters of 2003. Factory orders are up 5 percent year to date, while shipments are up only 3.5 percent. Finally, inventories are down more than 10 percent since last year. These three factors indicate that at worst this sector will exert only a modest drag on the Texas economy in coming quarters, and at best it could add to the recovery.

Oil and Gas

Energy has historically been a strong contributor to growth in Texas. However, recent

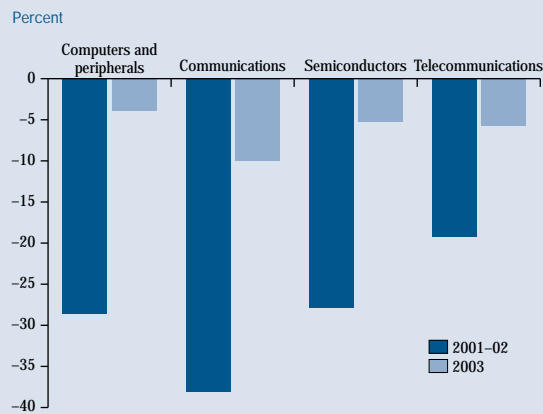
higher oil and natural gas prices have failed to spur much job growth in this sector. The rig count—which went from a low near 800 last summer to just over 1,100 today—is more than 80 percent gas-directed. With inventories right at the five-year average for the start of the heating season, the rig count is unlikely to move too far from its current level. Weak balance sheets, a lingering memory of the last severe drop in oil and gas prices in 2002, and further industry consolidation have also prompted companies to reexamine combined exploration programs and properties and reduce employment, especially in redundant white collar jobs.

However, this sector has also benefited tremendously from productivity increases. Technological innovations and gains from consolidation have steadily improved industry conditions. Consequently, while job growth has not materialized, the energy sector is contributing to Texas' output growth.

Positioned for Growth

While employment statistics from the business survey remain sluggish, they are positive this year compared with the previous two years' net job losses. A glance at the household survey reveals even more cause for optimism. Employment measured by this survey grew by more than 2 percent through August, compared with the business survey's 0.25 percent. The household survey tends to recover faster than the business survey at the bottom of a business cycle and thus provides better evidence of an economic turnaround. The household sur-

Figure 2
High-Tech Job Losses Slow



SOURCES: Bureau of Labor Statistics; authors' calculations.

vey data should signal improvement in the business survey.¹

The slow recovery has meant limited job growth for Texas. However, employment and output have turned positive, and signs point to continued strength in the coming quarters. Temporary employment has increased sharply this year, which indicates employers are facing rising demand. The Texas Coincident Index has pointed toward growth since the first quarter of this year, and the state's leading index is also signaling faster near-term job growth. With its young workforce, low cost of living and friendly business climate, Texas remains strategically positioned for growth as the recovery gains momentum.

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Note

¹ A more detailed discussion of bias inherent in the business survey is found in a report by John Kitchen, chief economist of the U.S. House of Representatives Budget Committee, titled "A Note on the Observed Downward Bias in Real-Time Estimates of Payroll Jobs Growth in Early Expansions," August 2003, <http://users.starpower.net/jkitch/payrollbias.pdf>.

Measures of output in Houston, such as the rig count and the Houston Purchasing Managers Index (PMI), are indicating local growth. The rig count is up 47 percent since earlier this year, and the PMI has been up since January. The job market is still bleeding, however, continuing a very slow descent in total jobs. Since peaking in April 2001, the Houston economy has lost 26,000 wage and salary jobs, a 0.5 percent annual rate of decline. The good news for Houston comes from the U.S. economy, which is now recording fast GDP growth and where the job market is expected to stabilize late this year.

Retail and Auto Sales

After nice improvements in sales in August, retail merchants reported that September was soft once more. Discount stores continued to hit their sales targets, but department stores, furniture stores, food stores and small independents all found the September market more difficult.

Auto sales are also slow, down 8 percent from August 2002. Dealers are increasingly concerned about how many future sales have been stolen by incentive programs.

Real Estate

Local real estate continues to reflect broader economic trends. The strength of consumer spending and personal income growth keeps retail rents and occupancy stable to growing. High productivity growth keeps the Houston office market soft. Occupancy citywide has fallen from 89 percent to 83 percent since late 2001. Low interest rates con-

tinue to attract renters into single-family housing, so the local apartment market has seen no absorption in the last 12 months. Quoted rents are up slightly, but heavy concessions by landlords, especially in class A, are making the effective rents much less.

Oil and Natural Gas Prices

Crude oil prices are holding steady at \$30 with OPEC's surprise announcement of a cut in its oil production. Oil prices have been supported by instability in Iraq and Nigeria and by crude inventories in the United States that ran about 10 percent below normal for much of the period.

Natural gas prices softened recently from \$5 per thousand cubic feet to \$4.50, as inventory injections remain right on track for a normal refill of storage by Nov. 1. Injections in late summer and early fall have been much larger than normal. Industrial consumption of gas continues to decline, adding to supplies available for storage and consumption elsewhere.

The domestic rig count continues to level off near 1,100 working rigs, a low level only in the sense that current oil and natural gas prices would justify even more drilling. Reasons offered for the conservative approach to drilling vary: big company consolidation, continued balance sheet issues for some producers, distrust of current energy prices and a lack of domestic prospects. International

drilling activity continues to improve slowly, providing good revenues for oil service companies.

Petrochemicals and Refining

Gasoline took center stage in August, as the blackout in the northeastern United States briefly knocked about 3 percent of U.S. refinery production offline. The loss came at a critical moment, with gasoline inventories already below the normal range and with Labor Day looming as the biggest driving weekend of the year. Wholesale prices briefly soared from 95 cents to \$1.12 but have since fallen back below 90 cents. Heating oil prices have fallen steadily in recent weeks as inventories of distillates returned to healthy levels.

Refiners saw their profit margins spike along with gasoline prices, but margins have since fallen as prices declined. Refiners are now entering the turnaround period for seasonal maintenance, which should reduce capacity utilization by an average of 3 percent or so for the next few weeks.

Petrochemical producers reported little change in basic petrochemicals as demand weakened slightly, overcapacity persisted and profits remained low. Plastic product prices were mixed, with increased demand pushing up polyethylene and polypropylene while weaker demand pulled down polystyrene prices.



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