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Houston Business
A Perspective on the Houston Economy

Houston 2001: A Half-Empty Glass?

So far, 2001 is shaping up as a mediocre year for job growth in Houston. If we use wage and salary employment growth as a guide, Houston averaged annual increases of 2.6 percent per year in the 1990s. The best years were 1997 and 1998, with growth of 4.9 and 4.5 percent, respectively. In both years, large gains in local oil and gas extraction employment led growth. Over the first six months of this year, Houston jobs grew at a 2.7 percent annual rate compared with the same period last year.

The current pace of local job growth remains quite healthy and looks downright robust compared with the U.S. economy, where the labor market came to a standstill during the first six months of 2001. If Houston's results are disappointing—with the glass seeming half empty—it is because expectations for this year were very high. 2001 was to see strong continued growth in the domestic economy, solid global performance and a full-blown oil boom under way in the United States. These circumstances normally drive strong job growth in Houston, and forecasts were in the range of 3 to 4 percent.

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U.S. AND GLOBAL ECONOMIES SLOW

Growth of the national economy has been disappointing in 2001. The longest continuous economic expansion in U.S. history slowed dramatically in the first half. GDP growth has averaged near 4 percent since 1994, and the fact that it soared to 6.1 percent in 2000 made the subsequent slowdown all the more painful.

It was the rapid pace of expansion in 1999 and 2000 that led the Federal Reserve to raise short-term interest rates, boosting the federal funds target rate from 4.75 percent in November 1998 to 6.5 percent in May 2000. The goal was a soft landing—a slowdown of the economy from 6 percent GDP growth to 3 to 3.5 percent. But the soft landing has clearly hit an air pocket. So far the economy has averted a crash landing, but growth has stalled.

What happened? If we look back at June 2000, just after the Federal Reserve finished raising rates, the effectiveness of interest rate increases was widely doubted. The classic pattern of a monetary-induced slowdown was surfacing—in housing and other construction as well as in consumer durables such as autos. However, growth in 1999–2000 was being driven largely by the New Economy—by semiconductors, telecommunications and new Internet companies that did not need banks and were immune to rising interest rates. Equity investment poured into these industries from many sources, and the boom in Nasdaq-listed stocks symbolized a growing bubble in tech-related equity values.

The bubble burst in June 2000. Suddenly, in late 2000, both New and Old Economies shifted into reverse. Six rate cuts by the Federal Reserve's Open Market Committee in 2001 have slowly turned around the Old Economy once more, with inventories clearing out nicely and housing and consumer durables showing signs of recovery. But near-term recovery of the New Economy remains in doubt.

Expectations last year were for a strong global economy as well. The world economy had made solid gains in the wake of the Asian financial crisis, with global GDP returning to 3.5 percent growth in 1999 and 4.8 percent in 2000. Last October, the International Monetary Fund forecast 4.2 percent growth in the world economy for 2001. By May, the forecast was reduced to 3.2 percent, led by cuts in the advanced economies: 1.5 percent growth in the United States, down from 3.2; 0.6 percent in Japan, down from 1.8; and 2.4 percent in the European Union, down from 3.3.

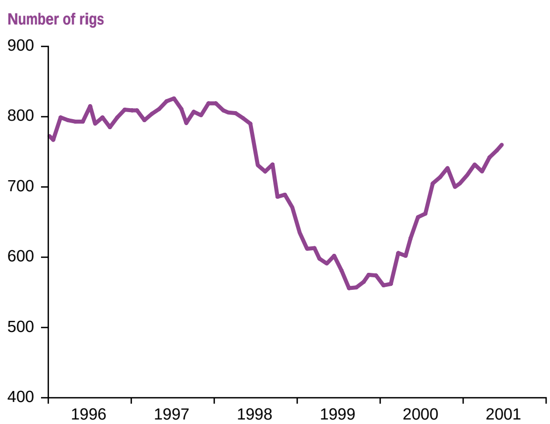
For U.S. producers, weakness in international markets is compounded by an extremely strong dollar. The dollar strengthened by nearly 15 percent during the 1997–98 Asian financial crisis. It gave up nearly 6 percent of this gain as global financial conditions returned to normal in 1999, but by last December the dollar was back at the peak levels of the Asian crisis. The dollar continued to strengthen in the first half of this year, moving above the Asian peak to levels not seen since 1984–85. U.S. and Houston exporters find it increasingly difficult to sell abroad without cutting prices and profit margins, and foreign competitors find it easier to compete in U.S. markets.

OIL AND GAS EXPLORATION

The bad news has been slower growth in markets at home and abroad. The half of Houston's economy that is not engaged in oil-related activities—including companies such as Compaq Computer Corp., Continental Airlines and American General Corp.—has not experienced the expected growth. The good news for Houston is that oil and natural gas exploration continued strong through the first six months. The domestic rig count rose to 1,271 in June, a gain of 174 rigs, or 15.9 percent, from last December. Natural gas exploration led the increase; over 80 percent of domestic working rigs are now directed to natural gas. The domestic rig count has not been this high since 1986.

The other good news in oil and gas has been a steady increase in exploration outside the United States and Canada (*Figure 1*). In contrast to the U.S. rig count, the foreign rig count has not yet returned to the peak levels of the 1996–98 exploration cycle. However, the June rig count reached 760, up from 705 in December 2000. The international market is important because its large and complex projects use more resources, and thus more oil services and machinery, than domestic projects. The slow recovery is partly because oil-directed drilling dominates this market, and the uncertainties of OPEC pricing have provided less incentive than the market-driven price for U.S. natural gas.

Figure 1
Foreign Rigs Working Outside the United States and Canada



SOURCE: Baker Hughes.

Another factor in the foreign rig count's slow growth in this exploration cycle may be the mergers of big oil companies, such as Exxon/Mobil, BP/Amoco/Atlantic Richfield and Total/PetroFina/Elf Aquitaine, over the last couple of years. Foreign oil projects are extremely expensive and often risky, requiring deep pockets. Many of the super-majors have been tied up in the internal issues of completing these mergers; only now are the new, combined companies beginning to address the specific role of these large projects.

Table 1
Houston Job Growth in 2001
(Percent change, fourth quarter to fourth quarter)

	Bad news	Good news
Total private	2.2	2.5
Mining	5.0	5.2
Manufacturing	5.1	6.2
Durables	6.6	7.7
Construction	2.3	2.6
Finance and services	2.4	2.5
Trade	.8	1.0
Transportation and utilities	.8	1.1

SOURCE: Author's calculations.

WHAT NEXT?

Clearly, what comes next depends on the answers to some difficult questions about the course of the U.S. economy, the strength of the dollar and the price of oil and natural gas. Economists probably can't answer any of these questions definitively right now, and a range of possible outcomes is probably more informative than a bad guess.

For one scenario, assume the bad news continues. For example, U.S. GDP growth might stay sluggish through all of this year and persist into the first half of 2002. Labor markets will lag this slowdown, but the unemployment rate will continue to climb through the end of this year, perhaps hitting 5 percent before year-end before stabilizing at 5.3 percent over the first half of next year.

In contrast, a second scenario might bring better news, with U.S. GDP growth rebounding in the second half of 2001. The unemployment rate would still respond more slowly, peaking at 4.8 percent in the fourth quarter but improving to 4.6 percent by second quarter 2002.

Further, the bad news scenario assumes the dollar gets no worse but remains at its current level. The better news would be a gradual weakening of the dollar, so that it falls in the same quarter-by-quarter pattern in which it strengthened. In this scenario, the dollar would be 2.2 percent weaker by year-end and 5.4 percent weaker by second quarter 2002.

Third, for the bad news scenario, assume that domestic drilling has peaked, although it remains at the current high level into the middle of next year. Drilling has flattened out in recent weeks for a variety of reasons. Midyear is a common point for producers to pause and reexamine drilling budgets, and the recent decline in natural gas prices has affected cash flows and given even more reason to reconsider drilling programs. Although natural gas prices remain highly profitable at $3 per thousand cubic feet, the rapid decline has provoked concern. Some argue that constraints have also been encountered in rig availability, crews and drilling prospects.

For the better news scenario, assume modest growth in drilling continues, with additional stimulus from either domestic or foreign sources. The overall stimulus is reduced over the next 12 months, however, to the equivalent of another 125 domestic rigs.

Table 1 summarizes the results of the two scenarios, showing percentage change in wage and salary job growth in 2001. There is not much difference in the outcome between the two: 2.2 percent versus 2.5 percent. This is partly because the year is half over and partly because many decisions have already been made to determine the outcome for the second half of 2001. Not shown in the table are the differences that would emerge in early 2002 under the two scenarios; next year will be very slow if additional stimulus cannot be found for the local economy and bad news continues far into the year.

The outcomes in Table 1 are also similar because our scenarios are not that different. They do not test the effect of a serious recession in the United States, for example, or a collapse of natural gas prices. While no scenario can be discounted completely—and you should always plan your business with the worst outcome in mind—our middle ground is the more likely outcome at present. The bottom line here is a year of moderate job growth for Houston. Growth will be less than what was expected, but perhaps the glass is really half full if measured against the difficult economic backdrop that has emerged.

The Houston economy continues to look healthy, with job growth accelerating slightly in recent months. Local purchasing managers report a slightly slower rate of expansion in mining and manufacturing, but the Houston Purchasing Managers Index remains a robust 57, indicating a very healthy rate of expansion.

RETAIL AND AUTO SALES

Retailers report slowing sales in recent weeks and say they are no longer meeting 2001 plans. Some retailers suggest buyers may have postponed purchases until the August sales tax holiday. Stores with multiple outlets across the state report that Houston is holding up well compared with other markets.

Auto sales were down 14 percent in May and 2 percent in June, compared with the same month last year, and are off 6 percent for the year to date. Still, 2001 remains the second-best year ever for auto sales in Houston.

REAL ESTATE

Local housing markets were only marginally affected by Tropical Storm Allison. New home sales surged 6 percent in June, and existing home sales slipped by only 2.5 percent compared with a strong June 2000. Indicators in other markets remained generally favorable. Second-quarter office vacancy rates remained flat, and rents increased. Multifamily housing made strong occupancy gains, also with rising rents. Industrial vacancy rates rose slightly as new speculative space came online.

ENERGY PRICES

Crude prices remained mostly in the $26–$28 range in May and June but weakened in July, briefly falling under $25. OPEC announced a withdrawal of 1 million barrels per day of production from world markets, provoking a rally that moved prices back over $27.

Weak crude prices were driven largely by a collapse of gasoline prices, resulting from weak summer vacation demand, high production levels at home and a surge of imports at twice the normal rate. Refiners' strong May profit margins evaporated in June and July. At least 10 refiners have announced reduced runs or production switches to heating oil and diesel.

Natural gas prices moved downward with gasoline prices. Gas fell below $3 per thousand cubic feet for the first time since April 2000. At least 12 consecutive weeks of injections in excess of 100 billion cubic feet have filled storage at an unprecedented pace. Concern is growing over how low gas prices could fall if storage fills before the winter heating season. The excess gas available for storage stems from a combination of factors: reduced demand—the result of the economic slowdown and spiking natural gas prices—and new supplies brought online by 1,000 rigs searching for gas in the United States.

DRILLING ACTIVITY

With falling natural gas prices squeezing cash flows, producers have pulled back on drilling to reassess their budgets for the rest of this year. Rigs are coming back on the market onshore and offshore, and both utilization rates and day rates for rigs are falling. Beige Book respondents describe the market as orderly, with oil producers and drillers renegotiating price rather than simply dropping rigs under the assumption they can be picked up later at even lower rates. However, there is a growing consensus that drilling has peaked for now.

PETROCHEMICALS

Petrochemical producers continue to suffer from high feedstock prices, weak demand and growing capacity coming onstream from projects planned two or more years ago. High natural gas feedstock prices have kept U.S. producers locked out of world markets. Exports were off 70 percent during the first half of this year, and profits remain poor. Respondents saw no improvement in demand for their product in recent weeks.

For more information, contact Bill Gilmer at (713) 652-1546 or bill.gilmer@dal.frb.org.

For a copy of this publication, write to Bill Gilmer, Houston Branch,
Federal Reserve Bank of Dallas, P.O. Box 2578, Houston, TX 77252.

This publication is available on the Internet at www.dallasfed.org.