



HoustonBusiness

A Perspective on the Houston Economy

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Poor Job Growth Impairs Texas Recovery

This article outlines reasons for the state's recent poor economic performance and concludes that any significant pickup in job growth is likely to be delayed until at least next year.

Over the past 10 years, private employment in Texas has grown at 2.8 percent per year, well ahead of the strong 2 percent performance turned in by the U.S. economy. Right now, however, both the U.S. and Texas economies are struggling to recover from the 2001 recession. Output growth is still too slow to convince employers to hire in large numbers.

Throughout the 1990s, three growth engines drove the Texas economy: oil and gas exploration, high tech and growing international trade, especially trade with Mexico. If one engine failed, it seemed the others were able to keep the ship moving forward. During the recent recession, however, all three engines broke down, and none of them has yet returned to full throttle.

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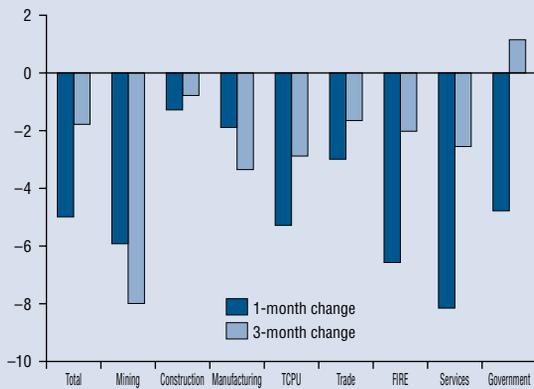
Poor Job Growth in 2002

After losing jobs through eight of the last nine months of 2001, Texas seemed to turn the corner in January 2002 with a solid gain in employment. However, the advances of early this year have slowly evaporated, and second quarter 2002 private employment averaged levels slightly below those of fourth quarter 2001. Through the first half of 2002, government and services were providing new jobs, while goods-related industries (as well as related trade, transportation and utilities) continued to lose them. This pattern weakened all year, however; by July only government had provided any new jobs over the prior three months, and no major industrial sector showed positive job gains during the month (*Figure 1*).

A similar pattern emerged among the state's major metro areas. Cities with the largest service and government sectors—San Antonio and Austin—held onto jobs better than the

Figure 1
Job Growth Weakens Across All Industry Groups, July 2002

Growth rate (percent)*



*Seasonally adjusted, annualized rate.

NOTE: TCPU is transportation, communications and public utilities; FIRE is finance, insurance and real estate.

SOURCES: Texas Workforce Commission; author's calculations.

rest of the state; they even registered overall job gains throughout the first half of 2002. By July, however, these cities had joined Dallas, Fort Worth and Houston in failing to produce new jobs over the prior three months. By July, weakness was widespread geographically, and all five cities saw job losses accelerate sharply.

Internal Engines Falter

Oil and Gas. Oil and natural gas drilling also has suffered. Drilling in the United States peaked in July 2001 at 1,293 working rigs. By March 2002 the rig count had fallen 43 percent. In April, the count seemed to turn, registering seven consecutive weeks of gains and improving by 121 working rigs, to 859. Then the count flattened out, and for the past 13 weeks it has averaged 848.

Natural gas dominates domestic drilling. It has accounted for 80 to 85 percent of all drilling activity in recent years. Recent starts and stops have been due to gas prices. Natural gas spot prices fell from \$3.49 in June to \$2.98 in July, where they remained through much of August. High natural gas

inventories are responsible for pushing prices down and raising doubts about the direction of gas prices. By mid-July, storage was 17 percent higher than the average over the previous five years. In recent weeks, however, hot weather has cut into the surplus. By late August inven-

tories had fallen to only 11 percent over the five-year average, and gas prices began rising slightly on speculation that the storage surplus would continue to ease through September.

Some producers have held back on drilling because of poor balance sheets, while others hesitate to risk their numbers, given current uncertainty over gas prices. Mild weather and record inventories will continue to retard drilling and leave the rig count in limbo, but a cold winter would almost certainly spark a strong upturn in drilling.

High Tech. Like oil and gas, high-tech industries in Texas seemed to have bottomed out early this year, with semiconductors and computer parts poised to turn. The best news in the first half came from semiconductors, whose sales in the Americas rose 16 percent between November 2001 and May 2002 after plunging 61 percent since mid-2000. Data from the national income accounts for the first half of 2002 confirm a moderate, broad-based advance in spending for information technology equipment and software, which rose at a 7.5 percent annual rate. However,

more recent data on factory orders indicate this equipment demand has been vacillating. Spending was down 10 percent in June and then up 14 percent in July, and tech inventories have begun to climb again. The order slowdown quickly fed back into semiconductor sales in June, reducing them by 1.6 percent.

Telecommunications equipment seems to have finally found bottom, but this sector has little chance for a quick rebound. The deteriorating financial health of four major telecom services providers offers little hope of a sustained turnaround in capital spending. Again, high technology in Texas, like oil and gas exploration, had a promising start in 2002, but it has turned increasingly tentative with time.

Trade. Maquiladora employment growth in Mexico was an important part of the 1990s boom along the Texas border. In the 10 years leading up to the October 2000 peak in maquiladora employment, the four Mexican states bordering Texas (Chihuahua, Coahuila, Nuevo León and Tamaulipas) added 420,400 new factory jobs, a 143 percent increase. The combination of cross-border traffic generated by the maquilas, plus the location of numerous manufacturing suppliers such as metal stampers and plastic injection molders on the U.S. side, fueled rapid growth in Texas border cities.

The U.S. recession hit northern Mexico's maquiladora belt from several directions: Closely linked U.S. manufacturing was the hardest hit part of the U.S. economy, the important U.S. market for maquila products dwindled, and Mexico itself imported the U.S. recession

and suffered through five quarters of negative growth. Throughout Mexico, 288,000 maquila jobs were lost, 130,000 of them in Texas-border states. The U.S. economy began to grow again in late 2001, however, and the Mexican economy registered positive growth in the first two quarters of this year, at 1.4 and 5.8 percent annual rates, respectively. Maquila employment and exports followed upward in April and May, and solid job gains are now being registered in all four Texas-border states.

So far, however, the growth on the Mexican side has yet to show up in border cities on the Texas side in jobs related to retail trade, transportation and manufacturing.

Looking Forward

The three growth engines discussed above all heavily influence the state's manufacturing sector. The strongest signs of a national recovery this year have been gains in manufacturing, measured, for example, by six increases in industrial production and the purchasing managers index. Texas industrial production, in contrast, is down 0.5 percent over the past six months, and the manufacturing component is off 1.1 percent. The state has lost 20,500 manufacturing jobs in 2002, with losses coming in every month (*Figure 2*). The purchasing managers indexes for Texas metropolitan areas indicate expansion in Dallas and weak expansion in Houston and Austin.

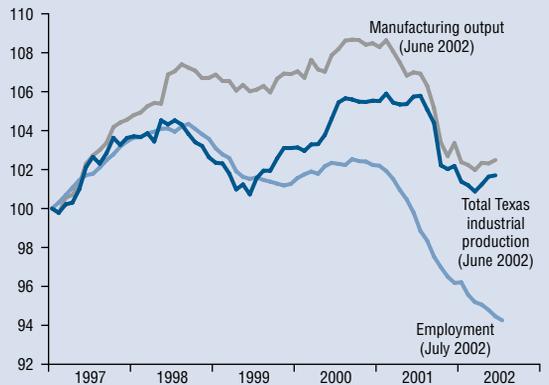
Unable to generate growth internally, Texas could use some help from outside the state—most specifically a kick-start from the U.S. economy. Rapid U.S. growth would keep

the Mexican economy on track, increase demand for oil and gas, and spur investment in high-tech goods. By most measures, the U.S. recession probably ended in fourth quarter 2001, and we can see scattered signs of the national economy's improvement throughout Texas: the Mexican turnaround, much-improved demand for petrochemicals on the Houston Ship Channel and better expansion in the diversified Dallas manufacturing sector than in other metro areas. However, the U.S. expansion has proven too slow to generate much more than weak growth in Texas.

Why so slow? First, the U.S. recovery was expected to be slow. It was not a deep recession, so the bounce-back should be proportional. Although recent data revisions show three quarters of decline in 2001—ending the debate over whether there was a recession—the data mostly tell us the inventory cycle was deeper and longer than expected. Final demand from business and consumers held up well throughout the recession, with only two quarters of slight decline. Part of keeping final demand strong was low interest rates, which maintained housing and auto sales throughout the recession at levels that normally would correspond to healthy expansion. Historically, housing and autos have been ingredients of big recoveries but won't contribute much to this one.

Figure 2
Texas Manufacturing Remains Weak

Index, January 1997 = 100



SOURCES: Texas Workforce Commission; Federal Reserve Bank of Dallas.

Although the advance report on second-quarter GDP was disappointing, at only a 1.1 percent annual growth rate, it contained positive news: Inventory cutting seemed to be coming to an end, business investment grew for the first time in two years and recent declines in the dollar exchange rate make it unlikely that the 1.8 percentage points lost to foreign trade will be repeated going forward. All in all, the U.S. expansion is shaping up as a slow recovery—perhaps a repeat of the jobless recovery of the early 1990s—and not a double-dip recession.

The slow recovery means limited growth and few jobs for Texas until the U.S. expansion gains momentum. The Texas Leading Index has been flat since January, consistently signaling sluggish growth ahead. Texans simply need to show some patience in waiting for the job market to heat up again. The state's historical advantages of a young labor force, good business climate, low costs and strategic location remain in place. As we put the excesses of the 1990s behind us, we can expect both the U.S. and Texas economies to return to high levels of performance.

Houston's job market weakened slightly over the summer, giving back the few thousand jobs it had managed to add over the first half of the year. With the U.S. economy growing slowly and drilling activity moving sideways, only scattered signs remain that the local economy is making any progress. These include increased demand for chemicals on the ship channel and four straight months of weak expansion, indicated by the Houston Purchasing Managers Index. Beneficial effects of the U.S. recovery should spread through the local economy the rest of this year, but the drilling outlook depends on natural gas inventories and weather.

Retail and Autos

Retailers continue to report sales falling short of plan in recent weeks. The sales tax holiday was disappointing, with most stores failing to match last year. Discounters and specialty stores are finding it easier to meet sales plans than furniture and department stores. Inventories remain under control.

Auto sales did not reach their post-Tropical Storm Allison highs of July 2001 but did achieve the second-best July ever. Sales were down 8 percent for the month, and year-to-date sales are off 4 percent.

Energy Prices and Drilling

Spot crude oil prices remained mostly in a range of \$26–\$28 per barrel in recent weeks, except for a brief spike over \$30. Fears of war with Iraq, falling Iraqi oil output

and tightening inventories have supported crude prices, with the “war premium” variously estimated at \$2–\$6 per barrel. Prices fell back under \$30 with Saudi guarantees of wartime supplies.

Natural gas prices have mostly remained near \$3 per thousand cubic feet, with rising oil prices supporting gas prices and high inventories pulling them down. With summer weather ending, natural gas inventories will probably begin the heating season at record highs.

Uncertainty over the direction of natural gas prices has kept drilling flat, with the number of working rigs in the United States unchanged over the past 13 weeks. Following seven weeks of increases in April and May, producers have now turned cautious because of uncertainty about natural gas prices and inventories.

Refining and Oil Products

In mid-July, a series of unplanned outages constrained production and briefly pushed up wholesale gasoline prices. Otherwise, wholesale and retail gasoline prices remained stable in recent weeks, held down by high gasoline imports. Crude runs on the Gulf Coast were stable at 94 to 95 percent of capacity. Refiners' margins were unchanged, remaining low. The price of heating oil has begun its seasonal rise.

Petrochemicals

Demand growth for chemicals slowed sharply in recent weeks as a long period of inventory restocking came to an end. Demand remains strong, however, because fundamentals from housing, autos and the economy have kept product moving. Prices continued to rise for polyethylene, polypropylene and polyvinyl chloride, but the general upward pressure on chemical prices seems to have eased. For ethylene, overcapacity remains a problem; price fell slightly in recent weeks, and spot price remains below contract.

Real Estate

Houston's new-home market softened in July, dropping 5 percent. The existing-home market, however, hit a record for July, as low interest rates continued to attract buyers. In both cases, the market has shifted sharply away from upscale properties, and sales are increasingly concentrated at the starter-home level.

Vacancy rates for downtown Houston office space will bump way up this fall when Enron Center South is auctioned off and enters the statistics. Quoted rental rates have already fallen by \$2–\$3 per square foot, and effective rates are falling much faster. Weakness is spreading to the Galleria and West Houston areas.



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