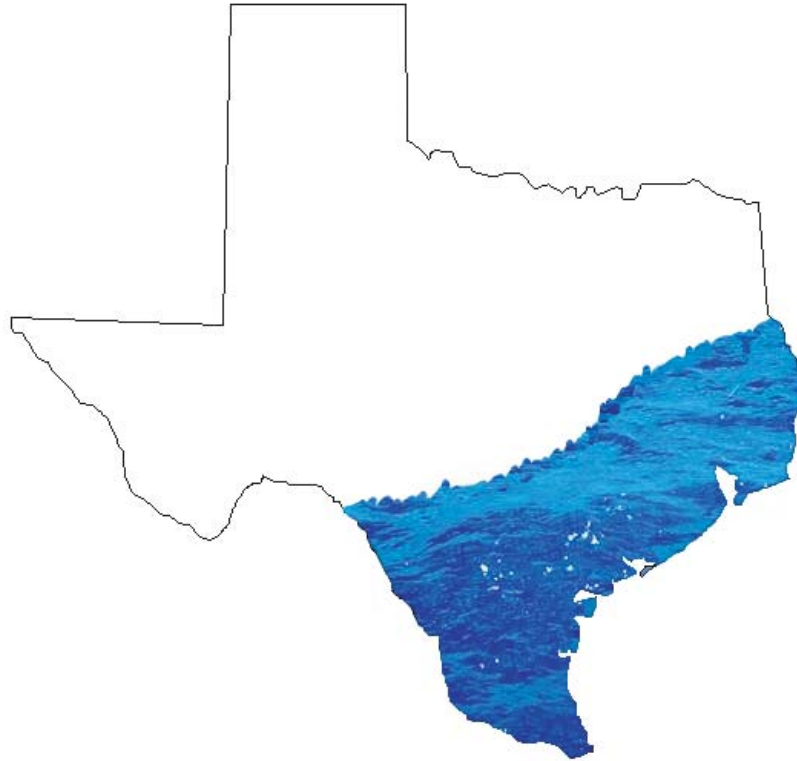


The Unsinkable Texas Economy Takes on Water



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January 2002

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As you all know, the U.S. economy officially entered a recession in March 2001. Even as the U.S. economy began to slow down and then slip downward, the Texas economy continued to expand. The ability of the Texas economy to remain buoyant as the national economy slipped into a recession, led many people to call the Texas economy “unsinkable.”

More recently, however, the Texas economy has begun to take on water. The questions we want to address today are: What accounts for the Texas economy’s buoyancy? How much water have we taken on? To what extent did the terrorist attacks of 9/11 affect the Texas economy? and What are the prospects for smooth sailing in the near future?

Texas Usually Outperforms the Nation

Over the past decade, Texas employment has expanded at a faster rate than the nation’s (Figure 1). U.S. employment has grown about 2 percent annually. In contrast, Texas employment has grown about 3 percent annually. In fact, the Eleventh District economy outperformed all other Federal Reserve Districts during the most recent expansion (Figure 2).

As shown in Figure 3, the Eleventh District economic performance was consistent throughout the expansion. The Eleventh District began the expansion with a relatively fast start in comparison to other Federal Reserve Districts. From the mid 1990s onward, however, the Eleventh District really began to extend its lead. As we can also see, the Eleventh District economy has slowed less than those of most other Federal Reserve Districts.

Figure 1

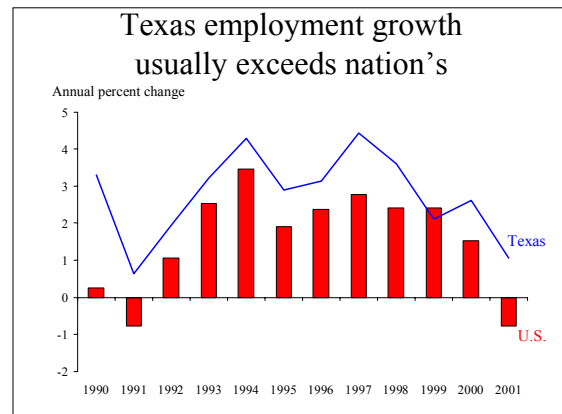


Figure 2

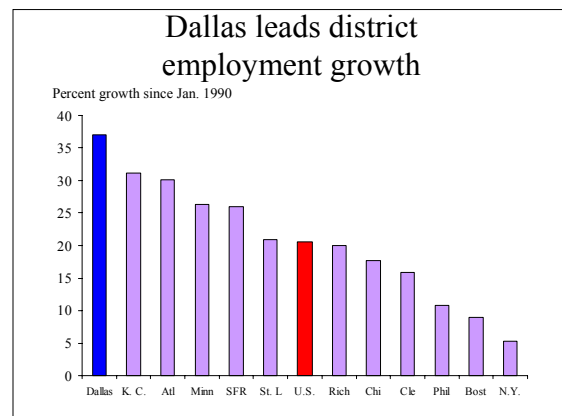
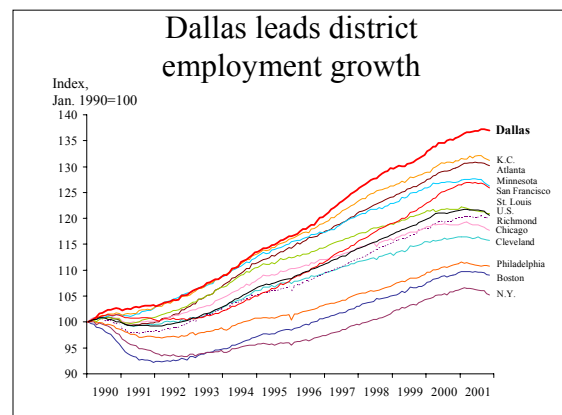


Figure 3



A number of factors contribute to the faster growth and buoyancy of the Texas economy over the past decade. For one, Texas has a superior mix of industries. It has larger concentrations of the faster growing industries. The mix of industries explains 40 percent of the differential in the growth rates between Texas and the United States. The Texas energy industry has also helped by acting to diversify the portfolio of industries in the state.

Texas has a faster population growth. About half is due to high birth rates and low mortality rates. Half is due to in-migration. In-migration is the result of economic opportunities and a general shift of the U.S. population to South and West.

Texas has a low cost of living and doing business. Texas also has a relatively attractive state and local government policy. Texas is a small government state, and the mix of taxes and spending generally supports economic growth.

The Current Recession

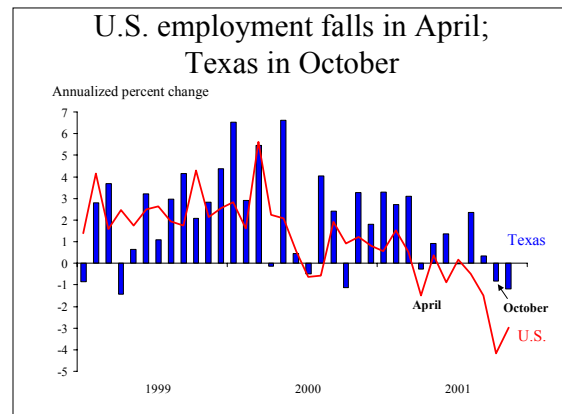
Like the nation's economy, the Texas economy has been slowing since early 2000 (**Figure 4**). Nonetheless, the Texas edge is evident in the current recession. U.S. employment began falling in April last year. Texas employment fell in April, but it did not begin falling on a sustained basis until October.

A number of factors have contributed to a weakening of the Texas economy. Slowing U.S. and world economies weakened markets for goods produced in Texas. The recession started in high-tech industries. The high-tech recession was brought about by overestimated profits and distortions in investment spending that resulted from Y2K. With large concentrations of high-tech firms in Dallas and Austin, this downturn hit us hard.

The recession spread to manufacturing and was particularly evident in economic activity along the Texas-Mexico border. Weakening world economic activity has reduced world energy demand and put downward pressure on energy prices, negatively affecting the region's energy industry. In mid-2001, even construction—a consistently fast-growing industry in the region—began showing signs of slowing.

In looking at how the slowdown began in Texas, it is instructive to look at the distribution of high-tech jobs (**Figure 5**). The Dallas-Fort Worth and Austin areas account for more than three-fourths of Texas' high-tech employment. With a smaller employment base, Austin has the highest concentration of high-tech jobs in the state. It is not surprising that Austin is where reports of weakening economic activity first surfaced in Texas.

Figure 4



As a result of the declines in high-tech, of the major metropolitan areas in Texas, Dallas and Austin have seen the sharpest increases in unemployment rates (**Figure 6**). Despite these recent gains, the unemployment rates remain below those of the past decade. In recent years, the Austin unemployment rate had fallen to unbelievably low levels.

In late 2000, Texas exports began to fall as the world economy weakened (**Figure 7**). Falling exports to Mexico made a prominent contribution. Mexico accounts for nearly half of Texas exports, and exports to Mexico began falling in mid-2000. Exports to most other country groupings began falling later in 2000.

Figure 6

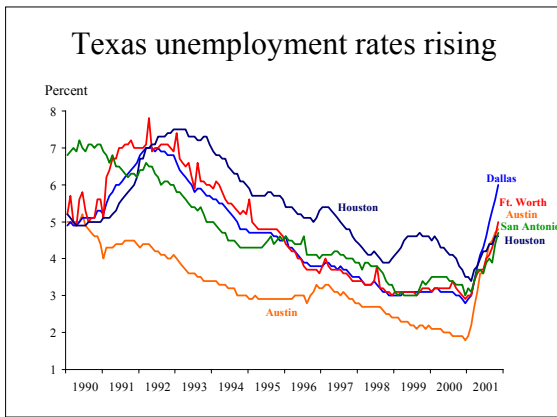
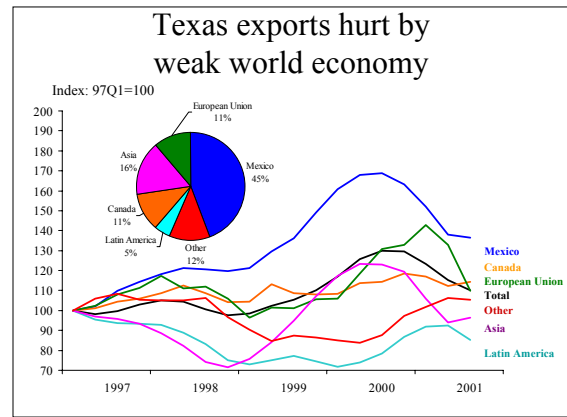


Figure 7



Prior to the weakening, the border had been a source of strength in the Texas economy. Since 1998, we have had what could be characterized as a ‘border boom’ with border job growth outstripping growth in the rest of the state (**Figure 8**). Among the most encouraging trends during this growth spurt were gains in border per capita income—income that had been stagnant for decades.

With weakness in manufacturing spreading to production plants in Mexico, however, maquiladora employment began to drop late in 2000 (**Figure 9**). The rate of decline accelerated in 2001 and by year end, maquiladora employment had shrunk by over 200,000 jobs.

Figure 8

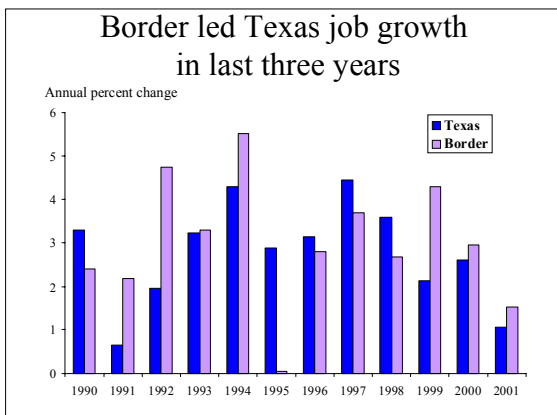
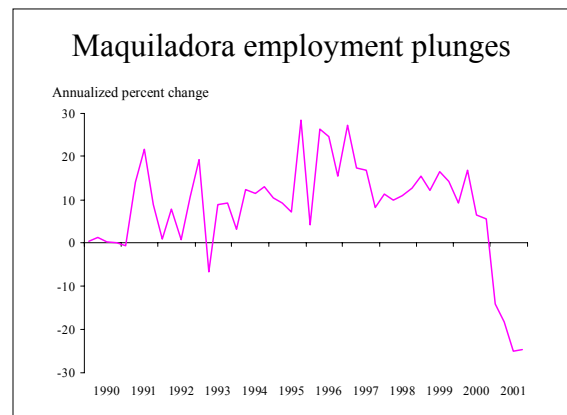


Figure 9



The boom had brought about record declines in the border unemployment rates, but the weakening maquiladoras and a troubled Mexican economy caused unemployment in Texas border cities to begin rising again in 2001 (**Figure 10**).

Border crossings between Mexico and the U.S. are another measure of economic trade and well-being along the border. With the slowdown in the economy, border crossings began falling in the spring of 2001 (**Figure 11**). Border crossings suffered another hit with the events of 9/11.

In the days following, border bridges were subjected to repeated bomb threats and many had to be closed for hours on end. Since then, increased security measures implemented after the terrorist attacks have led to lengthy delays and kept thousands of Mexican shoppers away from border retailers. Border crossings fell sharply in September and have remained well below last year's levels. Retail sales in El Paso have fared a little better because Mexican shoppers, while making fewer trips, are purchasing more on each trip.

The Effects of the 9/11 Terrorist Attacks

As in the nation, the terrorist attacks of September 11 have pushed Texas toward recession. As Evan Koenig said in November, the attacks further weakened the U.S. economy. Weakening U.S. economic activity further hurt markets for Texas-produced goods, and delayed a potential high-tech rebound. Weakening economic activity also contributed to further declines in energy prices. In addition, the airline industry was one of the most greatly affected industries, and Texas is more exposed to the airline industry than the nation as a whole.

Texas employment growth slowed in September (**Figure 12**) (a month for which the data would not reflect the events of September 11). Texas employment fell in both October and November. This is the first two-month consecutive drop in Texas employment since 1991. Our intelligence gathering suggests to us that December data are also likely to show falling employment for that month.

Figure 10

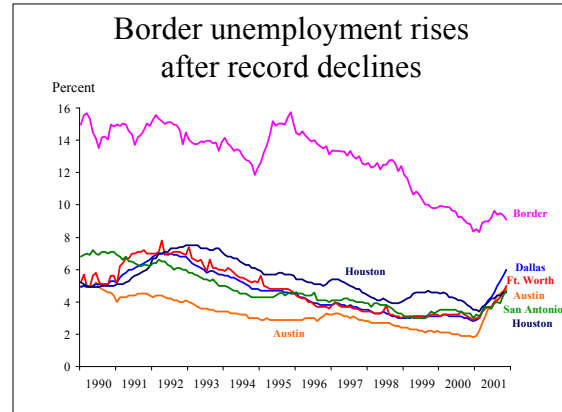


Figure 11

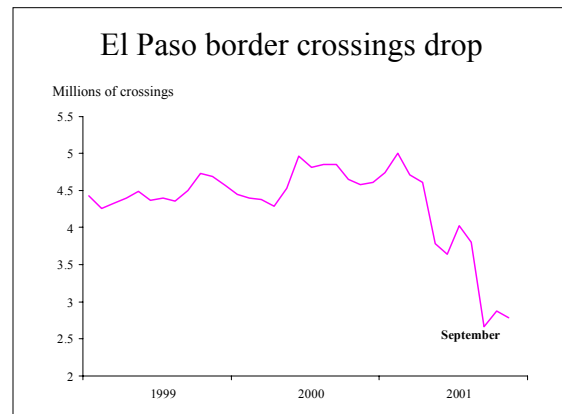
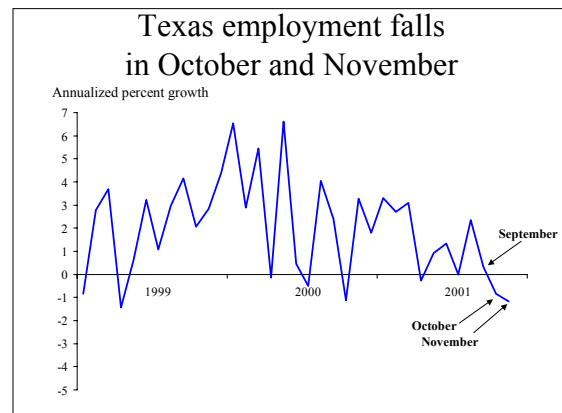


Figure 12



A Texas Recession?

Looking at a broader measure of Texas economic activity, the Texas coincident index, we see that Texas economic activity has been slowing since early 2000 and declining since July (Figure 13). (The coincident index combines employment, unemployment and gross state product.) Economists distinguish between recessions (in which economic activity declines) and growth recessions (in which economic activity stagnates). Typically, an economy appears to be in a growth recession before it is evident that it is in recession.

If we compare the current status of the Texas economy with past Texas recessions and past Texas growth recessions, we can see that Texas has at least entered a growth recession. It is quite likely that the Texas economy is in recession, but we do not yet have sufficient data to show that Texas has moved past a growth recession.

Declines in our index of Texas leading economic indicators, as shown in Figure 14, suggest that Texas economic activity will continue to decline through at least the current quarter. The leading index also suggests a high likelihood of recession. The index has declined about as much as it has in the previous two recessions, though less in percentage terms.

The leading index is made up of the nine components shown in Figure 15. These frequently reported series help predict later movements in broad measures of Texas economic activity. As is shown in the figure, all but one of the components declined in 2001.

Figure 13

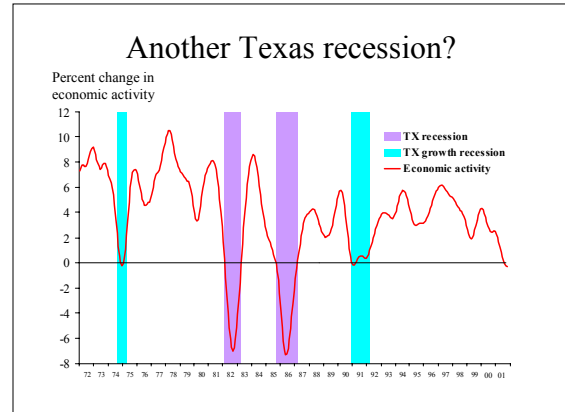


Figure 14

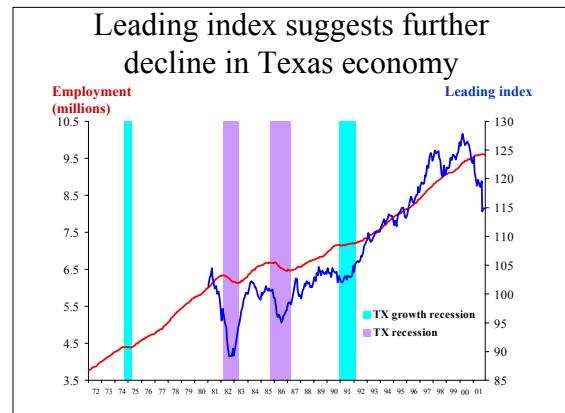
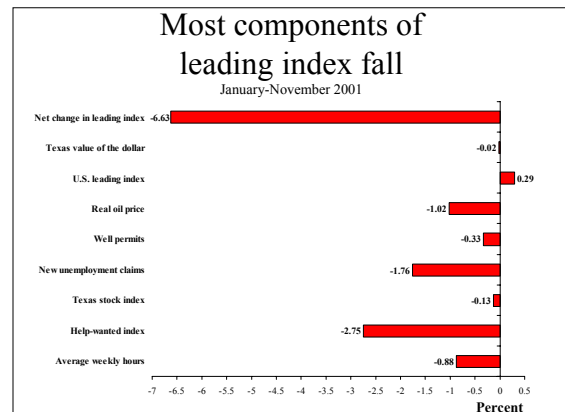


Figure 15



Texas Fiscal Condition Deteriorating

The economic slowdown affects the state government's fiscal picture. The state government is currently growing faster than the ability to pay. During the first eight months of 2001, state government expenditures grew by more than personal income. State government revenues did grow by more than spending, but only because strong energy prices boosted severance tax revenues.

With the economic slowdown and much lower energy prices than late 2000, the growth in state government revenue has slowed sharply since August. State sales tax revenue rose by only 0.2 percent from December 2000 to December 2001. Severance tax revenues were likely much lower for the last four months of 2001 than they were those same months a year earlier.

In the meantime, the pressure to increase expenditure is unlikely to ease. Spending on health and human services is growing rapidly. Capital expenditures have already been cut sharply.

The Texas Outlook

Given the current set of economic circumstances, we generally expect the Texas economy to move with the U.S. economy. If energy prices remain in their current range, the Texas economy should begin to resurface as the U.S. economy moves toward recovery. Given the greater buoyancy that the Texas economy has than the U.S. economy, the number of months with declining employment should be fewer. In general, we expect the current Texas recession to be milder than the most recent two.

This outlook has some risks. A sharp and sustained increase in energy prices would improve the outlook for the Texas economy while it hurt the nation's. Conversely, a sharp and sustained decline in energy prices would worsen the outlook for the Texas economy while it improved the nation's. Further terrorist activity in the United States could deepen and prolong the U.S. recession with negative effects on Texas economic activity.

Looking farther ahead, we expect the Texas economy to continue to outperform the nation's during the first decade of the 21st century. The factors that contributed to a strong economic performance over the past decade remain in place.