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Southwest Economy

Texas Economy Stalled by Recession

Texas followed the nation into recovery at the beginning of the year, but the state's job losses resumed in May, even as the nation continued its anemic recovery. The current Texas recession is shallower than previous ones but will probably last longer. The extent to which Texas remains in recession depends greatly on the strength of the national and global economies.

If we define recession as two consecutive quarters of negative employment growth coincident with gross state product (GSP) declines in at least one quarter, Texas went into recession in April 2001. Employment declined in the last three quarters of 2001, picked up in first quarter 2002, then declined again in the second and third quarters (*Chart 1*). The September employment numbers (the latest data available) show a slight decline of 0.4 percent (annualized) for total employment and a greater drop of 1.1 percent for private employment. Employment is down 1.7 percent (annualized) for the quarter and 0.2 percent (annualized) year-to-date.

Looking at output, the Dallas Fed's estimate of Texas GSP growth looks similar to U.S. GDP

(Continued on page 2)

The National Economy: Heading for a Dip?

The recession began in March 2001 and despite the events of September 11, appears to have ended the following November. How far have we come since November 2001? And where are we headed?

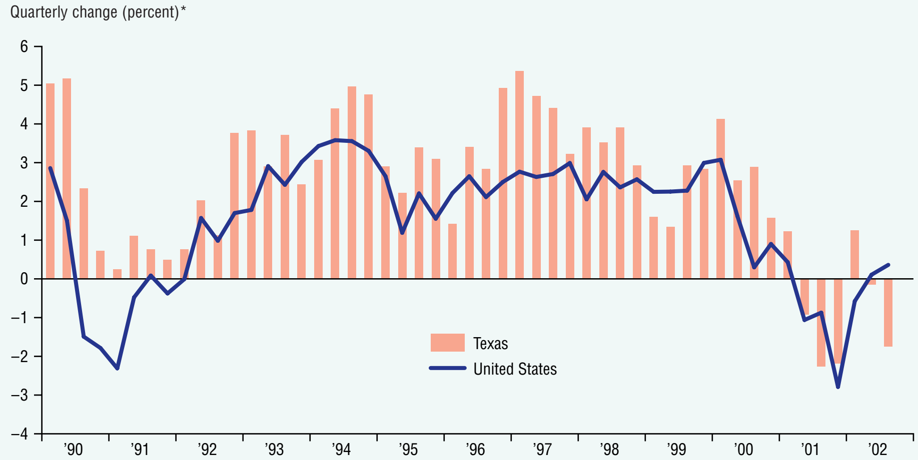
The key features of the apparent expansion have been slow growth in output and almost nonexistent growth in employment. The former is unsurprising, given the mildness of the 2001 recession. The latter, however, contrasts sharply with the usual pattern of post–World War II expansions. In terms of employment growth, the recovery from the 2001 recession is shaping up to be a repeat of the jobless recovery that followed the 1990–91 recession.

Troubling as the lack of job growth has been, more worrisome still is evidence that the pace of the expansion has cooled, beginning around July.

(Continued on page 9)

Chart 1

Employment Falls in Third Quarter



* Seasonally adjusted, annualized rate.

SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Texas has not yet emerged from recession.

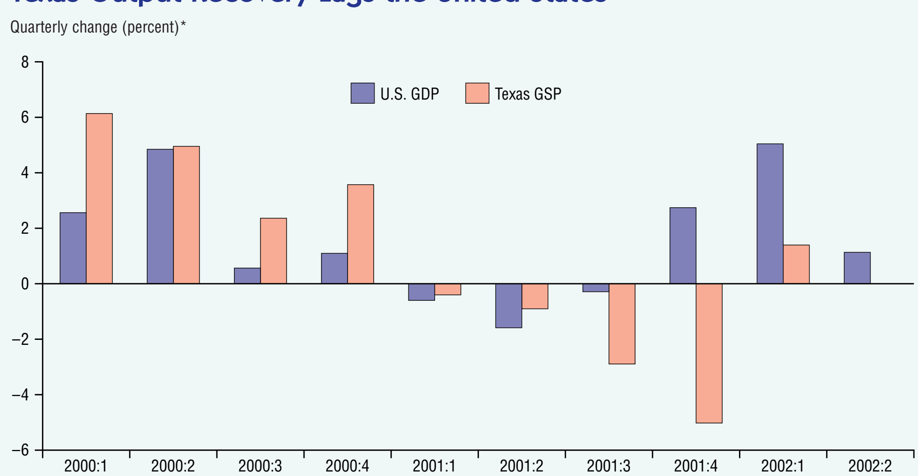
growth (*Chart 2*). Texas slipped into recession with the nation, registering negative GSP growth in the first quarter of 2001. However, in contrast to the United States as a whole, Texas continued with negative growth in the fourth quarter. Like the nation, Texas GSP grew in the first quarter of 2002.

The Dallas Fed's coincident index is a more general indicator than either employment or GSP growth. It tracks current economic activity by combining changes in employment, output and the unemployment rate. Chart 3 shows the index, along with the current and two previous Texas recessions.[1] When the index turns negative, it signals recession. As can be seen, the index is still in negative territory, implying that Texas has not yet emerged from recession.

Anecdotally, the most recent Beige Book—the Fed's survey of business conditions—suggests that economic growth declined in September and early October

Chart 2

Texas Output Recovery Lags the United States



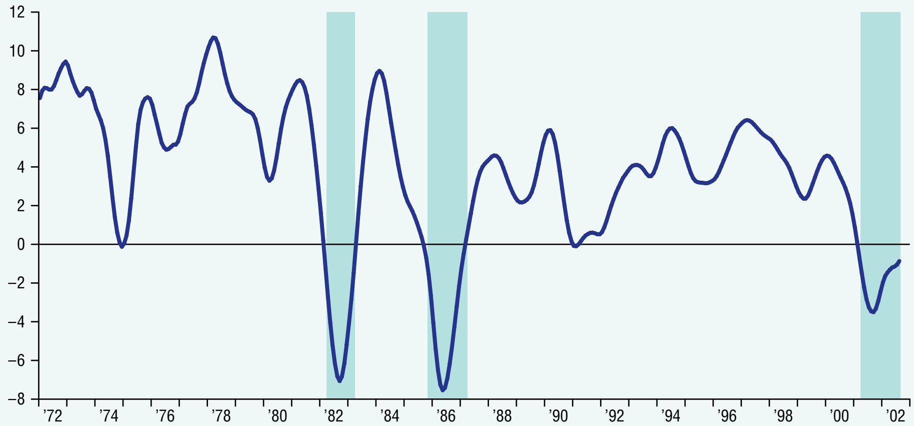
* Seasonally adjusted, annualized rate.

SOURCES: Bureau of Economic Analysis; Federal Reserve Bank of Dallas.

Chart 3

Texas Coincident Index Signals Continuing Recession

Monthly change (percent)*



* Seasonally adjusted, annualized rate.

NOTE: Shaded areas indicate recession.

SOURCE: Federal Reserve Bank of Dallas.

The Texas economy is bouncing along the bottom with slightly negative employment growth.

and that Texas' economy is slightly weaker than the nation's. Texas seems to be lagging the nation in recovery because we have a larger concentration of industries that suffered during this recession: transportation (effects of September 11), high tech (the telecom bust and beyond) and energy (weak oil and gas prices in fourth quarter 2001).

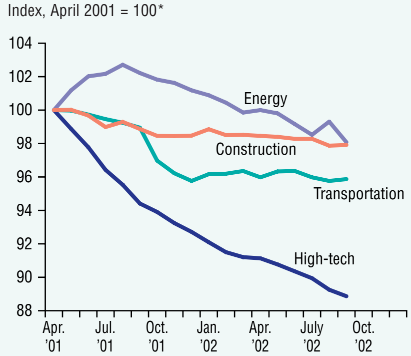
At the national level, the question is whether the U.S. economy will double-dip. However, in Texas a more relevant query is whether the state has even come out of recession. Given the unimproved employment situation, weak state output and negative index of coincident indicators, Texas is still in recession. The extent and pace of the national recovery will largely determine the rate of rebound in Texas economic activity.

Chart 4

Hardest Hit Sectors

Texas employment

Index, April 2001 = 100*



* Seasonally adjusted, annualized rate.

SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

What Are the Current Conditions?

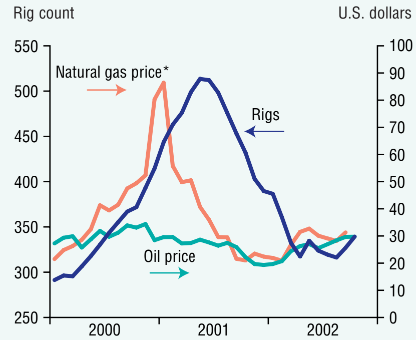
The Texas economy is bouncing along the bottom with slightly negative employment growth. Since April 2001, total Texas employment is down 1 percent and private employment down 1.7 percent. The downturn is broad-based across sectors. Manufacturing and mining have been hardest hit, with TCPU (transportation, communication and public utilities) following suit. Looking at more detailed data, the high-tech, transportation and construction industries declined most (*Chart 4*).

Transportation. The transportation sector was already in bad shape before September 11 and went into a tailspin after. Since April 2001, this sector has lost about 4 percent of its employment (15,300 jobs). Although the sector stabilized in 2002 as the national economy gathered strength, it is still weak and a long way away from prerecession levels.

Energy. The Texas oil and gas extraction sector has lost 4,900 jobs (3.2 percent of employment), and the Texas rig count has declined 28 percent—by

Chart 5

Drilling Follows Natural Gas Prices



* Natural gas price is multiplied by 10.

SOURCES: Hughes Tool Co.; *Wall Street Journal.*

Overall conditions in high tech remain bleak.

136 rigs—since April 2001 (*Chart 5*). This may seem surprising, given the current strength of oil prices. After hovering around $27 per barrel in the first eight months of 2001, oil prices fell nearly 30 percent at year-end. Prices climbed back after the first quarter of 2002 and reached $30 in August, largely because of rumblings of war with Iraq.

Drilling activity is following the natural gas market rather than the oil market these days; 86 percent of domestic drilling is for natural gas. The high levels of natural gas in storage (7 percent more than the five-year average for this time of year) have put downward pressure on drilling. After rising in September, the rig count declined again in October. Although natural gas prices have firmed up, the industry is afraid prices will collapse if we have a mild winter. The Beige Book has been reporting that weak balance sheets are keeping some producers from drilling aggressively. Overall, the price and investment picture remains murky in the energy sector.

High Tech. Overall conditions in high tech remain bleak, and employment continues to drop. Texas' high-tech sector has lost 45,300 jobs since April 2001, about 11 percent of total high-tech employment. High-tech manufacturing jobs have declined 4.4 percent year-to-date (*Chart 6*). The outlook seems to be softer rather than firmer, according to industry contacts. Activity is not expected to improve in the next six months, and recovery in telecom won't come until after 2003. Prospects for earnings growth are poor, keeping sales activity and equity prices in the cellar.

Going forward, several factors present downside risks for recovery. First, overcapacity continues to discourage investment in new equipment. Relatively new hardware available through bankruptcies and shutdowns is being sold at fire-sale prices, competing with sales of new equipment. Second, purchasing managers are still cautious about invest-

Chart 6

Texas High-Tech Bust in Manufacturing Employment

* Seasonally adjusted, annualized rate.

SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

ment, and spending budgets for new technology are constrained. This phenomenon has given rise to longer sales cycles and purchases in smaller increments. Finally, venture capital is still declining; venture capital funding to Texas firms in the second quarter of 2002 was down 73 percent from year-earlier levels.

Telecom employment, so vital to North Texas, has continued to drop. Jobs in telecom equipment manufacturing and telephone communications are down 6.6 percent and 5.4 percent, respectively, for the year. The Dallas/Fort Worth Metroplex Technology Business Council estimates that companies in the Richardson Telecom Corridor, which at the peak of the high-tech boom employed 80,000 tech workers, have shed 10,000 to 15,000 jobs in the downturn. Firms that recently laid off workers are reluctant to take on overhead but still have work outstanding, providing short-term (three to six months) contract work for displaced workers. Other laid-off workers have been absorbed by small and midsized companies that previously couldn't compete with exorbitant compensation packages.

The AeA Texas Council reports that while reductions in Texas high-tech manufacturing have been severe during the high-tech bust, software and computer services have not been as hard hit.[2] On the other hand, there are also reports that conditions among software companies in Austin have turned very weak in recent weeks.

Although global chip sales rose in August, they fell in the Americas, mainly because of weak computer and telecommunication equipment sales. New orders for computers and communications equipment were down in the Census Bureau's latest advance durable goods report, which does not bode well for the industry. The semiconductor equipment book-to-bill ratio fell below unity for the first time since February, signaling that new orders are not as strong as shipments.

Construction and Real Estate. Overall construction and real estate conditions have deteriorated in the past few months. The commercial situation remains weak, and previously strong sales in low-priced homes are softening. Strength in single-family housing held up the construction sector fairly well in 2002; the large employment losses came mainly in 2001. Construction employment is down 0.6 percent (annualized) for the year and down 1.3 percent since April 2001. About 10,000 jobs have been lost.

Nonresidential construction and real estate markets continue to decline. Office vacancy rates stand at 25 percent in Austin (up from 8 percent in first quarter 2001) and 26 percent in Dallas (up from 18 percent). Landlords are scrambling to land solid tenants in Houston, where the vacancy rate, currently around 16 percent, is expected to rise to the mid-20s within a year. Construction contract values for office, industrial and commercial properties have been falling since the end of 2001 (*Chart 7*). Rent concessions in commercial properties have persisted, and real estate contacts don't expect a turnaround anytime soon.

In reaction to the events of September 11, insurance premiums on some commercial real estate assets have risen 50 percent in the past year, exacerbating the negative environment in nonresidential real estate. In addition, hoteliers are still feeling the crunch of decreased business travel. Texas has the second-most delinquent hotel loans in the country—about $85 million. Three North Texas hotels have already closed in the past year, and industry observers expect more to follow. With new capacity brought on by recent hotel development, recovery in the sector won't be easy.

Despite weakness in the fundamentals, secondary real estate markets are abuzz with activity, and capital abounds for buying opportunities in commercial and multifamily space. After repeated pummeling in equity markets, investors seeking stability now welcome the predictable rental payments of strong tenants.

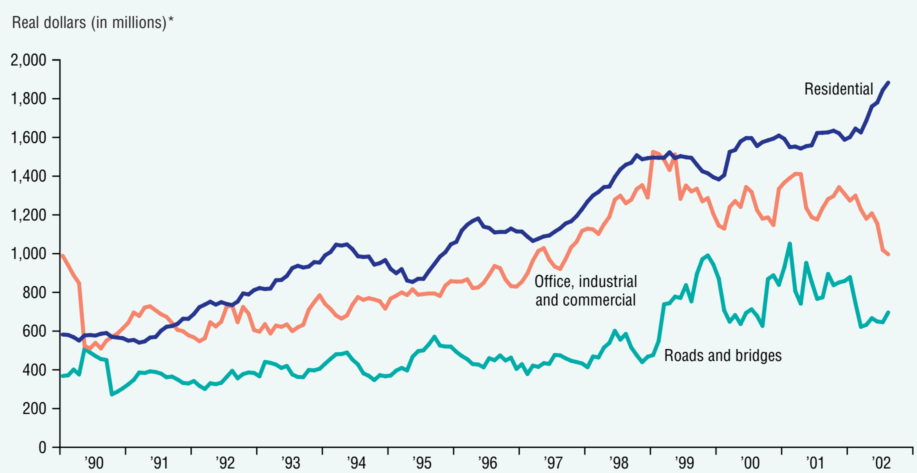
Texas single-family construction was held up by strength in the lower priced segment throughout the year. Construction contract values for residential properties shot upward in 2002 (*Chart 7*), and single-family permits trended up throughout the year because of very strong sales of homes priced below $150,000. However, some weakness has appeared in the past month. The lower-end market has attenuated in recent weeks, despite low mortgage rates. Some contacts have noticed a significant change in momentum in the Dallas/Fort Worth metroplex, and cancellations have increased in Houston.

Exports. Exports picked up in the first quarter of this year for the first time since mid-2000. Total exports were flat in the first quarter but rose 10 percent in the second. Exports were up for all trading partners except Latin America (excluding Mexico). Exports to Asia were

Chart 7

Residential Construction Strong, Office Segment Still Weak

Texas construction contract values



* Seasonally adjusted, five-month moving average.

SOURCE: McGraw Hill Construction/F.W. Dodge.

Table 1

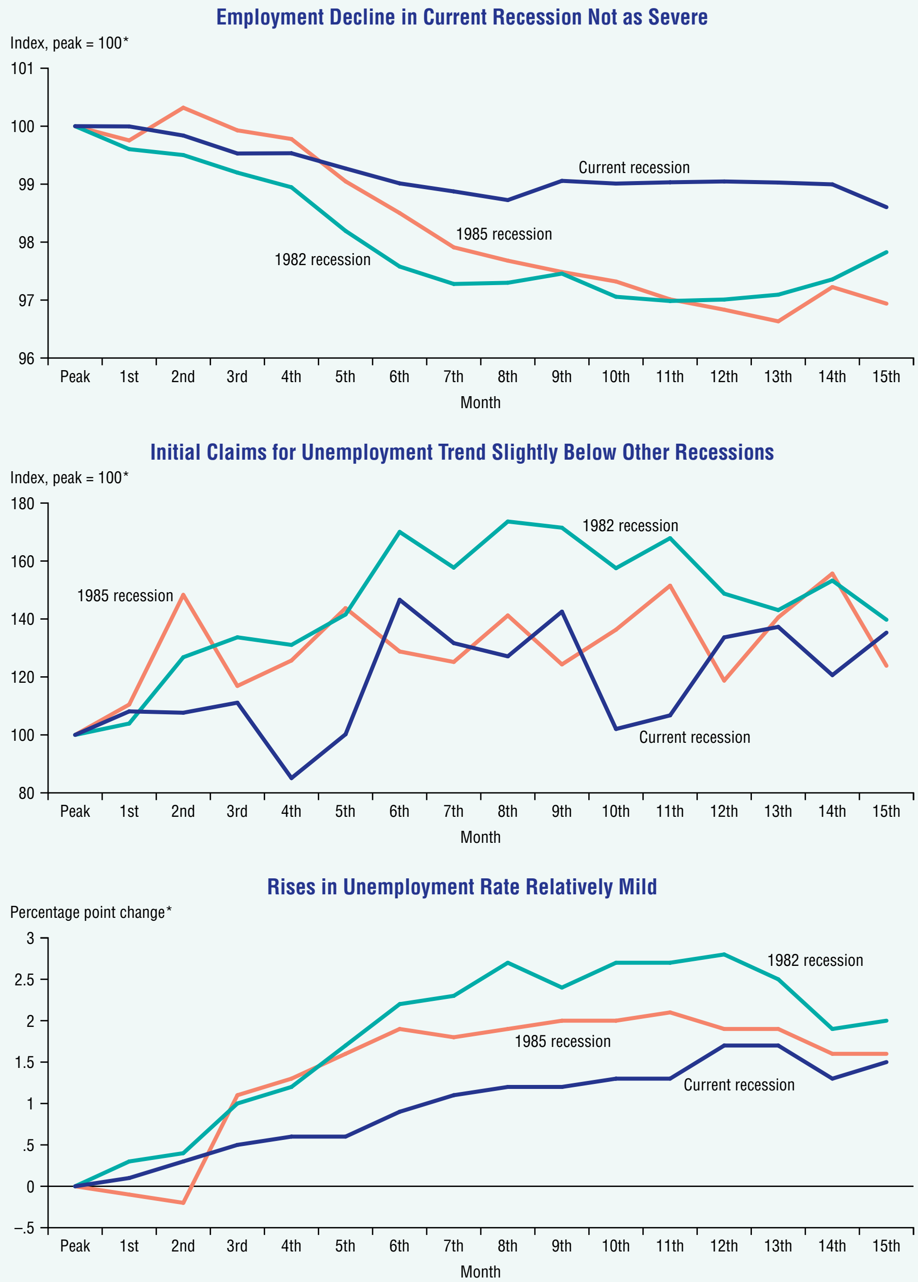
Three Texas Recessions

	1982 Recession	1985 Recession	2001–02 Recession
Duration	12 months	17 months	18 months and going
Change in employment	–3 percent	–3.1 percent	–1 percent (September)
Change in gross state product	–1.1 percent	–5.9 percent	–2.3 percent
Change in unemployment rate	2.8 percentage points	2.1 percentage points	1.7 percentage points

The current Texas recession is shallower than previous ones.

Chart 8

Labor Markets



* Seasonally adjusted.

SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

particularly strong, increasing 17 percent. Exports to Canada and Mexico increased 7 percent. (See "Beyond the Border" on page 19 for details.)

How Does This Recession Compare with Previous Ones?

Using changes in employment and GSP to date recessions, we compare the current recession with those of 1982 (lasting from April 1982 to March 1983) and 1985 (November 1985 to March 1987). The current Texas recession started in April 2001 and is not over yet. Table 1 compares key characteristics of these three recessions. Other differences between the current and previous recessions are seen in various economic indicators.

Employment. The current recession has been shallower than the previous two in terms of employment (*Chart 8*). Initial unemployment insurance claims are also at a relatively lower level in the current recession, and the unemployment rate has not climbed as much.

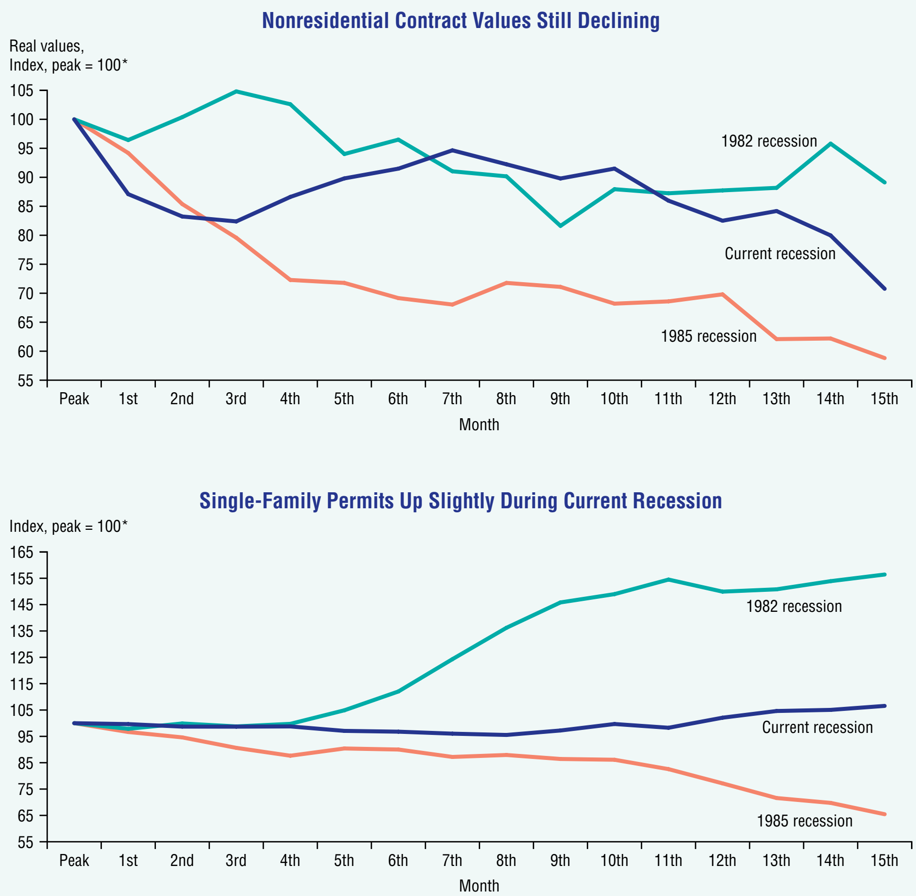
Gross State Product. GSP growth became positive after three negative quarters in this recession; it took longer to turn during previous recessions. GSP has dipped 2.3 percent in the current recession but fell almost 6 percent in 1985. Although the 1982 recession was more severe in all other aspects, GSP growth did not suffer as much.

Construction. Chart 9 shows that the office and industrial construction sector has declined substantially in the current recession, although not as severely as in the real estate bust of the mid-1980s. The nonresidential sector held up pretty well

The current Texas recession started in April 2001 and is not over yet.

Chart 9

Real Estate Conditions



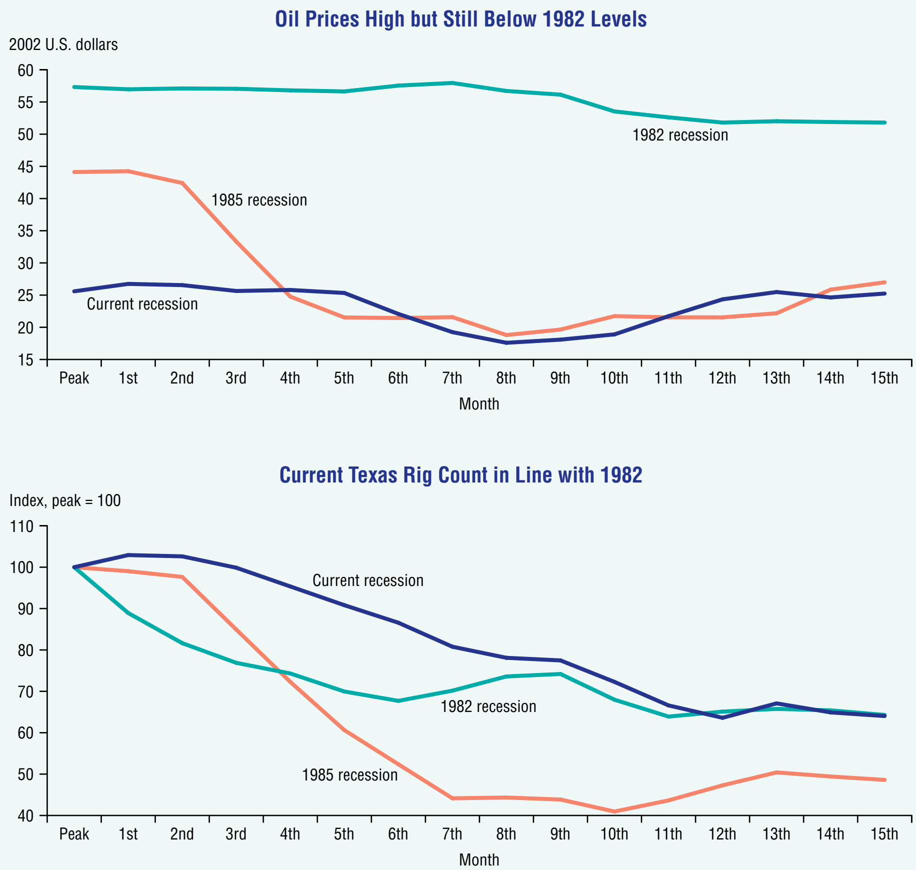
* Seasonally adjusted, five-month moving average.

NOTE: Normalized by Texas population.

SOURCES: McGraw Hill Construction/F.W. Dodge; Census Bureau.

Chart 10

Energy



SOURCES: *Wall Street Journal*; Hughes Tool Co.

during the 1982 recession because of the Economic Recovery Tax Act of 1981, which gave favorable tax treatment to commercial property.

Single-family housing has kept the construction sector going in this recession. Housing also continued strong during the 1982 recession. This was part of what some academics called "the lending frenzy," spurred by several events that gave financial institutions a large pool of available funds to lend to real estate investors.[3]

Energy. Although prices dipped to $19 per barrel at the end of 2001, they have been relatively stable near $26 per barrel since April (*Chart 10*). In real terms, current prices are near the 1985 oil-bust levels. Oil prices were relatively stable during the 1982 recession after falling from highs of $37 per barrel to around $30 per barrel. Prices remain about half what they were during the 1982 recession (about $55 per barrel in today's dollars).

The rig count fell 53 percent with the collapse of oil prices in 1985. It fell 36 percent in the 1982 recession. Although oil prices have been relatively strong in this recession, the rig count has declined about 32 percent from its peak.

In sum, this Texas recession is shallower but will probably last longer than previous ones. Even though the energy sector has fared poorly, it has still bested its performance in earlier recessions. It didn't help Texas, but it didn't hurt the state either.

Where Do We Go from Here?

The general consensus is that the nation came out of recession at the end of 2001. It is hard to reach such a consensus for Texas. Employment growth has been negative since May, but the rate of decline has been very close to zero. The Fed's most recent survey of business conditions notes that economic growth declined in the region in September and early October. The leading index, which forecasts economic activity in Texas three to six months ahead, has been on a downward trend since April 2002, implying weakening economic activity. Texas fared somewhat worse than the nation in employment losses because the state has a larger share than the national average of the industries hit in this recession, such as high tech and transportation.

The outlook for Texas depends very much on the health of the national economy. If the U.S. economy double-dips, the Texas economy will be stalled in recession for some time. If the U.S. economy picks up, however, we could see Texas also turning the corner early next year.

—Mine K. Yücel
John Thompson

Yücel is a senior economist and assistant vice president and Thompson is an assistant economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

1. The Texas Coincident Index was developed and is maintained by Keith R. Phillips of the San Antonio Branch of the Federal Reserve Bank of Dallas.
2. Texas Council AeA, News Release, Dallas, June 26, 2002.
3. One such event was passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, which phased out interest rate ceilings on time and savings deposits. The second was the Garn–St. Germain Depository Institutions Act of 1982, which created the money market deposit account.