Economic Slowdown Affects U.S. and Texas Economies

The ongoing slowdown in economic growth in the United States and across Texas is led by international trade and manufacturing but tempered by construction, which has been stimulated by lower interest rates. Houston has been hit harder than Texas and the rest of the nation because of its ties to oil, commodity chemicals and international trade, but the local slowdown is part of a pattern of economic problems spreading out of Asia. Despite the weakened economic performance, the nation and much of Texas can still expect reasonably healthy growth in the months ahead. However, the risks to continued economic expansion—a shock from unforeseen international events, for example—have grown in recent weeks and months.

Expansion Continues

The U.S. economy has begun to slow, although this deceleration begins from a very high rate of growth. Six consecutive quarters of annualized growth of gross domestic product (GDP) in excess of 3 percent culminated in 5.5 percent growth in the first quarter of 1998, before falling to 1.8 percent in the second quarter. There are numerous qualifications to the strong first-quarter GDP figure (inventory buildup, for example) and the weaker second quarter (inventory drawdown, the General Motors strike). It is probably simplest to average the two and acknowledge that the first half of 1998 experienced very strong, 3.7 percent growth.

However, the advance data for third-quarter GDP growth confirm a likely slowdown, with growth running at only 2.3 percent apart from a large buildup in inventories. The chief source of
weakness is the manufacturing sector, where the third-quarter index of industrial production was essentially flat after an increase of 1.7 percent in the second quarter. The National Association of Purchasing Management produces a widely watched index of activity in U.S. manufacturing that uses a dividing line of 50 to indicate expansion (above 50) or contraction (below 50). This index slipped below 50 in June but has since remained between 49 and 50, values that indicate negligible decline in manufacturing. The benchmark for recessionary conditions in the U.S. economy would be an index that falls below 43.6 for a prolonged period.

Meanwhile, despite two years of GDP growth that has averaged over 3.5 percent, prices are subdued. The producer price index shows no sign of inflation buildup in the production pipeline, as the Asian recession and a strong dollar hold down the prices of chemicals, computers, oil and many other commodities. The Consumer Price Index has risen only 1.4 percent over the past 12 months, although cheaper food and oil have curbed the increase, with core inflation (excluding food and energy) up 2.4 percent.

Many of the forces of change weaving their way through the U.S. economy can be traced to last fall’s Asian crisis and the global financial turmoil that ensued. The Asian recession itself has turned out to be much worse than anticipated due to structural weakness in Asian financial systems, the recession in Japan and the general compression of Asian trade flows as regional trading partners saw economies collapse around them. Defensive actions by some developing nations in Eastern Europe and Latin America—such as raising short-term interest rates to protect their currencies—have slowed their growth. The world’s advanced economies have not proven immune to these Asian problems. In October 1998 the International Monetary Fund (IMF) forecast the world’s advanced economies would experience GDP growth of 2.9 percent this year, but the IMF now says they will close out 1998 with only 2 percent growth—and with the prospect of only 1.9 percent for 1999. For the world as a whole, the IMF forecast 1998 growth of 4.3 percent but has revised its estimate to less than half that amount—2 percent—with 2.5 percent projected for next year.

As global economic stress has spread to Russia and Latin America, capital has fled the developing world, strengthened the U.S. dollar, made imports cheap and made it harder for American companies to export. The U.S. trade deficit, measured by exports minus imports, has reached record levels and presents a source of domestic weakness that is not expected to turn around soon. At the same time, falling domestic interest rates have stimulated investment in housing and business, providing a partial and continuing offset to trade-induced weakness.

Looking ahead, our best estimate is a return to U.S. trend growth near 2 percent to 2.5 percent through 1999. This retreat from the rapid pace of the past two years is normal and probably a healthy development for long-term U.S. growth. What has changed in recent months is not so much the likely trend growth path for the U.S. economy but the prospect that this growth could be blindsided by unanticipated international financial problems. Russia’s financial collapse and its default on sovereign debt, for example, have raised the markets’ aversion to risk and increased the probability that a spreading financial crisis could reach the United States—with the most direct and damaging route being through Latin America. Unfortunately, our ability to foresee and forecast contagion effects from financial crises is practically nil.

**ACROSS THE STATE**

If the economy was good in the United States in 1997, it was better in Texas. Payroll employment in the United States grew 2.6 percent between 1996 and 1997, for example, while it rose 4.3 percent in Texas. Mining employment in Texas increased 6.5 percent, led by oil and gas extraction. Durable manufacturing jobs rose 4.3 percent, construction jumped 5.7 percent, and wholesale and retail trade increased 3.2 percent. Over the first nine months of 1997, Texas wage and salary jobs were up 3.2 percent; but so far in 1998, they have grown a more modest 2.3 percent.

The situation in the United States holds for Texas—trade-induced weakness in mining and manufacturing, partially offset by the effects of falling interest rates. Like the nation, the Texas economy is downshifting to more normal speeds.

- The Texas unemployment rate remained at 5 percent in September, tying June and August as the highest rates of 1998
but staying below the 5.4 percent average for all of 1997.

- The Texas Industrial Production Index has been nearly flat since June. During the six-month period from April to September 1997, the Texas economy added 13,100 jobs in durable manufacturing and 6,300 in mining. The comparable figures for 1998 are 3,300 and –2,700, respectively.

- The Texas Leading Index has declined slightly every month since February, consistently pointing to slower growth ahead. The key factors pulling the index down have been a strong dollar, the lower real price of oil and fewer well permits.

- Low interest rates and the need to catch up with the extraordinary expansion enjoyed in 1997 have kept Texas construction activity high, especially residential construction (Figure 1).

Table 1 summarizes this situation in a different way, showing annualized growth rates for wage and salary employment for Texas and several of its largest cities. Together, Houston, Dallas, Fort Worth and Austin account for well over half the jobs in Texas. The table shows annualized growth rates for three six-month periods for mining, manufacturing, construction and total employment. In Texas, both six-month periods prior to April 1998 were quite strong, with more than 4 percent total job growth, but since April job growth has fallen to only 2.6 percent. Mining employment has declined in the most recent period, and manufacturing has come to a virtual standstill. Construction job growth has weakened in the most recent six-month period to 3.8 percent, but it is still growing faster than the total.

The picture across the four cities is similar. Houston employment growth has gone from fastest (5.6 percent) to slowest (1.9 percent) over the past 18 months, a result that should not be surprising given the city’s dependence on oil, commodity chemicals and international trade. Houston’s local version of the Purchasing Managers Index has declined from a peak of 64 in November 1997 to 48.5 in September 1998. The contraction—like that in the United States—is still mild, but internal components of this index are pointing to further deterioration ahead, with sales down sharply and back orders declining.

Dallas, Fort Worth and Austin have seen their manufacturing sectors slowed by problems centered in semiconductors and electronics. It turns out that semiconductors can be commodities, too, and companies that are in the wrong niche are suffering losses. Construction employment continues to grow faster than total employment in all four cities, especially Fort Worth and Austin. Since April, Austin’s construction employment has fallen from a remarkable 16.1 percent annualized growth rate to “only” 8.7 percent.
The Houston economy continues to display a split personality: retail sales, home sales, general construction and auto sales churn out great results month after month; meanwhile, oil, natural gas, chemical and manufacturing results continue to deteriorate. Seasonally adjusted data, rebenchmarked to the first quarter of 1998, indicate that over the last six months Houston’s job growth has slowed to a 1.9 percent annual rate, down from the 4.6 percent annual rate enjoyed in the prior six months.

RETAIL SALES AND AUTO SALES
Retailers remain optimistic but cautious. Some softness has crept into the market, but sales remain solid and inventories are in good shape. Most Christmas plans were made last spring, and there is concern about how the consumer will feel by Christmas in the face of layoff announcements and a volatile stock market.

Auto dealers turned in an all-time record September, with sales 21 percent higher than the record-setting sales of last September. On a year-to-date basis, auto and truck sales in Harris County remain 9 percent ahead of 1997.

OIL AND NATURAL GAS MARKETS
The performance of oil, oil products and natural gas is tied to the weather. Storms Earl, Frances and Georges moved through the Gulf of Mexico, driving prices upward as production platforms were abandoned and refineries closed. Little permanent damage was done to energy facilities, and prices have returned to the low levels that prevailed before the storms. A high level of compliance with OPEC production cuts is being reported (85 percent to 90 percent), but these cuts by producer nations have yet to materially affect prices, and crude has slipped back under $14 per barrel.

Spot natural gas prices have recently fallen back under $2 per thousand cubic feet, and storage was 90 percent full by early October. Barring an early winter, downward pressure on gas prices will intensify once storage is filled and more gas enters the spot market.

Oil and gas drilling, services and related machinery continue to weaken. The rig count has fallen to 740, down from 800 at the end of August. Oil-directed drilling is approaching an all-time low. Natural gas, offshore and international drilling are declining more slowly. Layoffs have become widespread in the industry, and order books have weakened in the last few weeks.

PETROCHEMICALS AND REFINING
Weak results are also reported for the petrochemical industry, where profit margins are described as rock bottom. Chemical prices continue to fall, but at a slower rate than reported early this year. The industry’s problems mainly stem from an inability to export, competing imports and increasing capacity; however, domestic demand is now reported to be somewhat softer as well.

Refiners are not making money either. Gasoline is seasonally weak, and high inventories of heating oil are holding down its price. Heating oil inventories are at the highest levels of any October since 1986. Gasoline prices at the pump are at the lowest levels in more than six years. Poor profit margins were crimped further by the hurricane-induced run-up in the price of crude oil.

REAL ESTATE
The biggest news in real estate has been the sudden shutdown of financing for local real estate projects. Real estate investment trusts had pulled back some time ago because of their declining stock values, but conduit lenders, insurance companies and pension funds also pulled out of real estate financing several weeks ago. The flight from risk, the flat yield curve, falling rates and concern about the prospects for local real estate in the current economic environment all led to a sudden repricing of local real estate assets and a cutoff of financing for many planned projects.