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Southwest Economy

The Unsinkable Texas Economy Takes on Water

After a decade of strong employment growth, the Texas economy weakened significantly in 2001. Texas' economic growth, which began decelerating in early 2000, continued to slow throughout 2001. A sharp downturn in high-technology industries led to a decline in manufacturing activity and weak growth in the service sector. Demand for Texas products dropped on the national and world markets. Mexico, an important Texas trading partner, entered recession, which sharply reduced activity along the border.

By the end of the summer the Texas economy was vulnerable to an external shock. That shock came on Sept. 11. The U.S. economic slump and subsequent energy price decline worsened the outlook for Texas' economic growth. The energy industry quickly cut back activity, and the airline and travel industries laid off thousands of workers. The Texas economy has decelerated rapidly, and it is possible that it has been dragged into recession along with the nation.

What Has Made Texas' Economy Unsinkable?

Texas has a history of strong employment growth, which often continued even when the

(Continued on page 2)

The Federal Budget: What a Difference a Year Makes

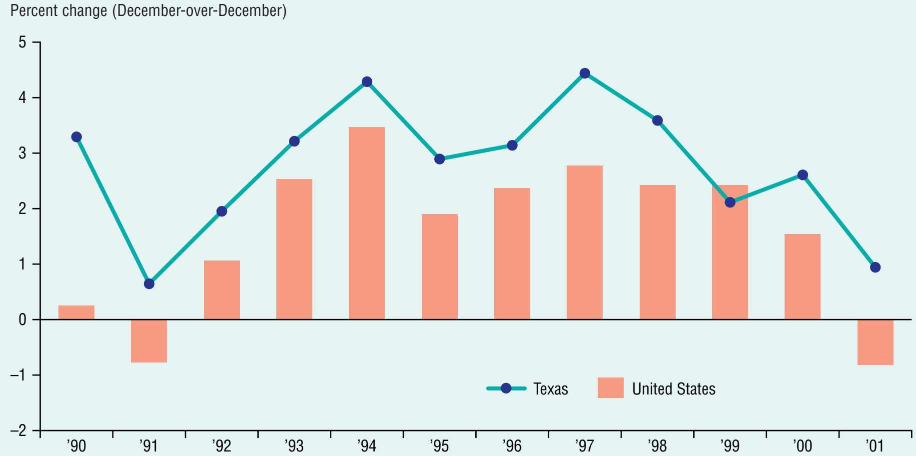
At the beginning of 2001, federal spending was lower and revenues were higher, relative to GDP, than in recent experience. The resulting surplus was paying down the federal debt. Projections indicated that the entire debt would eventually be retired if tax and spending laws remained unchanged.

Three major events during 2001 altered these budgetary patterns. In June, a new tax law brought sweeping income tax reductions. A recession, induced or deepened by the Sept. 11 terrorist attacks, further reduced revenue and pushed up spending. The budgetary response to the attacks also increased spending on defense, homeland security and recovery. As the policy emphasis shifted from preparing for long-term needs to meeting current challenges, the budget moved back into (or close to) deficit.

(Continued on page 6)

Chart 1

Texas Employment Growth Usually Exceeds Nation's



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

Texas has a strong portfolio of diversified industries selling to global markets.

U.S. economy was in recession. Employment growth in Texas has increased each year since the energy bust of 1986.

Many factors have led to the resilience of Texas' economic expansion over the past 15 years. Texas has a strong portfolio of diversified industries selling to global markets. While the state is no longer dependent on the energy industry for economic growth, the energy industry makes Texas' portfolio of industries special. Some of the state's industries benefit from high oil prices, and others benefit from low oil prices. High technology, petrochemicals, plastics and other industries have diversified the economy, buoying economic growth when oil prices weaken.

Other factors stimulate the state's strong economic growth as well. Favorable government policies, such as relatively few regulations, make it easier for companies to start and grow. As a right-to-work state, Texas has a smaller share of unionized workers than much of the country. Texas also has a relatively low cost of living, including low land and construction costs.

Texas' employment growth typically outperforms the nation's by roughly 1 percentage point (*Chart 1*).[1] The unsinkable nature of the state's economy means that economic growth had a long way to slow before entering recession.

Deceleration Accelerates in 2001

Texas job growth has been decelerating since early 2000. After increasing 2.6 percent in 2000, employment growth in 2001 rose just 0.9 percent. Texas private employment fell each of the last four months of the year. The first four-month consecutive drop since 1986.

Manufacturing employment has been falling since December 2000, primarily because of cutbacks at high-technology firms. Manufacturing employment accelerated its decline in fall 2001 and was joined by broad-based decreases in the service sector.

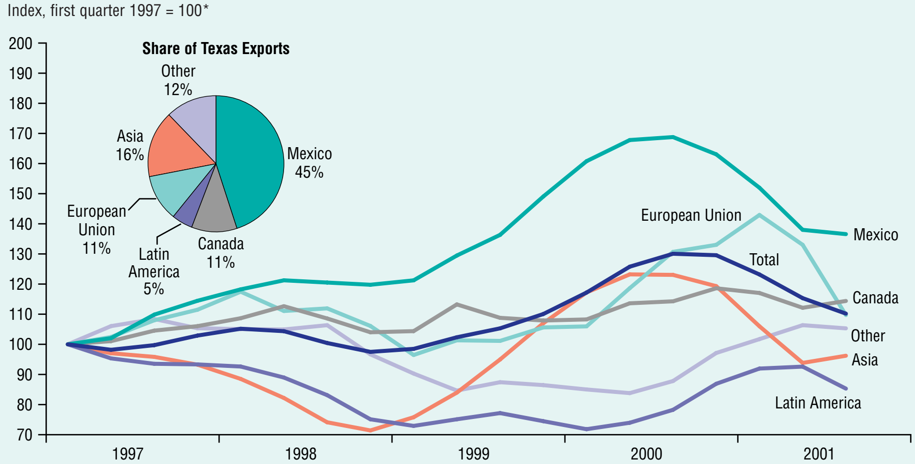
While much of the recent downturn has been related to job cuts at transportation and tourism-related businesses such as hotels, declines have been across the board in nearly all service-related industries. Employment at firms that supply temporary workers has been particularly weak, decreasing 4.8 percent in 2001.

There are several indications that economic conditions are likely to worsen before they improve. The U.S. economy, Mexican economy, construction activity, and the high-technology and energy industries have all been pillars of strength for the region but are now languishing. One or more of these sectors will need to recover before Texas economic activity picks up.

Global Markets Are Weak. Texas producers sell to the world, and weakening world economies have reduced demand for Texas products. Texas exports have fallen 25 percent since August 2000; exports to most major markets have declined (*Chart 2*).

Chart 2

Weak International Economic Conditions Are Hurting Texas Exports



*Seasonally adjusted.

SOURCES: Massachusetts Institute for Social and Economic Research; Federal Reserve Bank of Dallas.

Economic growth in Mexico remains very important to the Texas economy. The Mexican economy has weakened along with the U.S. economy and is expected to remain that way until the U.S. economy rebounds. Maquiladora activity—manufacturing plants along the Texas–Mexico border—has dipped sharply (*Chart 3*). This decline in maquiladora employment, along with a drop in cross-border traffic, has dampened activity in Texas' border cities. Difficulty crossing the border is discouraging day crossing and reducing sales at border-area retailers.

Weak economic conditions in Texas have reduced the number of Mexican migrants coming to the state and encouraged Mexicans in Texas to return to Mexico. While this labor pool reduction has helped the Texas labor market adjust to weakening economic conditions, on net the economic woes of Mexico and other Texas trading partners are a negative for the state.

Energy Industry Deteriorates. Energy activity weakened significantly in 2001 in response to lower energy prices. Natural gas prices started 2001 at very high

The U.S. economy, Mexican economy, construction activity, and the high-technology and energy industries have all been pillars of strength…but are now languishing.

Chart 3

Maquiladora Employment Dives

*Quarter-over-quarter, seasonally adjusted, annualized rate.

SOURCES: Instituto Nacional de Estadística, Geografía e Informática; Federal Reserve Bank of Dallas.

Recent Texas recessions have been accompanied by either a drop in oil prices or a U.S. recession.

levels but fell by nearly two-thirds—to a more normal range—as the U.S. economy cooled. A drop in demand from weakened world economies also resulted in oil prices falling by roughly one-third.

While energy activity dropped precipitously, it has not declined as much as would be expected with a one-third cut in the domestic rig count.[2] Recent oil industry mergers have left companies flush with cash and ready to invest. Deep drilling continues in the Gulf of Mexico, propping up demand for oil services. Further, the oil industry may be reluctant to lay off workers because cuts that occurred when prices fell in 1998–99 are now considered to have been too deep.

Construction Activity Drops. After growing strongly in the late 1990s, construction activity has been retrenching since early 2001. Contract values have weakened, and construction employment began to slide in late summer. Office vacancy and industrial availability rates have been rising, and reports of overbuilding in some office and high-priced home markets suggest construction investment will continue to slow.

Further, heavy construction along the Gulf Coast is unusually weak. Petrochemical activity would normally accelerate with falling energy prices, but weak demand and serious overcapacity are discouraging investment.[3]

What Triggers Texas Recessions?

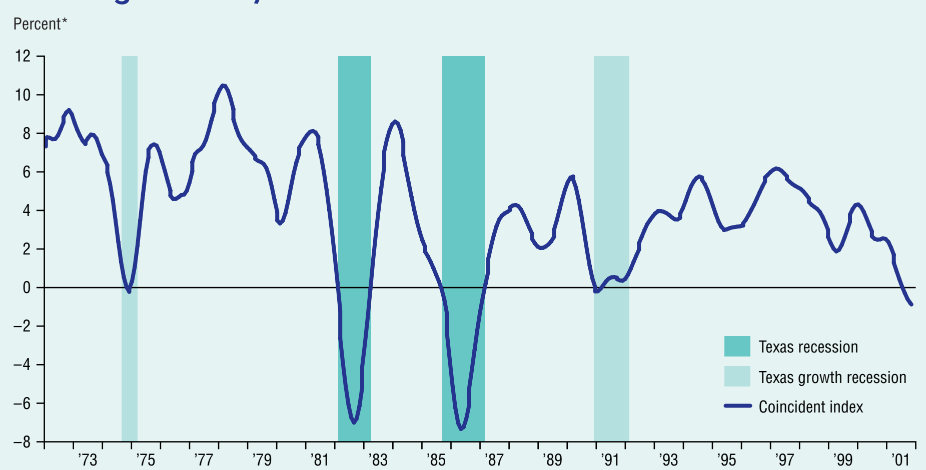
Recent Texas recessions have been accompanied by either a drop in oil prices or a U.S. recession, although neither of these events alone is sufficient to trigger a recession in the state. The coincident index, which measures the Texas business cycle, shows that Texas has had two recessions—at least two quarters of negative growth—over the past 30 years (*Chart 4*).[4] During this same time Texas experienced two growth recessions—periods of growth very close to zero. The characteristics of these four periods are described below.

September 1974 to March 1975. During the growth recession of the mid-1970s, a U.S. recession dragged down Texas employment growth. The 1973 OPEC oil embargo spurred a tripling of oil prices. Texas typically benefits from high oil prices, and the Texas rig count increased moderately during this period. However, wage and price controls limited the benefit to the Texas economy of the higher oil prices.

March 1982 to April 1983. The early '80s recession was sparked by a decline in energy prices and a sharp U.S. recession. This recession started the bursting

Chart 4

Coincident Index Shows Texas Economic Activity Declining Since July 2001



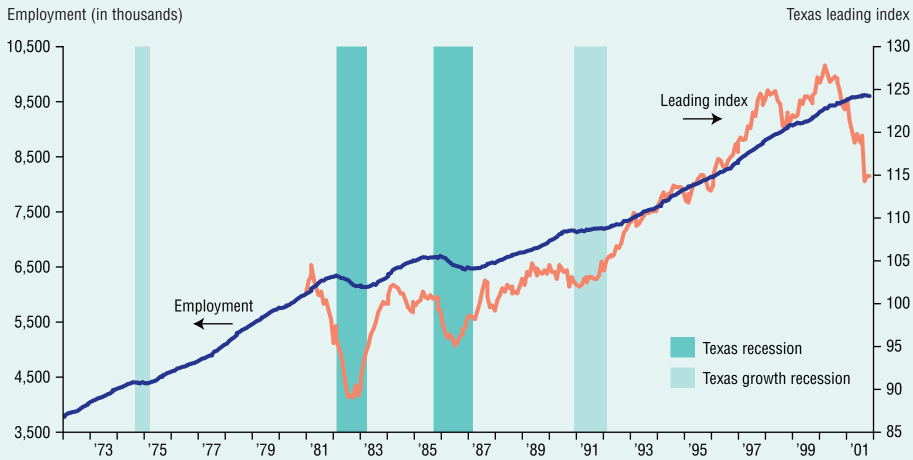
*Month-over-month, seasonally adjusted, annualized rate.

NOTE: Index is composed of employment, the unemployment rate and the gross state product.

SOURCE: Federal Reserve Bank of Dallas.

Chart 5

Leading Index Suggests Continued Downturn in Texas Economic Activity



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

of the Texas energy bubble. The early '80s recession led to a loss of 208,000 jobs in Texas, or roughly 3.3 percent of employment.

September 1985 to February 1987. The mid-'80s recession, commonly referred to as "the bust," was the result of sharply lower oil prices. Oil prices plunged by two-thirds, falling from $37 to about $12 per barrel. This recession was complicated by the elimination of tax incentives that had stimulated overinvestment in real estate. The bust resulted in the loss of another 207,000 jobs, or 3.1 percent of employment.

December 1990 to February 1992. Texas economic growth was again dragged down by a U.S. recession in the early 1990s; however, high energy prices helped keep Texas economic activity afloat.

Is Texas in Recession Now?

Several economic indicators, including Beige Book reports and the Texas Leading Index, suggest that Texas may have entered a mild recession. A forecasting model based on the leading index and past employment growth estimates the recession started in the third quarter of 2001 and will result in a loss of roughly 90,000 jobs, or just under 1 percent of employment.

The Texas Leading Index, which has been falling since March 2000, dropped sharply in September 2001 (*Chart 5*). While the index showed improvement toward the end of the year, most components remain below the August level (*Chart 6*). The recent strength in the index suggests economic growth will pick up, perhaps as early as the second quarter of 2002.

Summary and Outlook

Texas' economic growth began to decelerate in early 2000 and its decline accelerated in 2001. The state typically grows faster than the nation—by roughly 1 percentage point—so economic activity had a long way to slow before reaching negative territory. A U.S. recession and low energy prices may have dragged Texas into recession. But despite a sharp drop in the Texas Leading Index, at worst a recession is likely to be less than half as bad as the recessions of the 1980s.

—Fiona Sigalla

Sigalla is an economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

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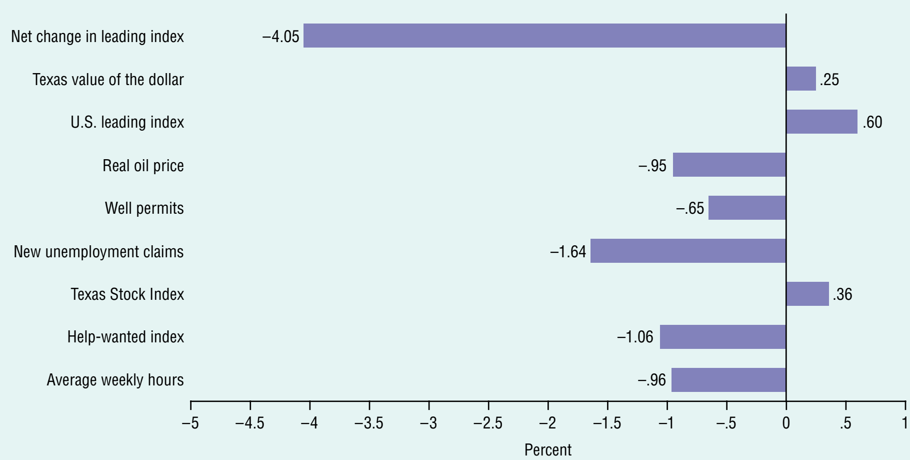
1. Fiona Sigalla and Mine K. Yücel (2001), "Another Great Texas Boom," Federal Reserve Bank of Dallas *Southwest Economy*, Issue 1, January/February, pp. 1–5.
2. Robert W. Gilmer (2002), "Slow Job Growth in Houston in 2002," Federal Reserve Bank of Dallas *Houston Business* (January).
3. Mark Eramo, Robert W. Gilmer and Arved Teleki (2001), "Petrochemical Outlook Still Bleak for 2002," Federal Reserve Bank of Dallas *Houston Business* (November).
4. The coincident index is based on movements in employment, the unemployment rate and real gross state product. The methodology behind the construction of the index is described in Alan Clayton-Matthews and James H. Stock (1998–99), "An Application of the Stock/Watson Index Methodology to the Massachusetts Economy," *Journal of Economic and Social Measurement*, vol. 25, issue 3/4, pp. 183–233.

Chart 6

Net Contributions of Components to Change in Leading Index

(September–December 2001)



NOTE: Help-wanted index not available for November and December 2001.

SOURCE: Federal Reserve Bank of Dallas.