Texas Economy Shifts into Higher Gear

By Fiona Sigalla

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After several years of barely keeping up with the nation as a whole, the Texas economy showed signs of renewed strength in 2005. While Texas hasn't yet kicked into overdrive, it did indeed enter the new year once again growing faster than the U.S. average.

Last year saw the most robust job growth since 2000. Texas' economy gained momentum through its traditional advantages—a resilient energy industry, a favorable business climate, a low cost of living and relatively inexpensive real estate. Even manufacturing managed to add jobs in 2005, buoyed by healthy global demand for Texas products.

Total employment grew by roughly 2 percent in 2005, slightly better than the rest of the nation *(Chart 1)*. Income data confirm that Texas' economy has shifted from losing ground to gaining it. After falling from 96 percent of the U.S. average in early 2001 to 93 percent at the end of 2004, real per capita personal income rebounded to 94 percent in last year's third quarter.

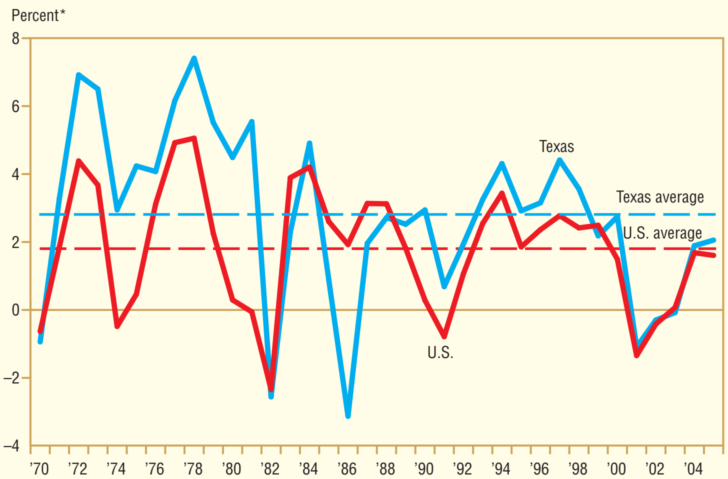
Regaining its edge over the nation doesn't mean Texas is experiencing a 1990s-style boom. Since the start of the U.S. and Texas recessions in 2001, job growth has been below the state's long-run average of about 3 percent. Among the factors that have been muting the expansion are structural changes in the high-tech sector, a lingering overhang of office space and a scuffle in the beleaguered airline industry. Consumer spending was dampened by real wage cuts in both the high-tech and airline industries.

The Dallas Fed's latest forecast indicates that the Texas economy should expand at a slightly faster pace in 2006, with job growth projected at around 2.8 percent. Energy will remain an asset because of heavy demand for drilling, increasing business for energy services and high royalty payments for landowners. The state's technology and manufacturing firms should continue to bounce back from their recessionary depths. Some construction activity might experience a slight slowdown, but rebuilding from Hurricanes Rita and Katrina should help keep the industry relatively strong. The expansion will be dampened somewhat by energy costs and interest rates that are higher than a year ago.

Texas boasts a friendly business climate, where companies can grow quickly in good times. They find a ready supply of potential workers in a state with rapid immigration, a young labor force and a low cost of living. With abundant vacant land, few regulations and low construction costs, building activity responds faster to demand in Texas than in most other parts of the country.

In large measure because of these advantages, Texas' share of U.S. payroll employment grew across all industries

Chart 1
Texas Job Growth Is Once Again Outpacing U.S. Growth



*Year-over-year, seasonally adjusted, annual rate.
SOURCE: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

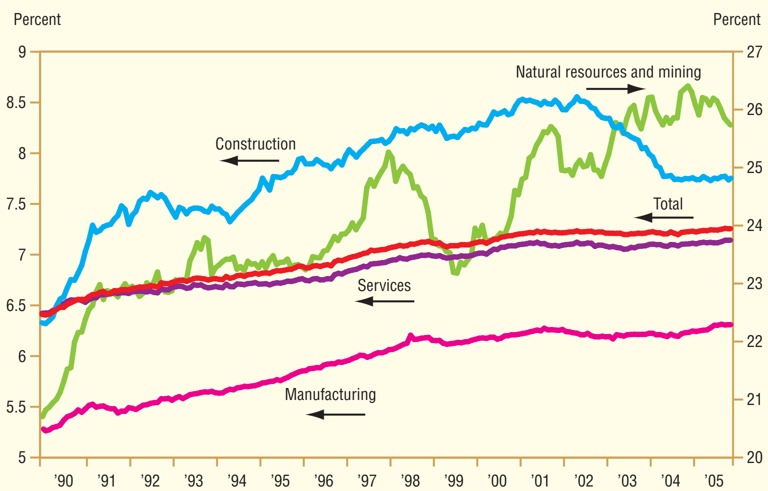
throughout the 1990s *(Chart 2)*. Expansion of technology firms during the late 1990s led to construction of factories, warehouses, offices and homes. Real estate investment during the high-tech boom probably reflected the expectation that the Texas economy would continue to grow faster than the nation's.

High oil and natural gas prices kept the energy sector humming last year, and manufacturing gave an added boost to the Texas expansion.

But Texas' ability to sustain fast-growing industries leaves it vulnerable in downswings. High-tech industries flourished in the 1990s. When the bust came in 2000, it hit the state harder than the rest of the country. Texas suffered massive layoffs, and office vacancies rose to among the nation's highest. From 2001 through 2004, as the U.S. economy recovered from recession, most sectors of the Texas economy struggled to regain their historical growth rates. Services and manufacturing, for example, barely managed to maintain their share of national employment. Sectors that moved against this trend included construction, whose share of national employment dropped between 2002 and 2004, and energy, which added jobs in Texas at a faster pace than the rest of the country.

In 2005, the patterns began to shift. Construction, slower to reignite after the 2001 recession, regained enough strength to stop losing ground. High oil and natural gas prices kept the energy sector humming last year, and manufacturing gave an added boost to the Texas expansion. These three industries—construction, energy and manufacturing—help explain why Texas did better last year. They also brighten the state's outlook for 2006.

Chart 2
Texas' Share of U.S. Employment Rose in the 1990s



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

Construction Revival Hits Home

For the nation, the post-recession revival of construction employment started in early 2003 *(Chart 3)*. For Texas, the turning point didn't come for another 18 months. Since mid-2004, the growth rate of Texas construction jobs has roughly matched the United States as a whole.

The 2001–04 decline in construction jobs largely reflected the real estate glut the boom years left behind. Weakness pervaded nonresidential construction, particularly commercial building, as well as specialty trades, such as roofers, electricians and other contract workers. By contrast, residential construction continued strong. Texas added workers to support this market segment at a faster pace than did the U.S. during much of the past few years.

In 2005, the improvement in construction came from apartment building and a surge in homebuilding, including condominiums. Heavy construction of highways, roads, bridges and pipelines also picked up strongly last year, and at a faster pace than in the rest of the country. Commercial construction experienced an uptick, although activity remains relatively weak.

Office vacancy rates have declined in recent years as commercial building slumbered and demand revived. Even so, downtown Austin remains third among U.S. cities in office vacancies; Dallas–Fort Worth ranks fourth. Houston fared better than Austin or Dallas, although the city's office vacancy rate still hovers above the national average. Houston was not hurt as much by the high-tech downturn because the city has a smaller concentration of those firms than the state's other two major metropolitan areas. Houston also benefits from being the nexus of the prosperous energy industry. Still, the city's office markets did not escape the recent recession unscathed. The Enron collapse left Houston with additional vacant high-rise office space to commemorate the birth of Sarbanes-Oxley.

Construction is likely to continue boosting economic growth in 2006, although some slowing could occur as supply surpasses demand for some types of properties. For several months, Dallas Fed real estate contacts have expressed concern about speculative construction in some Texas markets for condominiums, apartments and office space. The influx of hurricane evacuees has helped absorb some of the excess apartment supply, but uncertainty remains about whether the newcomers will settle in Texas or return to their home states.

Fewer worries afflict the homebuilding segment. Months in inventory remains relatively low in Texas—for most markets dipping in 2005 from six months to five. What's more, the Texas homebuilding boom hasn't been accompanied by the hefty price appreciation that occurred in other parts of the country. The state's slower price increases don't signal slack demand; rather, they reflect the ability to increase supply quickly in response to demand. In contrast to other parts of the nation, vigorous building has helped keep Texas real estate prices in check.

Texas' weak home-price appreciation may be a mixed blessing. Fears of an overpriced housing market that could result in falling home prices are muted in Texas, while they are palpable on parts of the East and West coasts. On the other hand, the state's consumer spending probably has been subdued. Without a substantial run-up in home prices, Texans couldn't extract home equity as readily as homeowners in many other areas of the country. State homestead and debtor-friendly laws also make it more difficult for Texas bankers to offer the same kind of equity financing available elsewhere.

The outlook should include a note of caution about the possibility of slower growth in homebuilding in 2006. Construction costs and interest rates higher than a year ago could dampen demand. Because home-price increases have been relatively tame, moreover, Texas homeowners don't have the equity cushion enjoyed by much of the rest of the country.[1] Foreclosures have been relatively high in the state. Any downturn in home prices could be accompanied by financial strain.

Energy Profits from Higher Prices

For most states, rising energy prices are bad news. Although oil and gas account for much less of Texas' economy than they did 20 years ago, the stimulus of higher energy prices is still a net positive for Texas.[2]

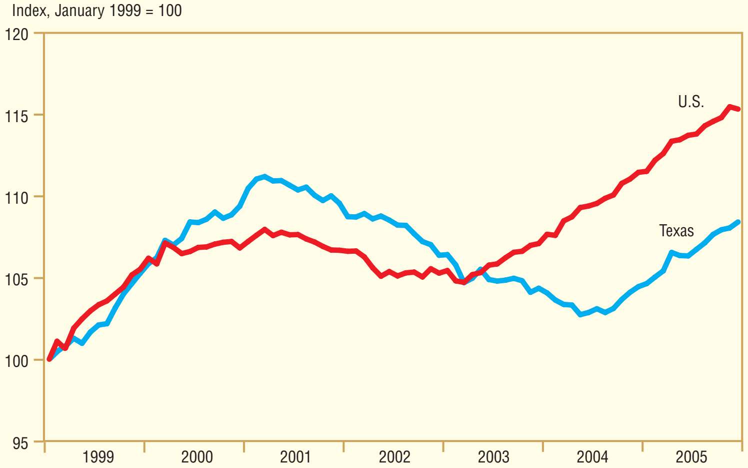
Most directly, they're a boost to the energy industry's revenues and profits, providing incentives to add jobs in oilfield services, refining and related businesses. Texas, Louisiana and the Gulf of Mexico account for 43 percent of the nation's oil and 41 percent of its natural gas reserves.[3] Refinery output is also concentrated in the area, with Texas and Louisiana home to just under half the country's refining capacity.

Texas' energy industry ebbs and flows with changes in oil and natural gas prices. With relatively high-cost production in the state, drilling in some areas becomes viable only when energy sells at a premium. Such was the case in 2005.

Energy prices were elevated at the start of the year, and they surged in mid-2005 as roaring demand and dwindling inventories led to concerns about the adequacy of supplies. Prices spiked even higher after Hurricanes Katrina and Rita disabled production, pipeline and refining facilities, some of which remained out of service at year's end.

Oil stayed above $50 per barrel for much of the year, jumping briefly to nearly $70 a barrel for West Texas Intermediate crude. Natural gas prices rose to nearly $15 per million Btu. Gasoline at the pump spent

Chart 3
Texas Construction Employment Slower to Rebound After Recession



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

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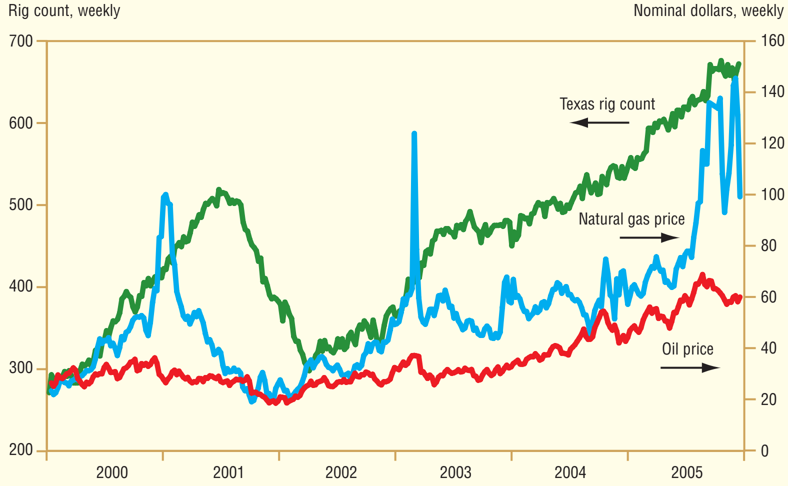
Chart 4
Texas Energy Activity Increasing with Higher Energy Prices



NOTE: Natural gas price is multiplied by 10.
SOURCE: *The Wall Street Journal*; Baker Hughes.

most of the year well above $2 a gallon.

Drilling activity jumped in response to higher prices, mostly exploring for natural gas. The Texas rig count ended the year at 672, well above the year-earlier level of 480 *(Chart 4)*. Higher energy prices and technological innovations make it profitable to explore and drill in more difficult locations.[4] Dramatic increases in activity sprouted in areas previously considered impenetrable, generating productive new sources of natural gas. Significant new drilling is now taking place in East Texas, the Texas Panhandle and areas north of Fort Worth.

Business leaders say energy activity and employment would have increased even more except for a shortage of equipment and trained workers. Activity in and around the Gulf Coast was disrupted by hurricane damage, which pushed facilities offline and forced workers to focus on rebuilding rather than expanding.

Royalty payments to landowners also gave the economy a boost. Texans receive larger royalty checks when energy prices rise because the energy extracted is more valuable. Higher energy prices also generate additional royalty payments; higher prices make it cost-effective to pursue ventures in new fields, so more people receive checks.

Energy prices are expected to drift lower in 2006 but are likely to remain high enough to sustain industry expansion.

Capacity constraints and the hurricanes kept production from expanding as fast as desired in 2005. Energy activity could be even stronger in 2006, despite weaker prices.

Manufacturing Rallies on Export Gains

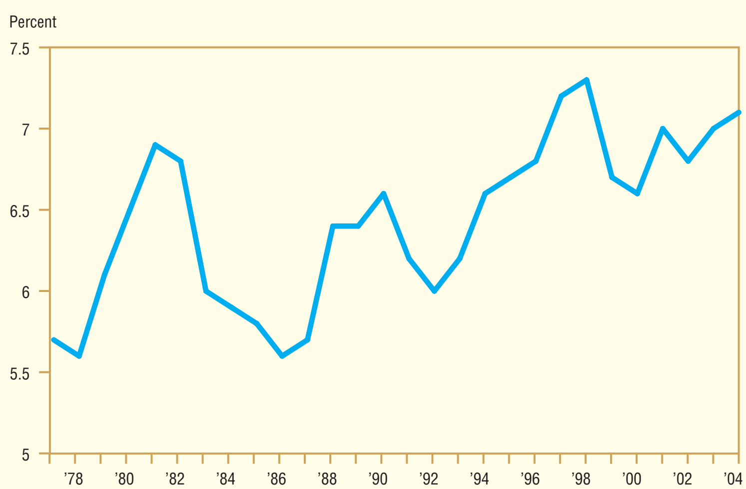
On a national scale, manufacturing has been one of the recovery's most conspicuous laggards. Texas is bucking the trend. Its traditional advantages—a fast-growing labor force, low cost of living and good business climate—have allowed the state to acquire a growing share of U.S. manufacturing output *(Chart 5)*.

Overall, Texas manufacturers produced $107 billion worth of manufactured goods in 2004, roughly 7.1 percent of the country's output. The state churns out nearly 30 percent of the nation's petroleum and coal products, 10 percent of its computer and electronics products, and 10 percent of its nonmetallic mineral products, such as brick, glass and cement.

Manufacturers have been adopting productivity-enhancing technologies and relocating production facilities to reduce costs. For some companies, the lower-cost location is overseas. For others, Texas fits the bill.

Newcomers are only part of the good news for Texas manufacturing. State firms have also shown they can be feisty global competitors. In recent years, Texas has increased its share of U.S. exports—from about 11 percent in 1997 to nearly 15 percent last year *(Chart 6)*. The surge in overseas sales allowed Texas to supplant California as the nation's top exporting state in 2002 (see Spotlight on Texas Exports, page 10). Nearly one quarter of U.S. exports of petroleum and coal products comes from Texas. Texas ships 22 percent of the nation's exports of electrical equip-

Chart 5
Texas Gains Share of U.S. Manufacturing Output



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

ment and appliances, 18 percent of computer and electronic components, and 17 percent of chemicals.

Texas goods are shipped to destinations around the world, but the largest export market for the state's products is Mexico. Some of these goods are consumed by our southern neighbor, but most are used as inputs at manufacturing plants—called *maquiladoras*—that assemble products and then ship them back for sale in the United States.[5] For example, the U.S. sends semiconductors and software to Mexico for assembly into computers that are then sold by U.S. vendors. Texas is a convenient location for firms that ship parts to maquiladoras.

The recent upturn in Texas manufacturing has been accompanied by a similar pickup in maquiladora activity. Employment at maquiladoras dropped in early 2001 as recessions in the U.S. and Mexico dampened demand. Maquiladoras began adding workers again in early 2004. Production at maquiladoras has increased over the past two years, helping boost Texas manufacturing.

Texas factories added jobs in 2005—nearly 6,000, or just less than 1 percent through November—notable considering this sector has been losing employment nationwide. State job growth has been mostly at factories producing durable goods, such as fabricated metals, machinery, semiconductors, and communications and transportation equipment.

The state's manufacturers are expecting more of the same in 2006. The Dallas Fed's new Texas Manufacturing Outlook Survey found solid optimism at least through mid-2006. In December, two-thirds of the respondents expected to raise output over the next six months, compared with 8 percent anticipating cutbacks. As for new hiring, 45 percent saw a potential to add jobs by June, while 12 percent anticipated paring payrolls.

Texas Economy Gearing Up in 2006

State and regional economies rarely move in tandem with the nation. At any time, some areas are doing worse than average while others are better. In 2005, Texas crossed the line from one category to the other. As the Texas expansion picked up steam, the state's economy once again started growing faster than the nation's, although the edge was slight. The drivers have been a thriving energy industry, a surge in residential construction and a pickup in Texas manufacturing. Texas is now more likely to once again be an asset to U.S. economic growth, although not at the magnitude it was in the 1970s and 1990s.

The state's expansion appears on solid ground for 2006. The Dallas Fed's Texas Leading Index rose sharply at the end of 2005 to its highest reading since 2000. While partly the result of a rebound from hurricane disruptions, the rise in Texas' leading indicators appears to be signaling a sustainable pickup in economic activity. Average weekly hours worked in manufacturing, for example, increased in November to its highest reading since 2003. Initial claims for unemployment insurance dropped to pre-recession levels.

The tens of thousands of Louisiana residents who have made the Lone Star State their home, at least for now, are boosting economic activity. Construction growth should remain strong, with perhaps a slight weakening, in 2006. Manufacturing and service activity should strengthen as energy prices come down, but the price declines aren't expected to be large enough to derail the state's energy industry. A healthy business climate will help the state remain a formidable global competitor.

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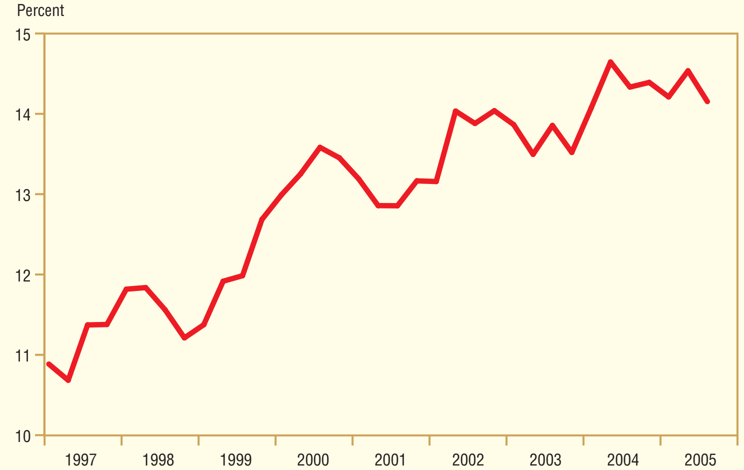
Chart 6
Texas Share of U.S. Exports Is Rising



SOURCE: Census Bureau, Foreign Trade Division; WISERTrade.

Notes

The author thanks Bill Gilmer, Keith Phillips, Frank Berger, Mine Yücel, Anna Berman and Raghav Virmani for help with this article.

1 "Has the Housing Boom Increased Mortgage Risk?" by Jeffery W. Gunther and Robert R. Moore, Federal Reserve Bank of Dallas *Southwest Economy*, Issue 5, September/October 2005.

2 "Do Higher Oil Prices Still Benefit Texas?" by Stephen P. A. Brown and Mine Yücel, in *The Face of Texas: Jobs, People, Business, Change*, Federal Reserve Bank of Dallas, October 2005, pp. 33–36.

3 Data are from the Energy Information Administration for Dec. 31, 2004. For more information, see "Concentration of Energy Production and Processing on the Gulf Coast," by Robert W. Gilmer, Carrie Ann Fossum and Iram Siddik, Federal Reserve Bank of Dallas *Houston Business*, December 2005.

4 For more detail, see "Texas Drilling Directed Toward Unconventional Natural Gas," by Robert W. Gilmer, Carrie Ann Fossum and Iram Siddik, Federal Reserve Bank of Dallas *Houston Business*, June 2005.

5 For more information about maquiladoras, see "U.S.–Mexico Trade: Are We Still Connected?" by Jesus Cañas and Roberto Coronado, Federal Reserve Bank of Dallas *Business Frontier*, Issue 3, 2004.