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Southwest Economy

FEDERAL RESERVE BANK OF DALLAS

In This Issue

President's Perspective

I have talked a great deal over the past three years about the challenges globalization poses for monetary policy. My gut tells me that a more integrated world economy is transforming the way the economy operates and changing how it responds to policy actions.

Wading into the debate about globalization and monetary policy, we have raised more questions than answers. The need for more research on key issues led the Dallas Fed to establish the Globalization and Monetary Policy Institute last September.

We have assembled a formidable team, starting with Dallas Fed vice president and senior economist Mark Wynne, the institute's inaugural director. Mark oversees a staff of five full-time research economists, all hired at the Dallas Fed within the past year or so. They'll work with three senior fellows—Dallas Fed chief economist W. Michael Cox, University of British Columbia economics professor Michael Devereux and University of Virginia associate professor Francis Warnock.

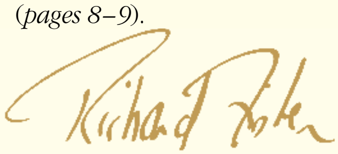
Our Globalization and Monetary Policy Institute will delve into tough issues and conduct cutting-edge economic research.

Providing the map and compass will be the job of the institute's advisory board. Its chairman is Stanford University's John Taylor, one of the most influential monetary economists of our times. He's joined by other world-class scholars—Martin Feldstein, a former chairman of the Council of Economic Advisers who is now president of the National Bureau of Economic Research; R. Glenn Hubbard, dean of the Columbia Business School; Harvard professor Kenneth S. Rogoff; and 2004 Nobel Prize-winner Finn Kydland, a Dallas Fed consultant and professor at the University of California, Santa Barbara.

We also brought international expertise to the board—Charles R. Bean, chief economist of the Bank of England; Otmar Issing, former member of the European Central Bank executive board and current president of Germany's Center for Financial Studies; Guillermo Ortiz, Governor of Banco de México; and William White, head of the Monetary and Economic Department at the Bank for International Settlements in Switzerland.

Our Globalization and Monetary Policy Institute will delve into tough issues and conduct cutting-edge economic research. I believe the institute's efforts will lead to a better understanding of the changes generated by globalization and the development of new tools to assist the Fed in creating the monetary conditions for sustainable non-inflationary economic growth.

The institute's work has already begun. Mark Wynne provides more information on its agenda and aspirations in this issue's *On the Record* interview (*pages 8–9*).



Richard W. Fisher
President and CEO
Federal Reserve Bank of Dallas

Texas Finds Cover from U.S. Economic Storm

By Fiona Sigalla

The 2007 Texas expansion was persistently underrated. While a national economic slowdown attracted headlines, the state's economy quietly grew at a rate that was Texas proud.

State job growth of 3.1 percent last year was triple the nation's 1 percent—and exceeded the state's long-run average of 2.8 percent for the third year in a row (*Chart 1*).[1] While declines in homebuilding were sizable, overall construction remained at high levels in Texas. Oil and gas drilling returned to heights not seen since the early 1980s energy boom.

Storm clouds rolled in around midsummer as it became apparent that the nation's housing and credit problems were spreading into the broader economy. The U.S. economy began to slow, reducing demand for Texas goods and services.

The nation's woes have stirred up headwinds for the state's expansion. Credit market disruptions and a deflating U.S. housing bubble have transmitted financial problems to lenders and builders in the state. Oil prices that threatened to hit $100 per barrel strained business budgets and consumer pocketbooks. How quickly and how much the U.S. economy will slow remains uncertain.

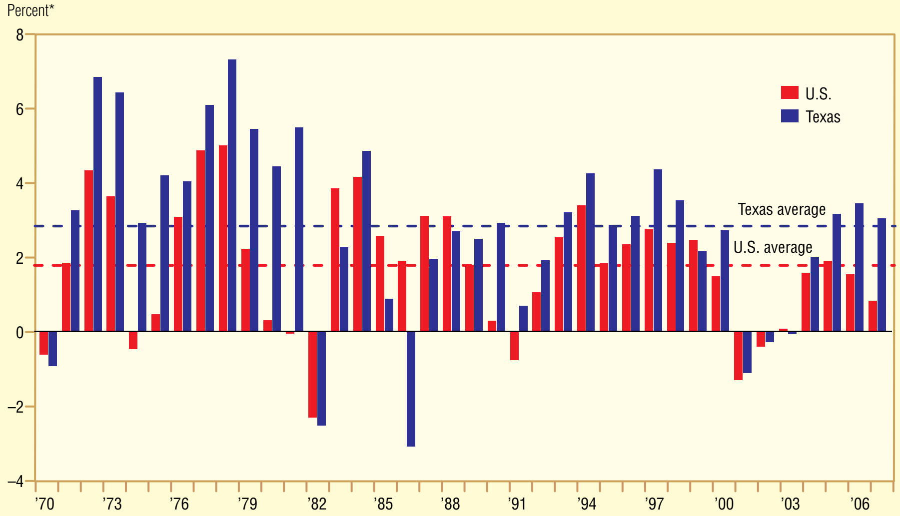
A Texas recession isn't in the forecast. A relatively low cost of living continues to attract firms and residents to the state, and an economy that is more globally integrated than in other states boosts demand for Texas products and services. The state remains the global epicenter for a prosperous energy industry. And while real estate activity is slowing, Texas markets are healthier than those in many other parts of the country.

The Texas economy had a full head of steam as the storm arrived, and odds are good that it will handily outperform the rest of the country in 2008. Even so, the expansion will probably be below average for the state, with job growth likely near 2 percent.

A Texas recession isn't in the forecast. A relatively low cost of living continues to attract firms and residents to the state, and an economy that is more globally integrated than in other states boosts demand for Texas products and services.

Chart 1

Texas Usually Outpaces U.S. in Employment Growth



* Year over year.

SOURCES: Bureau of Labor Statistics; Texas Workforce Commission; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

Extreme Construction and Lending

Seeds of the storm were sown during the recent expansion. Low interest rates and innovative lending practices stimulated a homebuying frenzy.[2] Construction surged in the U.S. and Texas, boosting nationwide demand for the state's builders and manufacturers of construction-related products.

With plentiful land and labor, Texas builders largely met demand, keeping home-price increases modest. But in other parts of the country, where land and labor are less abundant, builders had a hard time keeping pace. The supply of available homes tightened and prices climbed (*Chart 2*). Investors saw prices rise and bought homes in anticipation of continued increases. In some instances, wealth from accelerating home prices was used to finance larger homes than salary incomes permitted.

Rising home prices fueled consumer spending because homeowners felt prosperous. Home-equity loans allowed increased consumption. With the state's relatively weak home-price appreciation, Texans didn't feel as wealthy or have as large a spending boost as homeowners in other parts of the country. Still, the state's factories and service firms benefited from the national consumer spending spree.

The concept of spending wealth from rising asset prices works as long as the prices keep rising. But home-price increases in some parts of the country were from a speculative bubble. In late 2005, U.S. home construction caught up with demand as speculative investment eased and home inventories began to climb. In areas with rising inventories, prices started to fall. Homeowners felt less wealthy, and consumer spending began to slow.

In early 2007, uncertainty about the true value of many of the nation's homes took hold.[3] Financial markets became concerned about the declining value of real estate. In hindsight, it was apparent that lending practices did not adequately account for the risk of price declines.

Lenders pulled back from real estate investments in midsummer. Credit standards tightened. Innovative loans that were used to finance much of the expansion became unavailable even to the best borrowers. As financial markets struggle to value outstanding assets, some lending—both residential and nonresidential—is on hold.

The adjustment in housing and credit markets isn't over.

The banking system is welcoming back many of the more creditworthy customers, but the process is expected to take some time. Many large lenders in Texas are national companies that have taken enough losses that their lending may be constrained by a lack of bank capital.

Home construction is still dipping, and nonresidential construction shows signs of softening. U.S. home prices continue to decline, and homeowners are modifying their spending to reflect less wealth. Some loans that were used to finance the boom have adjustable interest rates scheduled to reset in 2008 and beyond. Further complicating the economic landscape are high food and energy prices, which are straining business and consumer spending.

Texas' Advantages

Texas will be affected by these economic challenges, but the Lone Star State has advantages that will help it weather the storm in 2008. Signs suggest that these advantages are weakening, but the state should still outpace the nation in growth.

The global advantage. Texas exports more than any other state. Its international connections, large seaport and good distribution network help businesses find global markets when U.S. demand slows.

In 2007, international demand was strong for such Texas specialties as chemicals, machinery and agricultural products. The state's chemical industry relies on natural gas as an input more than oil, which is heavily used in other countries. Oil prices rose faster than natural gas prices last year, giving Texas chemicals a cost advantage.

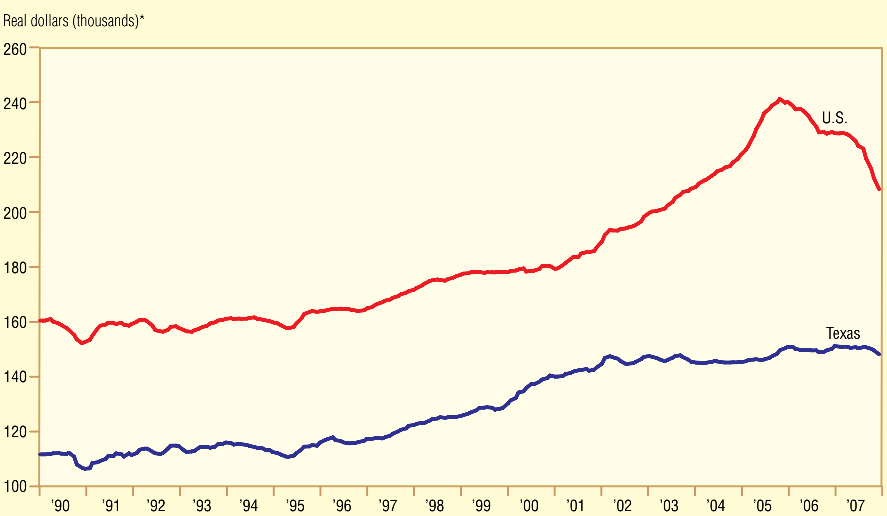
Over the past year, U.S. and Texas exports have been stimulated by declines in the dollar's value that have made these products less expensive in many countries. Not surprisingly, the rise in Texas exports has been greatest where currencies have appreciated the most against the dollar. Shipments experienced double-digit growth to France, Germany, Brazil, India, Japan, Singapore and Taiwan.

The state has received less of a boost from its largest trading partner. Export growth to Mexico slowed in 2007.[4] The peso's value didn't appreciate much against the dollar last year. The state also saw fewer benefits from Mexico's maquiladora plants because demand for their products softened along with the slowing U.S. economy.

The energy advantage. Texas is one of the few states that can claim high energy prices as an advantage. In early 2007, futures markets didn't forecast $100-per-barrel oil, but that is close to where prices ended the year. Rising oil prices pushed up other energy prices, including natural gas and gasoline.

High energy costs dampen economic activity and slow U.S. growth. But for Texas, high prices stimulated worldwide demand for equipment and services and led to a resurgence of drilling in the state. Producers

Chart 2
Texas and U.S. Median Existing-Home Prices



* Four-month moving average.

SOURCES: National Association of Realtors; Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

can afford to use expensive new technologies to profitably extract natural gas from ground previously thought impenetrable. The drilling surge has meant additional property owners are profiting from their mineral rights. More royalty checks are being cashed, and high oil and natural gas prices make payments larger.

While the state benefits more than others from high energy prices, expensive oil, natural gas, electricity and gasoline still create burdens. Not all Texans own mineral rights or work in the energy industry. As costs rise, businesses reduce production. Consumers forced to spend more on gasoline, heating and air-conditioning cut back on other expenditures.

The labor force advantage. Texans are among the state's biggest assets—they provide the labor necessary for strong job growth. In recent years, the population has grown twice as fast in Texas as the rest of the country (*see "Noteworthy" on page 15*).

Rapid job growth has given the state an increasing share of U.S. employment (*Chart 3*). Roughly 7.6 percent of the country's nonagricultural workforce is in Texas, and that figure is growing. Last year, the Texas economy added workers at a faster rate than the nation in all sectors, with the state creating 31 percent of the country's private nonagricultural jobs. The Texas construction sector added 27,000 jobs—up 4.3 percent—while U.S. construction employment fell by 222,000—down 2.9 percent.

In fact, Texas job growth was so strong that throughout 2007, firms said the inability to find qualified talent was restraining growth. The Dallas Beige Book, the Fed's anecdotal survey of business conditions, pointed to shortages of skilled workers such as welders, mechanics, engineers and information technology specialists.

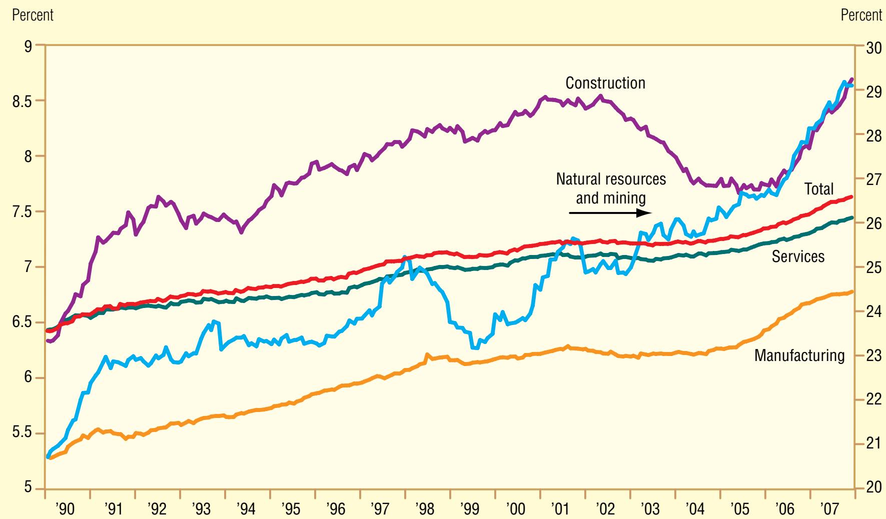
The labor market softened toward year-end, although reports suggest the market is still quite tight. In November, continuing claims for unemployment insurance dipped to the lowest level since 1982. The state unemployment rate rose to 4.5 percent in December but remained well below the U.S. rate of 5.1. For now, many firms say they are trying to minimize layoffs because workers are in such short supply.

The real estate advantage. Texas real estate markets are no strangers to boom-and-bust cycles. A construction spike in the early 1980s left a large inventory of homes, offices and retail space that took a decade for the state to absorb. Memories of earlier excesses may have helped temper building here in the face of rapid growth in the rest of the country. More likely, Texas real estate markets have stayed closer to fundamentals because strong economic growth absorbed new space as fast as builders could generate it.

With plentiful land, relatively few regulations and a large crew of workers, the Texas construction industry knows how to boom. Between 2000 and 2007, the state added over 1 million single-family homes. Even with this surge, the supply of homes doesn't appear to be too far ahead of demand.

At the end of 2007, it took just over six months for the average existing home to sell in Texas (*Chart 4*). The time it takes to sell an average home nationally is pushing above 10 months, and high inventories are

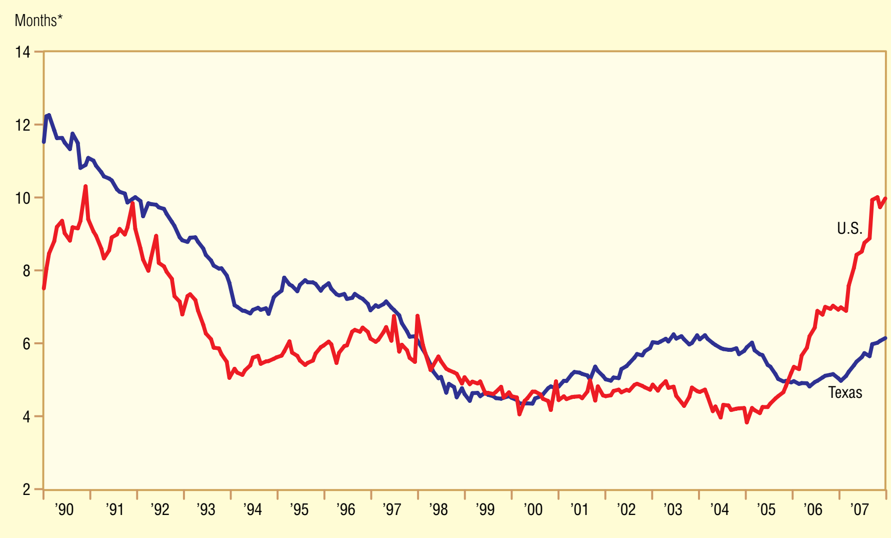
Chart 3
Texas Share of U.S. Employment



* Four-month moving average.

SOURCES: Bureau of Labor Statistics; Texas Workforce Commission; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

Chart 4
Existing-Home Inventories Growing



* Seasonally adjusted.

SOURCES: National Association of Realtors; Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

putting downward pressure on prices. With lower inventories in Texas, prices may recede but large declines aren't expected.

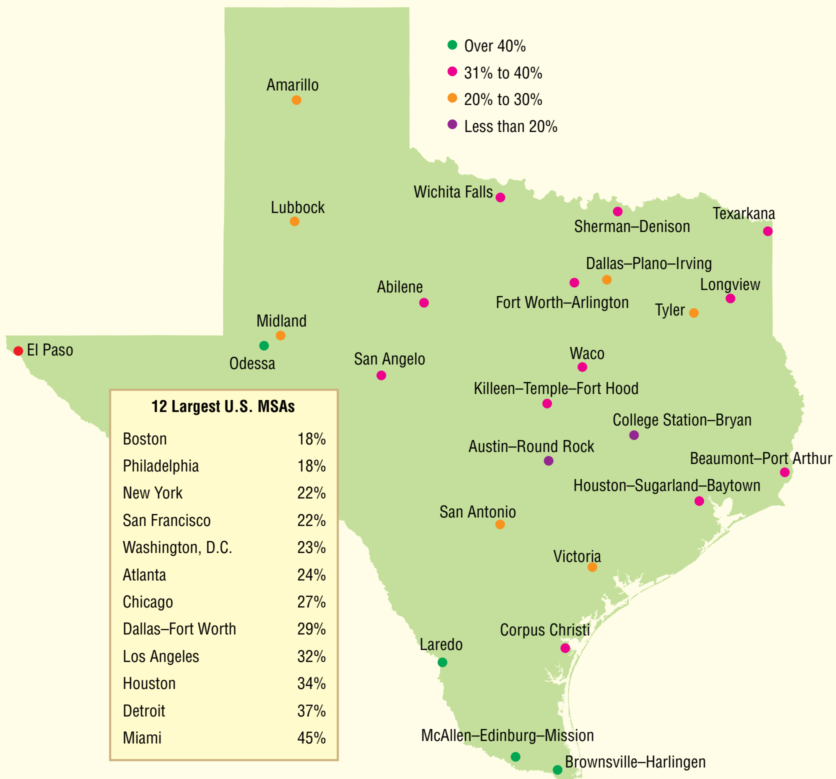
The relatively weak home-price increases in Texas led to smaller consumer spending increases than in other parts of the nation. That disadvantage became an advantage for the state economy as home prices began to fall rapidly in some parts of the country. Texas will be less affected than other areas by the loss of this stimulus.

However, Texas isn't immune to housing woes elsewhere. Relocating homeowners may be unable to complete transactions in this state if they can't sell their properties back home (*see "Hot Housing Market Catching Cold in Texas" on page 11*).

Nonresidential real estate markets have been a boon for the state since 2006, although that advantage has begun to diminish as well. When Texas homebuilding weakened last year, nonresidential activity picked up and was sufficient at first to compensate for cutbacks in residential construction. Numerous office, retail, energy and recreational facilities sprouted up across the state.

Several very large projects remain under construction in 2008, but nonresidential activity—while still at high levels—has begun to wind down.

Percentage of Higher-Priced Loans by Market
(2006 mortgage originations)



12 Largest U.S. MSAs	
Boston	18%
Philadelphia	18%
New York	22%
San Francisco	22%
Washington, D.C.	23%
Atlanta	24%
Chicago	27%
Dallas–Fort Worth	29%
Los Angeles	32%
Houston	34%
Detroit	37%
Miami	45%

SOURCES: Federal Financial Institutions Examination Council; Federal Reserve Bank of Dallas calculations.

Financial Strain

While not riding the boom-and-bust cycle seen in other parts of the country, the state's homeowners are feeling financial strain. Per capita income in Texas is below the U.S. average, and the state is home to some of the country's lowest-income counties. Many residents are particularly hard hit by high food and energy costs. Mortgage debt is becoming a burden for some Texans—more than for people in many other parts of the country.

In other states, rapidly rising home prices helped homeowners refinance or extract home equity to relieve financial pressures. Because Texas home prices didn't increase much, the state's homeowners built relatively little equity, leaving many with a thin financial cushion.[5]

Moreover, the percentage of higher-priced mortgage loans issued in Texas has been above average compared with other states.[6] In Texas' metropolitan statistical areas (MSAs), 30 percent of loans originated in 2006 were considered higher-priced—at least 3 percentage points above prevailing mortgage rates or the Treasury security of equivalent duration. This figure exceeded the percentages in most of the nation's 12 largest metro areas.[7]

Higher-priced loans were heavily used in several of the state's MSAs, particularly along the Texas–Mexico border (*see map*). The highest percentage was in McAllen–Edinburg–Mission, where such loans accounted for over half of the lending.

A closer look at the data gives additional insight into which Texans received higher-priced loans.

Just under a quarter of upper-income borrowers in Texas were issued higher-priced loans, while nearly half of moderate-income and 44 percent of low-income borrowers received such loans.

Single more than joint borrowers were most likely to be issued higher-priced loans. Over 35 percent of loans that went to single filers were higher-priced, compared with 19 percent for joint filers. Of single filers, the percentage for male and female borrowers was roughly equal.

More than 50 percent of loans issued to Hispanic or Latino borrowers and over 60 percent of loans issued to black or African-American borrowers were higher-priced. Fewer than 20 percent made to white non-Hispanic borrowers were higher-priced.

Other data suggest Texans are experiencing financial strain.

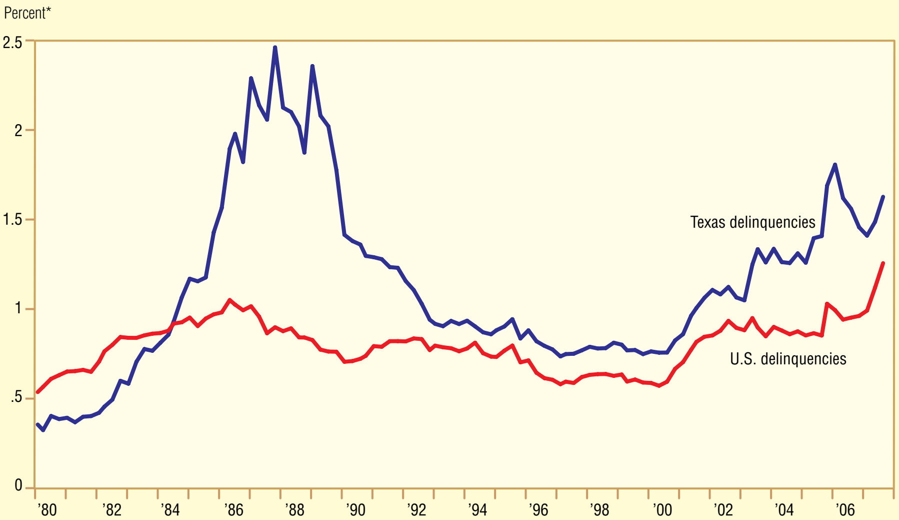
Home foreclosures in the state increased to 0.6 percent in third quarter 2007—slightly below the U.S. rate of 0.8 percent. Mortgage delinquencies also rose. Texas delinquencies for all loans 90 days past due were 1.6 percent in the quarter—higher than the U.S. rate of 1.3 percent (*Chart 5*).

Delinquencies for subprime loans—those that have higher interest rates—increased sharply. Delinquencies for subprime adjustable-rate mortgages, or ARMs, reached 6.5 percent in Texas in the third quarter, higher than the nation's 5.3 percent (*Chart 6*).

Slowing Growth in 2008

After seeing strong growth for most of 2007, the Texas economy has downshifted.

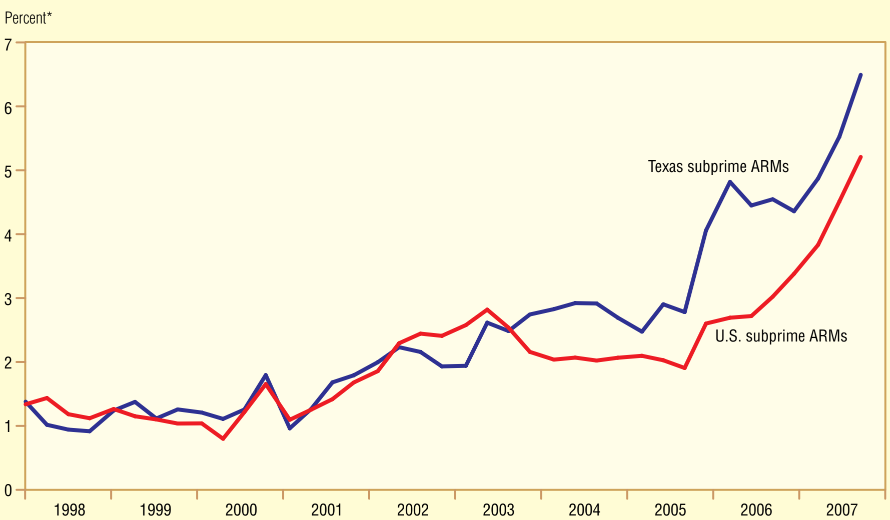
Chart 5
Residential Mortgage Delinquency Rates
(All loans of 90 days past due)



* Seasonally adjusted.

SOURCES: Mortgage Bankers Association; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

Chart 6
Share of Subprime ARM Delinquencies
(All loans of 90 days past due)



* Seasonally adjusted.

SOURCES: Mortgage Bankers Association; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

The Beige Book suggests the state's economy weakened rapidly in fourth quarter 2007. Consumer spending has softened, and some manufacturing activity has declined, particularly for construction-related products. Indexes from the Dallas Fed's Texas Manufacturing Outlook Survey (TMOS) have been signaling slowing growth for nearly a year.

Other indicators point to a slowing economy. The Fed's Texas Leading Index has been sluggish since late 2006. Employment of temporary workers has declined for the past five months; temp hiring has been a leading indicator of total employment growth in Texas.

Uncertainty has piqued the outlook. The Beige Book and TMOS indicate that some companies are planning for more limited growth in 2008, reducing capital spending and other purchases.

Challenges are on the horizon, but Texas enjoys advantages that will help it continue to outpace the nation.

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Notes

The author thanks Bill Gilmer, Amber McCullagh, Keith Phillips, D'Ann Petersen, Frank Berger and Kathy Thacker for their comments. Mike Nicholson and Raghav Virmani provided research assistance.

[1] U.S. and Texas employment data are estimates as of the publication date. Both are subject to revision.

[2] For more about the housing boom, see "The Rise and Fall of Subprime Mortgages," by Danielle DiMartino and John V. Duca, Federal Reserve Bank of Dallas *Economic Letter*, November 2007.

[3] "From Complacency to Crisis: Financial Risk Taking in the Early 21st Century," by Danielle DiMartino, John V. Duca and Harvey Rosenblum, Federal Reserve Bank of Dallas *Economic Letter*, December 2007.

[4] This paragraph is based on research in "El Paso Economy Sluggish in 2007: U.S. Slowdown Outweighs Fort Bliss Expansion," by Jesus Cañas, Robert W. Gilmer and Charles James, Federal Reserve Bank of Dallas *Crossroads*, Issue 2, December 2007.

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

[6] For additional information, see "Neither Boom nor Bust: How Houston's Housing Market Differs from Nation's," by Amber C. McCullagh and Robert W. Gilmer, Federal Reserve Bank of Dallas *Houston Business*, January 2008.

[7] Data are the most recent available and were collected as required by the Home Mortgage Disclosure Act. More information can be found at www.ffiec.gov/hmda.

OnTheRecord

A Conversation with **Mark Wynne**

Delving More Deeply into Globalization

Dallas Fed Vice President Mark A. Wynne, director of the Globalization and Monetary Policy Institute, discusses the creation of a new research center dedicated to improving policymaking in today's more-open economy.

Q. Why did the Dallas Fed create an institute to study globalization and monetary policy?

A: Globalization is one of the great economic issues of our time. A massive literature discusses its implications for everything from child labor to climate change. A couple of years ago, the Dallas Fed itself organized a conference that addressed some of the myths and realities of globalization.

However, a lot less has been written about globalization's implications for monetary policy. When Richard Fisher became Dallas Fed president in 2005, he made it clear that he wanted the study of globalization's implications for U.S. monetary policy to be the bank's signature research topic.

At the time this mandate was handed down, our Research Department wasn't well configured to conduct cutting-edge research on globalization and monetary policy. Our small international group had focused mainly on developments in Latin America, and our Center for Latin American Economics had established quite a reputation in this area. We weren't used to thinking about how international developments might matter for the conduct of U.S. monetary policy.

Q. What do you expect the institute to accomplish through its research?

A. We hope to make some substantive contributions by focusing on the implications of globalization for monetary policy, rather than the much broader questions of globalization. We're committed to conducting research that addresses the key issues policymakers are facing in a world where barriers to economic integration are falling. We will contribute to the peer-reviewed literature on international economics and monetary policy.

We're starting this institute from scratch, but we've already completed five working papers and put several research projects into motion. One of our economists, for example, is collecting data on IKEA prices around the world as a way to study how firms set prices in global markets and how these prices respond to exchange rates.

When I say that the literature on globalization and monetary policy is less abundant than the literature addressing other aspects of globalization, I don't mean it is nonexistent. A significant body of existing academic research on the conduct of monetary policy in open economies is relevant to our mission, and we expect to add to it.

Q. What issues does the institute plan to explore?

A. One of my objectives for the coming year is to draw up a research agenda that will serve as a broad outline for our efforts in the coming years. As of now, I see our research program proceeding along two tracks: first, deepening our understanding of the international economy by developing better models of trade, capital flows and migration and second, developing a better understanding of monetary policy in an open economy.

In more concrete terms, we will be studying the dynamics of the inflation process in the U.S. and asking how it has been impacted by globalization.

I don't buy the idea that large emerging markets can simply export deflation or inflation to the United States; globalization hasn't altered the ability of the Fed to control the price level in the U.S. in the long run. But I do think that increased competition from these countries and their thirst for raw materials affect the pricing decisions of U.S. firms in ways we don't fully understand.

We will also be thinking about how monetary policy ought to be made in an open economy. The Taylor rule relates short-term interest rates to inflation and the output gap, a measure of an economy's unused production potential. It has been a reasonably accurate characterization of Fed policy decisions over the past two decades or so. More important, it has been shown to deliver close to optimal performance in a wide range of settings.

One issue we need to think about is whether the Taylor rule in its current form works well in more open economies. Most research seems to have concluded that even in very open economies, central banks will do a reasonably good job just by focusing on domestic inflation developments and domestic slack. But the issue is far from settled.

Q. How does globalization alter the process of monetary policymaking?

A. We don't know yet—and that's what makes the institute such an exciting enterprise. We're used to thinking about the U.S. as essentially a closed economy for many purposes, and that remains the default position of many people when they think about U.S. monetary policy.

While the U.S. is less open than many other economies, such as Canada, for example, it has become a lot more exposed to international developments over the years. We are trading more with the rest of the world, *"As we have become more integrated with the rest of the world, some of the relationships that have traditionally guided monetary policy deliberations seem to have changed."*

we are receiving enormous capital flows from the rest of the world, U.S. firms are investing more overseas, and we continue to be the destination of choice for many emigrants.

As we have become more integrated with the rest of the world, some of the relationships that have traditionally guided monetary policy deliberations seem to have changed. For example, domestic inflation developments seem to have become less correlated with measures of domestic slack, and not just in the U.S.

Some argue that this is simply a reflection of better monetary policy around the world, while others argue that the relevant measure of slack is global rather than national. I'm not sure which explanation is the better one—both have their merits. But figuring out which is correct is an important challenge.

Q. Why a separate institute?

A. The main benefit of creating the institute is to underline our commitment to this research program and make it easier to achieve a critical mass by drawing on both internal and external resources.

Our first priority was to hire staff with technical expertise and research interests in open economy macroeconomics. We've been very successful in this regard, and the five economists we've brought on board over the past two years to further President Fisher's research program are the core of the new institute. Mike Cox, the Dallas Fed's chief economist, is one of the institute's senior fellows.

We don't intend to isolate ourselves from the rest of the Research Department. The staff economists affiliated with the institute participate fully in the department's core activities—especially the briefing process that helps prepare President Fisher for the policymaking meetings of the Federal Open Market Committee.

I think it is important to have the economists working to understand the implications of globalization for monetary policy actively engaged in the regular discussions of policy. Participation in these briefings can be a useful source of ideas for research and allows the economists to bring their research findings to bear on policy discussions.

Q. You've also been able to draw talent from outside the Dallas Fed.

A. Yes. This is one of the great advantages of creating an institute, rather than working exclusively within the Research Department. It gives us a greater opportunity to tap the expertise of some of the economics profession's experts on the important issues of globalization and monetary policy.

Our advisory board includes several eminent scholars, who will guide our research efforts and be a resource for us. Stanford University's John Taylor, who formulated the Taylor rule, is the chairman. Finn Kydland, a long-time Dallas Fed consultant, won the Nobel Prize in economics, in part for work he did emphasizing the need for rule-based monetary policy. Kydland has also made seminal contributions to business-cycle theory and international macroeconomics. A board of this caliber provides the institute with instant credibility.

In addition to the core group of economists at the Dallas Fed, we already have two external senior fellows—Michael Devereux from the University of British Columbia and Frank Warnock from the University of Virginia. We hope to add more during the coming year. The senior fellows will be involved in shaping the research agenda, working with our staff economists and giving us vital feedback on our research.

Q. How do you see your role as director?

A. My job is simply to make sure things stay on track and get done—from the day-to-day progress on research projects to maintaining the focus on the research agenda and recruiting new senior fellows.

I come from Ireland, and dealing with globalization becomes second nature to those who live in small countries. You have to think about what's happening in the rest of the world and how it affects you. Before becoming the Celtic Tiger, Ireland was one of the poorest countries in Europe and now it's one of the richest, partly because of globalization.

So I find something intuitively intriguing in studying globalization. I see this institute as an opportunity to be part of an effort to examine cutting-edge issues in economics and work with leading scholars, as well as fine young researchers.

SpotLight

Border Health Care

Booming Industry Creates Jobs Faster than State

The Texas cities along the Mexican border have sustained relatively strong job growth in recent years. A key factor has been a booming health care industry, driven by rising population and the large share of the population covered by government-sponsored health insurance.

Since 2000, health care's share of total jobs has risen faster than the state average in every border metro except El Paso. By 2006, health care jobs accounted for 22 percent of employment in Brownsville, 21 percent in McAllen and 14 percent in Laredo. El Paso matched the state as a whole at 12 percent (*Chart 1*).

The industry has become an important source of well-paying jobs in a region that has a higher than average share of low-paying jobs. High-skill health care workers earn wages comparable to the state average. For some occupations, such as pharmacists, the median border wage is higher than the state's (*Chart 2*).

Several factors are boosting the health care sector along the border. First, strong population growth has occurred over the past 20 years. From 1990 to 2006, it increased 49 percent in Brownsville, 83 percent in McAllen and 74 percent in Laredo, all well above Texas' 38 percent.

Residents used to travel outside the region for many surgical procedures, but the larger population base makes it financially feasible to open local medical offices and hospitals to provide those services.

Second, health care demand isn't wholly dependent on income. According to industry contacts, a significant number of border residents are eligible for government programs. Medicare covers many of the elderly who retire in the Lower Rio Grande Valley or stay there in the winter. Medicaid is available to the relatively large portion of the population with low incomes.

Population and job growth have been strong on the Mexican side of the border as well, and some Mexicans cross the Rio Grande for medical services. Contacts report, however, that most of the industry's recent growth has come from the U.S. side.

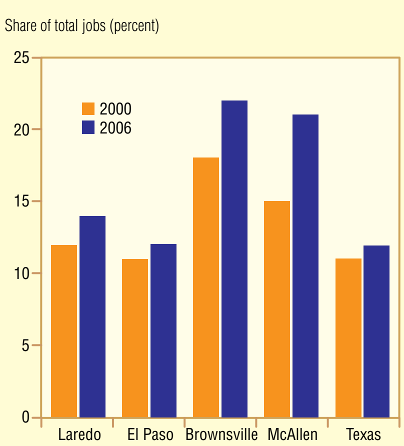
Home health care has been one of the strongest segments of medical services, with employment gains exceeding industry and statewide averages in all four border metros. From 2000 to 2006, annualized job growth reached 16.5 percent in Laredo and 14.6 percent in McAllen—both more than double Texas' 6.9 percent.

Health care contacts in the border region say home care is important for the elderly living on low incomes and for patients who resist going to doctors' offices because of language or other barriers. Services provided include wound care and treatment for diabetes. Low start-up costs are another factor stimulating the formation of home health care companies.

According to forecasts from the Texas Workforce Commission (TWC), strong employment growth will continue in the border health care industry. Between 2004 and 2014, for example, the TWC forecasts that high-skill health care jobs will increase 46 percent in the Lower Rio Grande Valley, compared with 34 percent in Texas. Similarly, Valley health care support jobs are projected to increase 51 percent, well ahead of Texas' 40 percent.

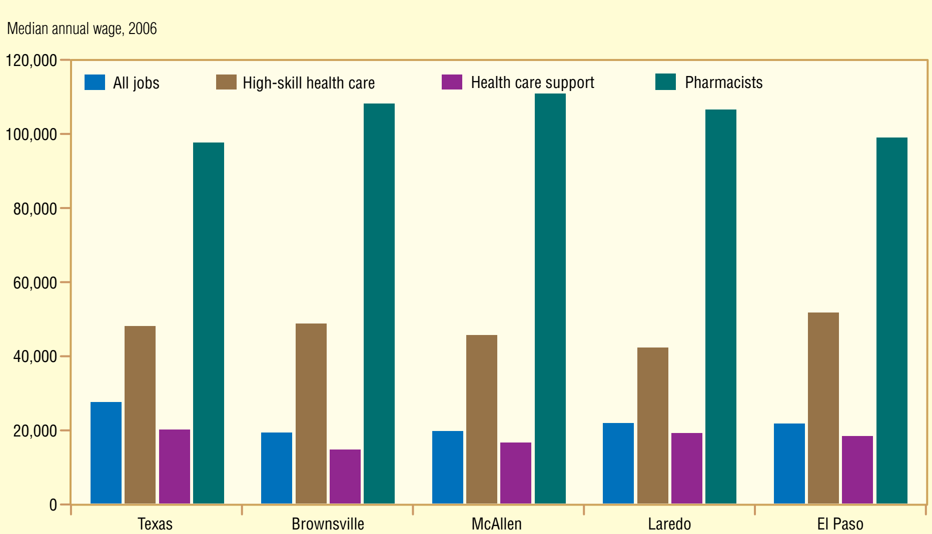
—Keith Phillips and Armida Riojas

Chart 1
Border Health Care Employment Rising



SOURCE: Texas Workforce Commission.

Chart 2
High-Skill Health Care Jobs Pay High Wages



SOURCE: Texas Workforce Commission.

Hot Housing Market Catching Cold in Texas

By D'Ann Petersen

The Texas housing market enjoyed a remarkable upswing in the middle of this decade.

Home sales and building accelerated in 2004 as the state's economic engine revved up, generating strong population and employment growth. Historically low interest rates attracted new homebuyers, while the rise in nontraditional mortgages fueled the market's strength as more Texans were able to obtain financing even if they had flawed credit or lacked down payments. The state's homeownership rate reached a record 66 percent in 2006, up from 61.8 percent 10 years earlier.

The nation's housing market began faltering in 2005, but Texas' kept expanding at a feverish pace through spring 2006. Then it began to cool. Buyers turned cautious and builders cut back in response to slower demand. Texas' existing-home sales bucked the national trend through December 2006, but they too started to slip as the new year got under way.

In 2007, national housing ills took a toll on Texas' housing sector. Persistent declines in U.S. sales and home prices spooked many potential Texas homebuyers. In addition, a slowdown in the regional and national economies, along with tighter credit conditions brought about by the subprime fallout, further reduced the pool of willing and able Texas home purchasers. Sales continued edging down, and home construction retrenched further. Homebuilders and manufacturers of residential construction products bore the brunt of the housing downturn and reduced payrolls to cut costs.

The Texas housing industry faces a difficult year in 2008. Many potential homebuyers are unable to get financing or await news of a housing turnaround. While Texas' housing sector is weakening, it remains healthier than the national average, and Texas metro markets are better positioned than many other parts of the country to thrive when housing demand turns the corner.

Homebuilding Takes a Hit

With sales in other parts of the country spiraling downward, large national builders—whose cash flow and balance sheets were hurt by problems elsewhere—at first shifted building to Texas and its robust economy. Permits for single-family home construction surged in late 2005 and early 2006 (*Chart 1*).

As concerns about the national housing market trickled down to Texas, the cooling showed up initially in new-home building. Buyers became more wary. Cancellation rates soared as would-be Texas homebuyers became unable to sell their existing homes elsewhere in the country.

The state was left with an increasing supply of finished homes. New-home inventories in Texas had already begun to edge up above the comfort zone of six months before new-home sales showed signs of cooling in the second half of 2006. That's when builders, responding to lagging demand and rising inventories, pulled back strongly on new-home construction.

As the pace of building slackened, other segments of the market remained on the upswing. Strong job growth of 3.5 percent in 2006—more than double the nation's—extended Texas' existing-home market expansion. Pre-owned-home sales, which account for almost twice the volume of new-home sales, hit a record high in 2006, despite a decline of 8 percent nationally.

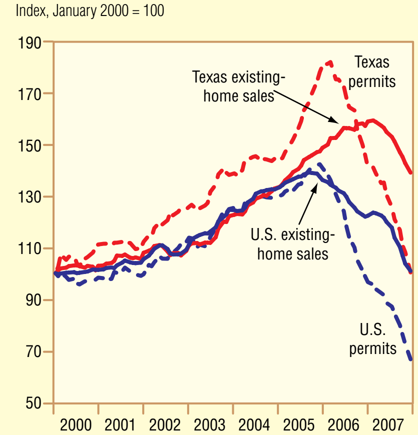
Affordability was a major factor in Texas, where the median home sold for less than 70 percent of the nationwide price. While increased job opportunities, rising incomes, low interest rates and easy credit spurred sales among Texans, residents from other states found Texas homes more attractive as prices skyrocketed in other parts of the country.

Texas owes its housing affordability to ample land supply and relatively few regulations on construction. This allows supply to respond quickly to demand, boosts competition and keeps a lid on price increases in both new and pre-owned markets. During the housing boom, Texas homes appreciated modestly, while prices elsewhere soared out of reach of many Americans (*Chart 2*).[1]

The National Association of Home Builders–Wells Fargo Housing Opportunity Index, which measures the percentage of homes sold at prices an area's median-income household can afford, gave Texas metros high scores in 2006. The index ranged from 52 percent in San Antonio to 67 percent in Fort Worth, compared with a national average of 41 percent. Areas of the country that witnessed rapid appreciation during the boom, including parts of California and Florida, recorded affordability rates in the single digits and teens.

Diminishing affordability contributed to the nation's housing woes.

Chart 1
Texas Housing Market Falters



NOTE: Existing-home sales are five-month moving average; housing permits are six-month moving average.

SOURCES: Census Bureau; National Association of Realtors; Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

Texts' home sales, both new and pre-owned, fell in 2007, although the annual decline was less dramatic than the nation's.

In 2007, U.S. home sales fell at a record pace, national home inventories ballooned to levels not seen since the mid-1980s, foreclosures shot up and home prices deteriorated throughout the year, especially on the East and West coasts.

Because Texas' housing sector held up relatively well in 2006, industry executives remained hopeful the state would be spared a hard hit in 2007.[2] Most were hoping for a minor dip in building. Those hopes were short-lived, however, as several negative factors converged during the past year, resulting in a statewide housing slump.

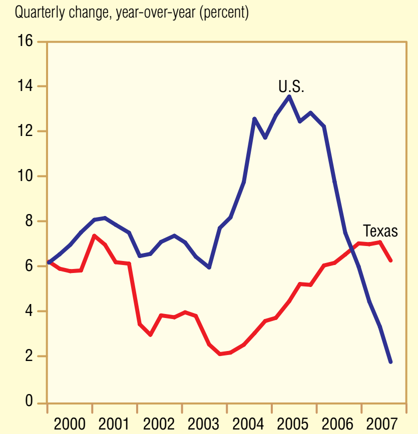
Although conditions were better than in the rest of the country, Texas homebuyers turned apprehensive, which dampened demand for both new and existing homes. In addition, more stringent lending standards associated with the subprime mortgage crisis eliminated many potential first-time homebuyers, a market that had spurred much of Texas' sales in prior years. Finally, a slowdown in economic growth both nationally and in Texas further reduced the demand for homes.

Texas' home sales, both new and pre-owned, fell in 2007, although the annual decline was less dramatic than the nation's. According to anecdotal reports including the Dallas Fed's Beige Book, the higher-priced segment of both markets remained strong throughout the year, but sales of lower-priced homes dropped dramatically after August 2007.

A Closer Look: Metro Markets

Because of their sheer size, the state's major metros make up the lion's share of new-home building and sales—accounting for roughly 80 percent of the state's total.

Chart 2
Texas Home Prices Less Volatile
(OFHEO House Price Index)



SOURCE: Office of Federal Housing Enterprise Oversight; adjusted by the Federal Reserve Bank of Dallas.

Like in the state as a whole, the pace of homebuilding began to edge down in most major metros in 2006 and decelerated further in 2007 (*Chart 3*). Metro existing-home sales held up through 2006 but weakened in 2007, especially in the second half of the year as the credit crunch took hold (*Chart 4*).

While the housing downturn has impacted all major Texas metros, the extent of the fallout is somewhat varied. The cooldown has been most prominently felt in Dallas–Fort Worth. The metroplex more closely resembles the nation than other Texas metros in economic structure. Following the U.S. lead, D–FW job growth slowed to 2.3 percent in 2007, down from a robust 4.3 percent in 2006. Fort Worth's rate of job increase decelerated from 2.7 percent to 2 percent over the same period. While still respectable, the slower rates of job formation mean fewer homebuyers.

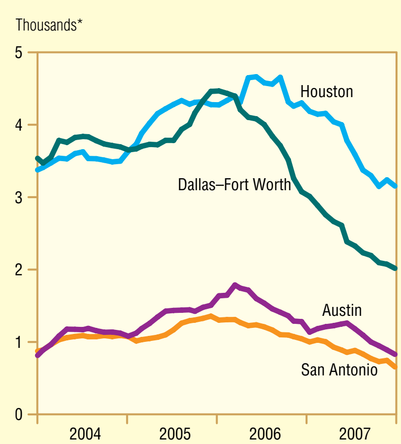
Total new-home sales in the metroplex fell 17 percent in 2007, according to Metrostudy, a residential consulting company, and existing-home sales declined 8 percent in Dallas and 5 percent in Fort Worth.[3] Builder inventories of finished homes reached record levels in early 2007. A sharp reduction in construction—with building permits plunging by more than 16,000, or 37 percent—brought inventories down to more comfortable levels by year-end.

In San Antonio, vigorous 2006 job growth, coupled with recognition as one of the country's best places to live, pushed up home sales and expectations of future demand. In 2007, however, the Alamo City's job engine slowed, putting a damper on sales. New-home sales edged down 8.5 percent and existing-home sales dropped 9 percent from the previous year. Builders reacted quickly and pulled the reins on housing construction. As a result, single-family permits fell by 4,511 last year, or 33 percent.

In 2006 and 2007, Houston and Austin led the state's major metros in job growth. Initially, the booming energy sector in Houston and a strengthening high-tech sector in Austin helped cushion the metros from the full impact of national factors that led to homebuyer uncertainty elsewhere. Despite their strong economies, the two metros saw new- and existing-home sales falter in 2007, especially as credit tightened late in the year. Builders cut back on construction; by December, single-family permits had fallen 21 percent in Houston and 30 percent in Austin from 2006 levels.

Texas home prices held up quite well in 2007, despite the weakening housing landscape. U.S. median existing-home prices fell 6.5 percent from December 2006 to December 2007, but Texas metros saw mostly stable home prices, with an overall increase of 1 percent (*Chart 5*). Price appreciation varied by metro, with Austin in the top spot at 8 percent and Dallas prices inching down 2 percent.

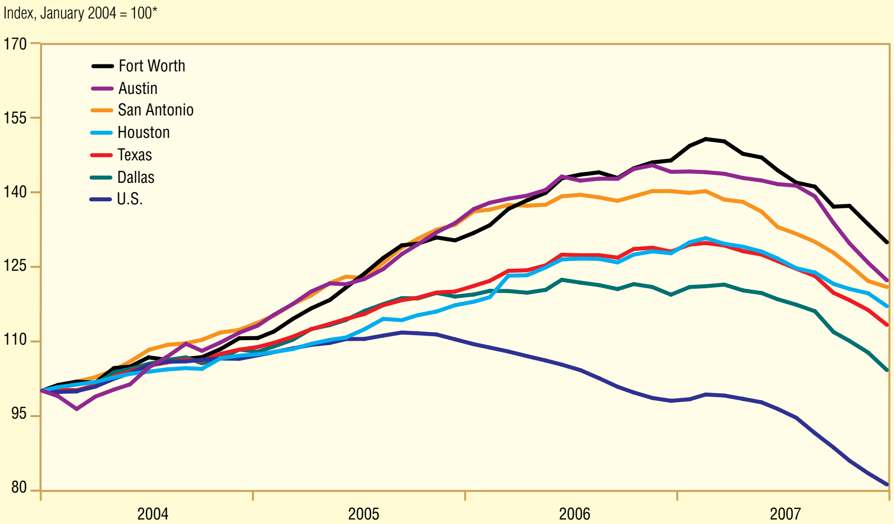
Chart 3
Homebuilding Ebbs in Texas Metros
(Monthly single-family permits)



* Five-month moving average.

SOURCE: Census Bureau; seasonal adjustments by the Federal Reserve Bank of Dallas.

Chart 4
Existing-Home Sales Edge Down in Texas, Plunge Nationally



* Six-month moving average.

SOURCES: National Association of Realtors; Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

While rising, prime and subprime ARM foreclosures remain a small part of Texas' overall loan pool.

New-home prices aren't readily available at the metro level, but Dallas Fed business contacts say prices have held mostly steady despite aggressive discounting on unsold inventory in some areas.

Down but Not Out

While the Texas housing industry faces some tough challenges in the year ahead, the state has so far managed to avoid the pitfalls of the nationwide housing downturn.

One major concern is the possibility of dramatic increases in foreclosures, which could inflate Texas home inventories and push down prices. So far (through third quarter 2007), foreclosures as a percentage of total loans outstanding have held relatively steady in Texas, while spiking in the U.S. (*Chart 6*). Likewise, Texas' inventory of loans in foreclosure as a share of total loans outstanding is below the national average.

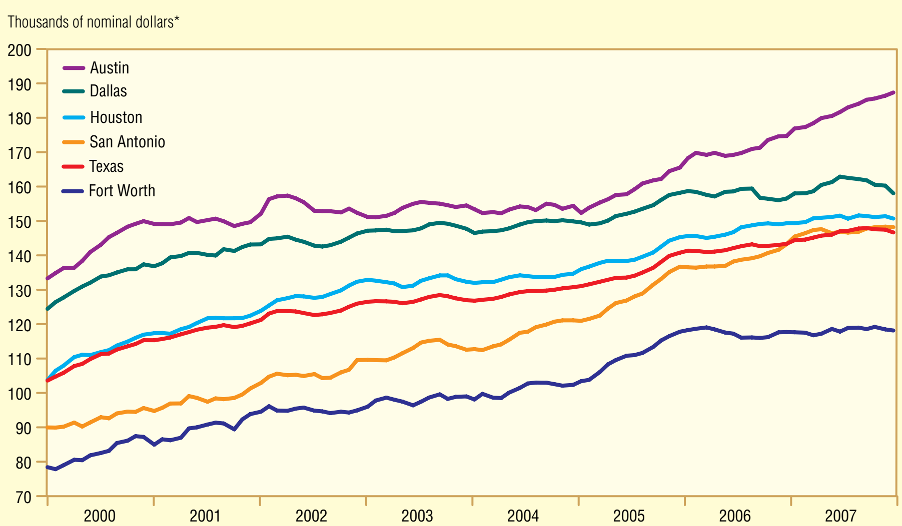
Texas' foreclosure rate remains close to the level recorded during the state's high-tech downturn, when telecom-related layoffs forced many homes back on the market. While the percentage is roughly the same, today's foreclosures are more likely skewed toward higher-cost loans and adjustable rate mortgages (ARMs) often used by first-time homebuyers and those without downpayments or with blemished credit.[4]

As interest rates reset on homes purchased with ARMs, homebuyers drawn in by creative financing may be unable to afford higher monthly payments. Texas' slower housing appreciation affords less opportunity to tap home equity when these homeowners become financially strained.[5] While rising, prime and subprime ARM foreclosures remain a small part of Texas' overall loan pool—0.8 and 3.6 percent, respectively, in the third quarter 2007, well below the U.S. shares of 0.97 and 4.7 percent.

Because of its relative affordability, Texas has a smaller share of jumbo loans—loans above the government's conforming limit of $417,000. While overall credit has tightened for all types of loans, the market for jumbo loans has become especially restrictive recently because it includes a large share of subprime mortgages.[6] In contrast, nonjumbo loans were mostly made up of traditional fixed-rate mortgages (88.1 percent).[7] The smaller percentage of jumbo loans may lessen the impact of the credit squeeze in Texas relative to some more expensive areas of the country.

Other factors should help Texas housing markets avoid the problems other states

Chart 5
Texas Median Existing-Home Prices Hold Up

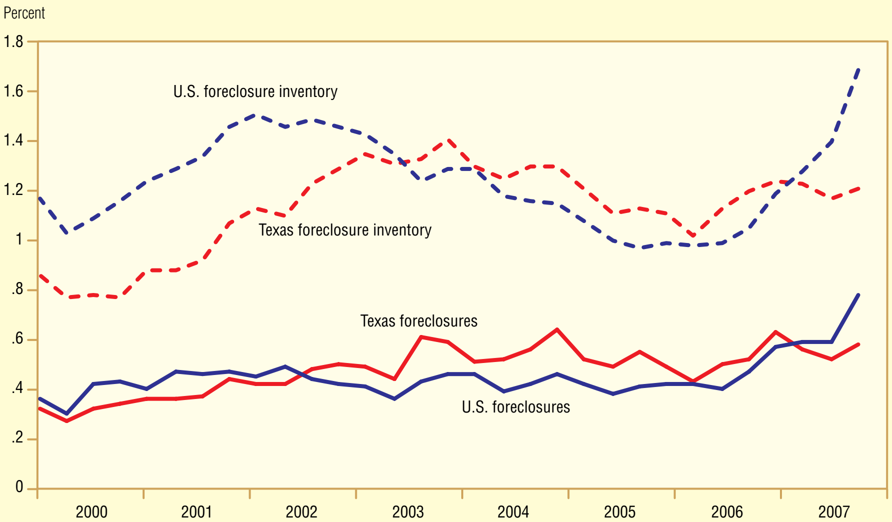


* Four-month moving average.

SOURCE: Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

Chart 6

Texas Foreclosures and Inventories Relatively Steady



NOTE: Foreclosures are number of foreclosures initiated in the quarter as a percentage of total loans. Inventory is total number of loans in the foreclosure process as a percentage of total loans.

SOURCE: Mortgage Bankers Association; seasonally adjusted by the Federal Reserve Bank of Dallas.

are facing. Most notably, Texas home prices continue to hold up fairly well compared with prices at the national level.

Thanks to plenty of land and few building restrictions, Texas didn't join the nation in the run-up in housing values during the boom years. More recently, builder restraint in response to weaker demand has helped keep Texas' new-home inventories in check—near six months' supply in most major metros, compared with more than 10 months at the national level (*Table 1*).[8] While existing-home inventories edged up slightly in 2007—from 5 months' supply to 6.1 months'—they're still well below levels recorded even as recently as the mid-1990s.

Tighter inventories should help buffer Texas markets from the large price declines prevalent in other areas of the country. While some downward movement is possible, the risk of price declines is much smaller in Texas than in other parts of the U.S.

The PMI Mortgage Insurance Co.'s U.S. Market Risk Index—a measure of vulnerability to future price declines—ranks Texas' metros among the 11 least vulnerable in its 50-city survey. In fact, Dallas, Fort Worth and Houston rank among the four lowest for risk of price deterioration.

Most important, while economic growth is expected to continue to slow, Texas is still expected to outpace the national average.

Long-Term Advantages

2008 will be a tough year for the Texas housing industry. While fundamentals are healthier in Texas than in many other parts of the country, housing demand has lost its luster, and it may be some time before buyers feel confident enough to jump back into the market.

A slowing national economy, the recent move toward more stringent lending practices, rising foreclosures and lagging housing prices in other states will continue to negatively impact the housing industry in Texas.

Table 1

Texas Home Inventories Tighter

(Months' supply of single-family homes)

	Existing homes Q4'07	New homes* Q4'07
Austin	4.6	7.3
D–FW		6.8
Dallas	6.5	
Fort Worth	6.3	
Houston	6.6	6.0
San Antonio	6.4	5.6
Texas	6.1	
U.S.	10.0	10.6

*Not seasonally adjusted.

SOURCES: Metrostudy; Census Bureau; National Association of Realtors; Texas A&M Real Estate Center; seasonal and other adjustments by the Federal Reserve Bank of Dallas.

There is a bright side. Texas metro housing markets remain better off than other areas of the country in terms of prices, inventories and foreclosures. Moreover, despite the recent pullback, Texas is still the top state for homebuilding.

In the longer term, Texas' location and cost advantages, fast-growing population and relatively buoyant economy put the state's housing industry in a strong position to respond when demand turns the corner.

Petersen is a business economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

Thanks to Bill Gilmer for comments and to Mike Nicholson for research assistance. Thanks to Metrostudy for sharing housing data.

1 The OFHEO home price index is a broad measure of the movement of single-family house prices. It is a weighted, repeat-sales index, meaning that it measures average price changes in repeat sales or refinancings on the same properties. This information is obtained by reviewing repeat mortgage transactions on single-family properties whose mortgages have been purchased or securitized by Fannie Mae or Freddie Mac since January 1975.

2 Based on the Dallas Fed's Beige Book, a regular survey of current economic conditions.

3 Calculated as total sales in 2007 versus total sales in 2006.

4 For more information, see "Neither Boom nor Bust: How Houston's Housing Market Differs from Nation's," by Amber C. McCullagh and Robert W. Gilmer, Federal Reserve Bank of Dallas *Houston Business*, January 2008.

5 A decline in Gulf Coast foreclosures, including Houston, can be attributed to actions taken by the Department of Housing and Urban Development, which implemented a moratorium on foreclosures in federal disaster areas for properties insured by the Federal Housing Administration from August 31, 2005, through August 31, 2006.

6 According to the Office of Federal Housing Enterprise Oversight, risky interest-only loans and negatively amortizing ARMs made up nearly two-thirds of the dollar volume of first-lien jumbo loans originated in the U.S. in the first half of 2007 and later securitized, whereas traditional fixed-rate mortgages composed only a quarter of those loans.

7 "Mortgage Market Note 08-01: Potential Implications of Increasing the Conforming Loan Limit in High Cost Areas," Office of Federal Housing Enterprise Oversight, Jan. 11, 2008.

8 Inventories are months' supply of single-family homes on the market at the current sales pace.

NoteWorthy

QUOTABLE: *"The U.S. rig count has held steady for several months while the Texas rig count jumped sharply, led by work in the Barnett Shale near Fort Worth."*

—Robert W. Gilmer, Vice President

AGRICULTURE: Overall Economic Impact in 2007 Sets Texas Record

Texas agriculture ended 2007 on an upbeat note. The Texas Department of Agriculture estimates that the industry's economic impact surpassed the $100 billion mark for the first time, eclipsing the record of $85 billion set in 2004.

Economic impact covers all activities linked to the agricultural sector, such as fertilizer production, food processing, machinery repair, transportation and distribution.

Texas saw favorable growing conditions, a departure from 2006, when the state underwent a severe dry spell. Overall, production reached near-record levels at a time of high commodity prices, bolstering farm incomes in the state.

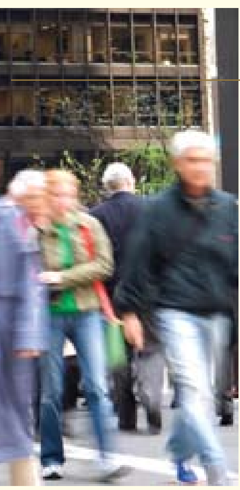
Some of the largest gains came from crops used to generate such alternative fuels as ethanol, which have seen expanding demand for more than a year. Compared with 2006, production rose 69 percent for corn and 159 percent for sorghum.

Increased planting of higher-priced biofuel-producing crops meant a sharp decline in total planted acres for Texas Upland-variety cotton. Even so, the crop registered a 40 percent increase in production, thanks to excellent yields.

Bankers responding to the Dallas Fed's fourth-quarter 2007 Agricultural Credit Conditions Survey say that the bountiful crop and favorable prices have improved Texas producers' cash flow and spurred investment in farm equipment.

The survey also indicates that farmland values continue to rise sharply in response to stepped-up demand for alternative uses, further benefiting the state's agricultural producers.

—Laila Assanie



DEMOGRAPHICS: Texas Population Growth Still High but Slowing

Newly released Census Bureau data show that Texas' population rose 2.1 percent in 2007, down from 2.5 percent the year before. The U.S. population grew about 1 percent in both years.

Texas is the seventh-fastest-growing state, with Nevada, Arizona and Utah leading the pack.

Although some states have faster growth rates, none adds more people annually than Texas. The state has gained an average of 422,220 people a year since 2000, split almost evenly between domestic and international migration and natural increase (births minus deaths).

The economic implications of population growth are significant—particularly from migration. Newcomers bring both labor and capital. While they come largely in response to ongoing growth, they also help expand the economy through their own consumption and investments.

In-migration is the biggest reason Texas can sustain its rapid pace of job growth. Texas employment grew 3.5 percent in 2006 and 3.1 percent in 2007. Even with hefty in-migration, labor markets tightened and unemployment rates fell over these two years from 5.3 percent to 4.5 percent.

—Pia Orrenius and Mike Nicholson

CREDIT: Modest Number of Factories Report Financing Concerns

A Dallas Fed questionnaire on credit conditions suggests that only a modest number of Texas manufacturing firms have recently encountered financing problems. In January, 11 percent of surveyed firms that sought credit reported difficulty obtaining it, down from 20 percent in December.

Asked to describe how recent market conditions had affected their ability to obtain credit, only 1 percent of all firms surveyed called their difficulties "significant" in January. None did the previous month. Firms replying "somewhat" fell to 5 percent in January from 14 percent in December. Forty-six percent of firms didn't seek credit in January, up from 29 percent.

The Dallas Fed began gathering information on credit conditions along with its Texas Manufacturing Outlook Survey after hearing reports of tighter lending requirements.

The share of factories indicating that credit availability has affected their outlook or operations fell from 26 percent in December to 17 percent in January. Among firms reporting changes in January, 12 percent said they were decreasing actual capital spending and 22 percent were reducing capital spending plans. In addition, 17 percent were hiring fewer workers and 22 percent were curtailing hiring plans.

The survey is one of the Dallas Fed's ongoing efforts to gather and disseminate timely economic information from the business community. A summary of the overall business conditions index is posted on the bank's website, www.dallasfed.org, as part of the monthly manufacturing outlook survey.

—Fiona Sigalla

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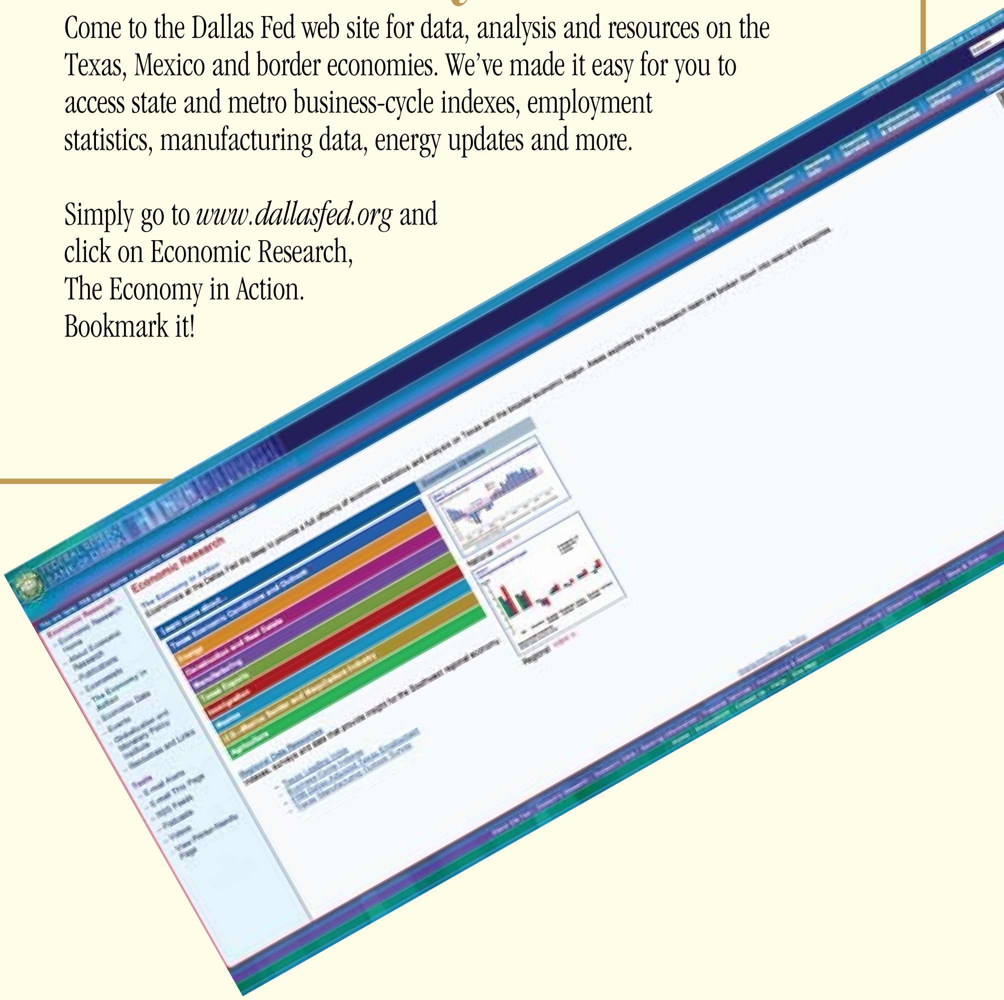

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