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.

¹ 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. 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 true value of many of the nation’s homes took hold. 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. 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

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

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* 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
Financial Strain

While not riding the boom-and-bust cycle seen in other parts of the country, the state’s homebuyers 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.

Moreover, the percentage of higher-priced mortgage loans issued in Texas has been above average compared with other states. 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.

Higher-priced loans were heavily used in several of the state’s MSAs, particularly along the Texas–Mexico border. 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.
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
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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.


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.