Texas Economy Shakes Off Rough Ride in 2009

By Laila Assanie and Pia Orrenius

Recent economic data and anecdotal evidence suggest the worst of the state's economic woes may be over. Activity is growing in several sectors.

Texas entered 2009 with its economy mired in recession, a consequence of the global financial crisis, collapsing energy prices and falling exports. After outperforming the nation the previous four years, the state experienced steep declines in economic activity last year that nearly matched the U.S. freefall.

Texas lost 338,600 jobs in 2009, and the state's unemployment rate rose to its highest level in 22 years.[1] The Dallas Fed's Texas Business-Cycle Index—a barometer of the state's economic health—plunged 4.6 percent from December 2008 to December 2009.

While conditions remain weak, it appears that the Texas economy is on a steadier course after a rough ride last year. Recent economic data and anecdotal evidence suggest the worst of the state's economic woes may be over. Activity is growing in several sectors. The state maintains its traditional advantages—relatively low living costs, modest taxes, a central location and an attractive business climate. Barring further setbacks, the Texas economy should pick up steam in 2010 and beyond.

Comparing Texas Recessions

Since the early 1970s, Texas has skirted three of the six U.S. recessions, thanks to high or rising oil prices, a net positive for a state with a large energy sector.[2] Even so, the state joined the U.S. in three recessions and had its own downturn in 1985–87. Oil prices fell steeply in 1986 and contributed to a widespread real estate bust and banking crisis.

We use changes in employment and output to compare the 2008–09 downturn with recessions that began in 1982, 1985 and 2001.[3] We date Texas recessions based on the Texas Business-Cycle Index, a measure constructed with data on Texas' payroll employment, the unemployment rate and real state gross domestic product (GDP). A rising index signals expansion, while a falling index suggests a downturn.

From the peak of economic activity in mid-2008 through December 2009, payrolls fell 3.7 percent—a deeper decline than the 3.2 percent in 1982–83, 3 percent in 1985–87 and 2.2 percent in 2001–03 (*Table 1*).[4]

Unemployment rate changes followed a similar path. From June 2008 through December 2009, unemployment rose 3.4 percentage points. The peak-to-trough increases were 2.4 percentage points in 1982–83, 2.1 percentage points in 1985–87 and 2.5 percentage points in 2001–03.

Looking at state GDP three quarters into each downturn, this recession's contraction of 5.4 percent exceeds the declines of 3.3 percent in 1982–83 and 3.5 percent 2001–03.[5]

Table 1
2008–09 Recession Hits Texas Hard

Measure	Texas recessions 1982–83	1985–87	2001–03	2008–09
Employment (percent change)	–3.2	–3.0	–2.2	–3.7
Unemployment rate (percentage point change)	2.4	2.1	2.5	3.4
State gross domestic product, first three quarters (percent change)	–3.3	–5.3	–3.5	–5.4

NOTE: Employment and unemployment changes are measured from peak to trough for past recessions and through December 2009 for the 2008–09 recession.

SOURCES: Texas Workforce Commission; Federal Reserve Bank of Dallas; Bureau of Economic Analysis.

The plunge this time is close to the 5.3 percent contraction experienced by the state economy during the 1985–87 oil and real estate bust.

Before the most recent recession, output and employment growth were much stronger in Texas than in the U.S. In fact, the state held its own in the first half of 2008, even as the nation slipped into recession under the weight of the housing bust. Texas' historically large declines in employment and output this time likely stem from the timing of external shocks. The financial crisis, the collapse in global trade and the plunge in energy prices delivered near-simultaneous blows to the state's large trade, energy and high-tech sectors.

Signs of Recovery

Texas has been hit much harder by the 2008–09 recession than previous ones. As 2009 drew to a close, however, hopeful signs began to emerge in the labor market and across several sectors, including manufacturing, exports, housing, energy and transportation.

Labor market losses subside. Texas' labor market contracted through most of 2009, declining 3.2 percent from December 2008 to December 2009, below the nation's –3.5 pace. The brunt of Texas' decline came in the first half of the year, when the state shed jobs at a 5 percent pace. With job losses mounting, the state's unemployment rate climbed from 6.1 percent in December 2008 to 8.2 percent one year later.

In the second half of 2009, employment losses gradually subsided. Job growth averaged about zero in the last three months of the year and turned positive in January 2010 (*Chart 1*).

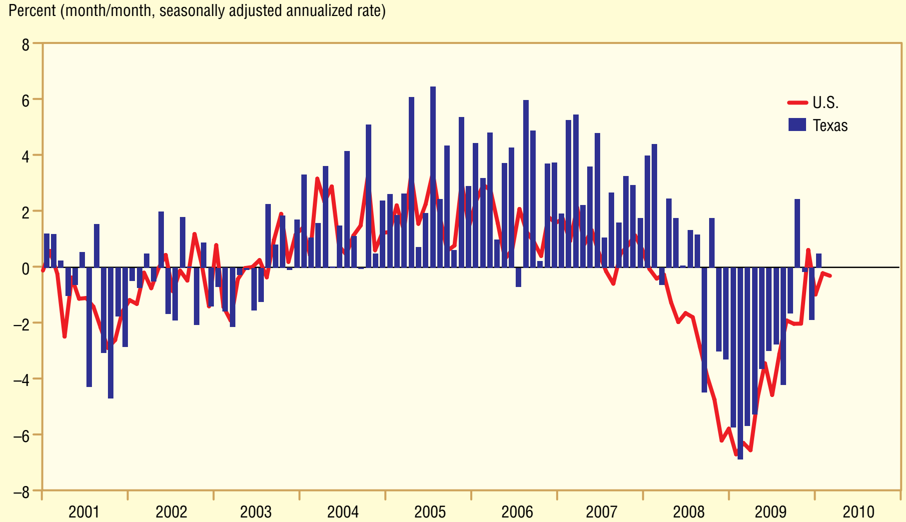
Service-providing industries held up better than goods-producing industries in 2009. The service sector shed jobs at a 1.3 percent pace from December 2008 to December 2009; meanwhile, employment in the goods-producing sector plunged 12.5 percent (*Chart 2*). This result isn't unusual: Goods-sector employment is generally much more cyclical than service-sector employment. The goods sector makes up about 15 percent of state jobs, and services accounts for the rest.

Despite the still-weak employment picture, the Texas labor market's leading indicators are improving. Initial jobless claims peaked in spring 2009 and have been falling since, suggesting the unemployment rate is at or near its high point. From October 2009 through January 2010, the state payroll survey reported increases in weekly hours worked in manufacturing, a positive sign because hours worked tend to rise before hiring.

Since September, the Dallas Fed's Beige Book—an anecdotal survey of current economic conditions—has been reporting that most employers are finished with job cuts and are holding employment levels steady. In addition, staffing firms are noting increases in temporary hiring, a favorable indicator because growth in short-term employment typically leads Texas job creation by about five months.

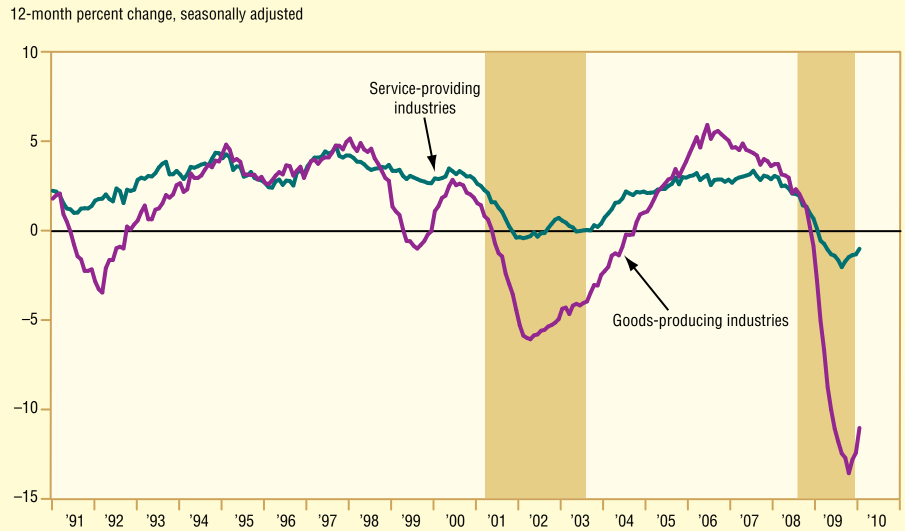
Broad indicator turns up. Declines in the Texas Business-Cycle Index have been decelerating since second quarter 2009 and the indicator grew in January, suggesting the state's economy is in recovery. The monthly declines moderated from –6.9 percent in

Chart 1
Texas Job Declines Slow in Second Half of 2009



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

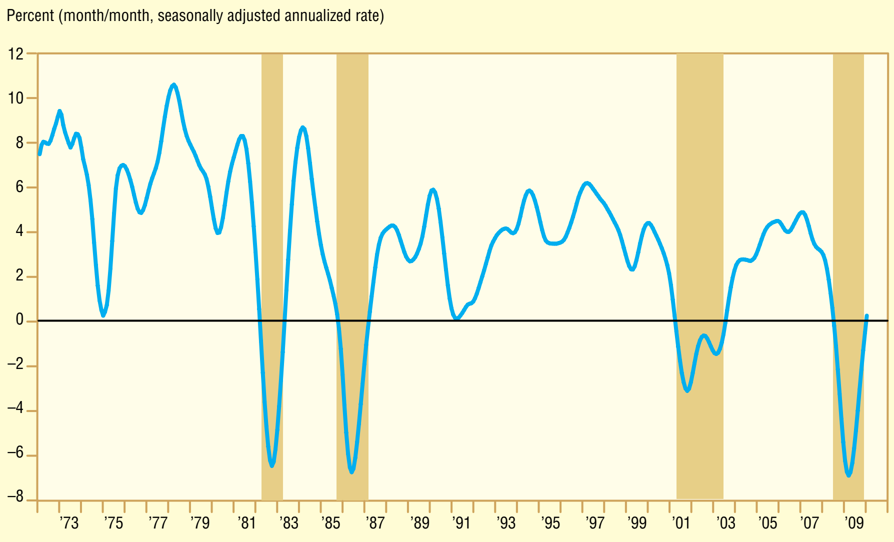
Chart 2
Employment Growth Less Volatile for Services than Goods in Texas



NOTE: Shaded areas represent Texas recessions.
SOURCES: Texas Workforce Commission; seasonal and other adjustments by the Dallas Fed.

Chart 3

Texas Business-Cycle Index Suggests State's Recession Is Over



NOTES: Shaded areas represent Texas recessions. The index is an aggregate measure of the state's current economic activity.

SOURCE: Federal Reserve Bank of Dallas.

March to –0.5 percent in December (*Chart 3*). The January increase was the first since June 2008.

A lack of fourth-quarter state GDP data is holding down the index. State economic output has been increasing since the last reading in third quarter 2009. Texas real GDP rose 1.6 percent in the third quarter, after coming in flat in the second quarter and declining 7.5 percent in the first quarter.[6]

Factory activity recovering. After a prolonged decline, the state's manufacturing sector appears to be improving. The Dallas Fed Texas Manufacturing Outlook Survey, which gauges the overall health of regional manufacturing, points to continued expansion in February. The index for production has been positive since November 2009 (*Chart 4*). The indexes for new orders and shipments, though volatile from month to month, signal moderate growth in the sector.

Anecdotal reports from business contacts confirm the uptick in activity. The February Beige Book reported continued increases in demand for high-tech, petrochemical and food products and a bottoming out in activity for transportation equipment and fabricated metals producers.

Weakness in construction-related manufacturing continues, but the rate of decline has been slowing. In January, the manufacturing sector added jobs for the first time since May 2008, and more firms reported increases in hiring, work hours or both.

Exports rising again. Texas' foreign sales peaked in mid-2008, then contracted well into the first quarter of 2009. But the picture has brightened recently. After a relatively flat second quarter, real exports rose a solid 15.8 percent (not annualized) in the latter half of 2009, aided by a pickup in global demand and a falling dollar.[7]

The 2009 surge was largely driven by a huge jump in sales to the nation's North American Free Trade Agreement partners, Mexico and Canada. Demand for Texas exports also rose in Asia, Latin America and Europe. In addition, the higher price of oil relative to natural gas has made chemical production competitive in the U.S., fueling demand for chemical exports. (*See "Noteworthy" on page 15.*)

As its trading partners' economies strengthen, Texas should see continued export gains in 2010. Mexico, the state's largest trading partner, is moving into economic recovery. Retail sales and consumer confidence are improving across the border, and industrial production has been expanding since September. Economic forecasts call for 3.9 percent GDP growth in 2010—a notable improvement from Mexico's 6.8 percent plunge in 2009.

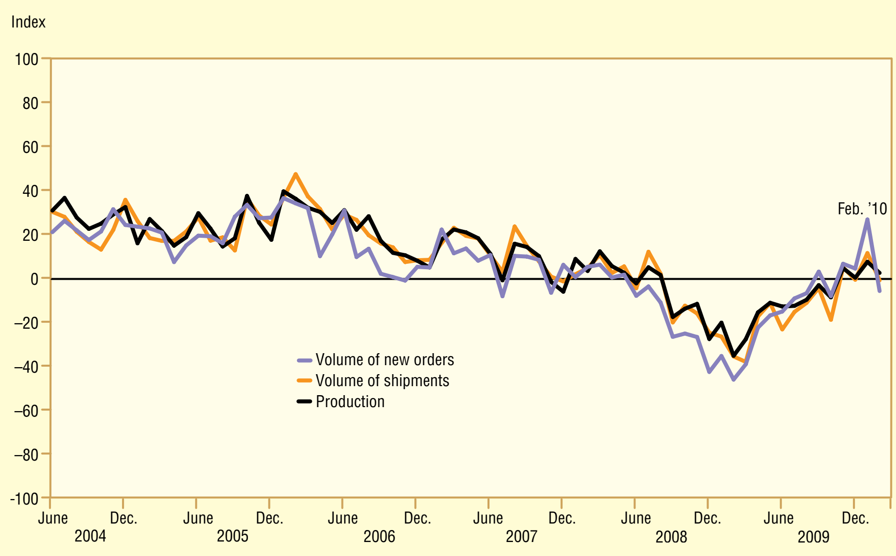
Going forward, the recent strengthening of the dollar against the currencies of some major Texas trading partners may partly offset the state's gain from rising global trade.

Housing indicators firming. Statistical and anecdotal reports point to stabilization in the state's residential real estate sector. Texas home sales have improved across all major metros, especially in the entry-level market, thanks to the first-time-homebuyer tax credit and low mortgage rates (*Chart 5*). Inventories of existing homes for sale are holding steady around seven months—slightly higher than the six months the industry considers healthy.

The improved housing picture has

Chart 4

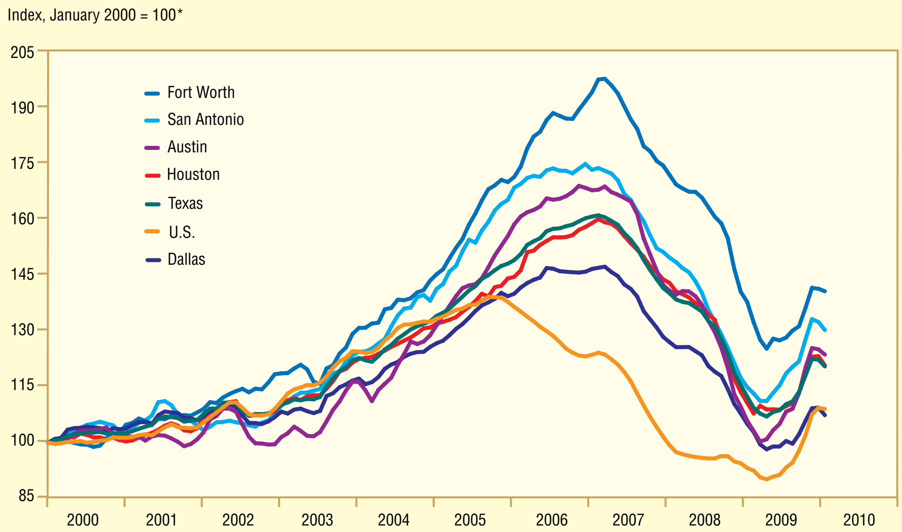
Texas Manufacturing Outlook Survey Signals Recovery in Factory Activity



NOTE: The Texas Manufacturing Outlook Survey is a monthly survey based on manufacturers' responses to questions about their Texas operations.

SOURCE: Federal Reserve Bank of Dallas.

Chart 5
Existing-Home Sales Holding Up in Texas and U.S.



*Six-month moving average.

SOURCES: Texas Real Estate Center; National Association of Realtors; seasonal and other adjustments by the Dallas Fed.

helped Texas home prices. The seasonally adjusted Federal Housing Finance Agency (FHFA) purchase-only price index, which includes repeat home sales financed with conventional mortgages, posted increases in the last three quarters of 2009. Multiple listing service data—a broader measure than the FHFA index because it also includes homes financed with unconventional mortgages—suggest Texas home prices rose modestly in 2009 compared with the previous year.

Residential construction activity has bottomed out. Housing permits and contract values have been rising since spring. Dallas Beige Book contacts report that single-family housing starts are increasing. However, overall housing starts—which don't separate single-family and multifamily dwellings—haven't recovered since hitting a low point in April 2009. The rise in single-family starts is likely being offset by a decline in multifamily construction.

On the downside, a weak economy and high unemployment rates have led to record increases in Texas mortgage delinquencies and foreclosures. Delinquencies remained on a steep trajectory in 2009, rising from 3.4 percent of mortgages in the third quarter to 3.6 percent in the fourth. The share of loans for which a foreclosure was initiated edged down from 0.9 percent to 0.8 percent of mortgages over the same period.[8] Still the foreclosure rate remains high compared with year-ago levels.

Rising mortgage delinquencies and a high foreclosure rate pose a significant risk to the recovery in the state's housing market. They add to inventories, put downward pressure on prices and hurt banks' ability to lend. However, a Dallas Fed study found that foreclosures are likely to remain low in Texas compared with the U.S.[9]

Energy activity supported by higher oil and gas prices. A sizeable contraction in the energy sector, brought about by the slump in oil and natural gas prices, contributed to Texas' weak economic performance in late 2008 and early 2009.

But energy prices were on the upswing by the second half of the year, due in part to improved demand. A rise in oil-related drilling activity helped boost the rig count from a low of 320 in mid-June to 565 in February 2010.

For much of 2009, natural gas drilling activity remained depressed due to low prices and bloated inventories, but a reversal of these factors during the cold winter has boosted gas-directed drilling. Business contacts note that shale-based natural gas drilling—much of which is outside Texas—is likely to prevail on a longer horizon over activity in conventional gas-bearing regions like the Panhandle, South Texas and East Texas.

Despite the production increase, the energy employment picture remains weak.

Health care expands strongly. The only recession-proof sector in this downturn has been health care services. Employment in medical services expanded at a 4.3 percent rate in 2009, adding 42,300 jobs between December 2008 and December 2009.

Health care demand is rising nationwide as the population ages and new technology enhances the delivery of medical services. Texas' population grew at twice the national pace last year, providing another spur for health care employment. Rising demand for medical services has also bolstered hospital and medical office construction in the state.

Transportation seeing a turnaround. Texas' central location in the U.S. has made it a prime spot for some of the world's largest airlines. The state also boasts large ports and is a major trade route to Mexico. Despite these advantages, payrolls in the state's transportation and warehousing sector shrank by 6.3 percent, or 24,500 jobs, last year.

A faltering economy and rising unemployment weakened discretionary spending and business and leisure travel. Airlines continued to lower costs by cutting capacity and payrolls. Trucking and warehousing employment plunged due to sluggish consumer demand.

However, weakness in this sector is abating, and transportation and warehousing employment is up from its November low. Beige Book contacts in this sector have also reported that activity appears to be stabilizing at low levels.

Sustained Headwinds

Lingering risks temper the optimism created by signs of a budding recovery in the Texas economy. Consumers remain cautious, given the high unemployment rate. Tight bank lending standards, depressed conditions in commercial real estate, low venture capital investment, rising mortgage delinquencies and weakness in the national economy could stall the nascent recovery.

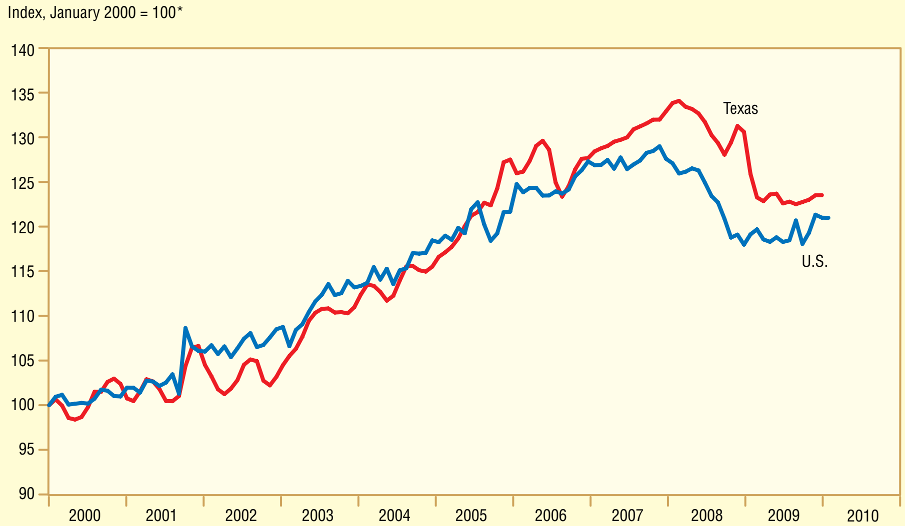
Additionally, some of the current growth has been supported by government intervention in the form of public-sector hiring and various stimulus programs. Much of this aid is slated to end in 2010.

Households still fragile. Consumer spending—which makes up the lion's share of Texas' economy—remains flat and may continue to constrain growth. Tight credit conditions, reduced household wealth from the housing bust, higher savings rates and weak job prospects are suppressing spending.

According to Dallas Fed estimates, Texas retail began recovering in mid-2009, after

Chart 6

Texas Retail Sales Remain Flat



*Seasonally adjusted, real dollars.

SOURCES: U.S. Census Bureau; Federal Reserve Bank of Dallas.

Chart 7

Sharp Rise in Texas Leading Index Suggests Modest Job Growth Likely in 2010

NOTE: The index is a composite of eight leading indicators that can predict movements in the state economy.

SOURCE: Federal Reserve Bank of Dallas.

falling for over a year (*Chart 6*).

The February Beige Book found retail activity increased the first two months of the year and sales were up year over year. Still, the outlook is cautiously optimistic, with contacts expecting a slow recovery in sales as the unemployment rate stabilizes and credit eases.

Commercial real estate woes continue. Commercial real estate continues to struggle. Rents are falling, vacancies are high and new building activity is almost nonexistent outside of education, health care and government. In 2009, sales of commercial properties were weak, posting year-over-year declines of 76 percent in Austin, 66 percent in Houston and San Antonio and 64 percent in Dallas.[10]

Banks in the Dallas Fed's Eleventh District have twice the national share of commercial real estate loans on their books, and the number of noncurrent loans has been climbing. The share of distressed commercial properties has also been rising across all major metros. Business contacts report uncertainty about how banks will rework loans on these distressed commercial properties.

On a positive note, in fourth quarter 2009, noncurrent commercial real estate loans as a share of total commercial real estate loans was 4 percent for Texas banks, relatively low compared with the nation's 7.1 percent. Business contacts also report rising investor interest in commercial properties. Even so, activity in the sector isn't expected to rebound until 2011.

Venture funding shrinks. Venture capital investment fuels new ventures and enterprises that generate jobs. In 2009, Texas venture capital investment was $644 million, off 50 percent from its 2008 level. The nation's decline was 37 percent. At the same time, Texas' share of total U.S. venture capital ebbed from 4.6 percent in 2008 to 3.6 percent last year.[11]

A large portion of Texas venture capital investment over the past three years has gone to the industrial and energy sectors, so falling energy prices explain some of the decline. The global financial crisis and U.S. recession are other factors restraining Texas venture capital investment.

What's in Store?

The Texas Leading Index, the Dallas Fed's barometer of future economic activity, has improved significantly in recent months (*Chart 7*). It climbed 16.8 percent from March to December, suggesting that job growth will pick up in coming months.

All of the index's eight components rose over the last half of 2009. The largest positive contributors were a significant improvement in the U.S. Leading Index, a decline in jobless claims, a rise in average weekly hours worked, an uptick in the Texas Stock Index and a decrease in the Texas export-weighted value of the dollar.

The employment forecast based on the leading index suggests Texas will see modest employment growth of 1 to 2 percent in 2010. While this increase will likely put Texas ahead of the nation once again, it leaves the state well below its historical

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(*Continued from page 7)*

pace of 2.8 percent.

The recession has adversely affected many Texas industries and taken a toll on the state. Recent data and anecdotal evidence suggest, however, that output is growing, labor markets are beginning to stabilize and the state is on track for a modest recovery. The Texas economy has steadied, although it has not yet firmed enough to take off.

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Notes

[1] The employment data used in this article are benchmarked to third quarter 2009 and are subject to revision.

[2] Texas employs one of every two workers in the U.S. oil and gas extraction industry.

[3] According to the Dallas Fed's Texas Business-Cycle Index, the 1982–83 recession was from February 1982 through March 1983, the 1985–87 recession lasted from September 1985 through February 1987 and the 2001–03 recession was from March 2001 through July 2003. The most recent recession began in June 2008 in Texas.

[4] Employment declines and unemployment rate increases are measured from February 1982 to March 1983 for the 1982–83 recession, from September 1985 to February 1987 for the 1985–87 recession and from March 2001 to July 2003 for the 2001–03 recession. The most recent recession's employment and unemployment changes are from June 2008 to December 2009.

[5] State GDP quarterly declines are measured from first quarter 1982 to fourth quarter 1982 for the 1982–83 recession, from third quarter 1985 to second quarter 1986 for the 1985–87 recession and from first quarter 2001 to fourth quarter 2001 for the 2001–03 bust. The time period is third quarter 2008 to second quarter 2009 for the most recent recession.

[6] The fourth-quarter state GDP estimate is not yet available. The Bureau of Economic Analysis does not provide quarterly state GDP data, but the Dallas Fed has a methodology for constructing quarterly data using the Chow–Lin procedure. For a description, see "A New Quarterly Output Measure for Texas," by Franklin D. Berger and Keith R. Phillips, Federal Reserve Bank of Dallas *Economic Review*, Third Quarter, 1995, www.dallasfed.org/research/er/1995/er9503b.pdf.

[7] Texas export data are from WISERTrade and have been seasonally adjusted by the Dallas Fed.

[8] Mortgage foreclosure and delinquency data are from the Mortgage Bankers Association and have been seasonally adjusted by the Dallas Fed.

[9] See "Texas Dodges Worst of Foreclosure Woes," by D'Ann Petersen and Laila Assanie, Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2009, www.dallasfed.org/research/swe/2009/swe0904c.cfm.

[10] Commercial investment sales data are from Real Capital Analytics' U.S. Capital Trends report.

[11] Venture capital data are from Thomson Reuters, PricewaterhouseCoopers and the National Venture Capital Association's MoneyTree report.

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