



Texas Likely to Continue to Lead Nation's Recovery

By Keith R. Phillips

▶ In 2013, Texas is likely to see faster economic growth than most U.S. states, although the pace will slow somewhat as manufacturing reflects weak international demand and energy extraction continues its moderation.

The prospects for Texas' economic expansion in 2013 appear slightly less robust than its performance in 2012, when the state exceeded its long-term trend and was stronger than most other states.

Illustrating the growth, employment increased 3.1 percent in Texas in 2012. State and local government jobs, recovering from steep cuts in 2011, paced labor market improvement as the Texas unemployment rate declined sharply to 6.1 percent from 7.4 percent in December 2011.

Private sector job growth stood at 3.7 percent last year as slowing manufacturing and energy growth was offset by acceleration elsewhere, particularly in construction. Weakening export demand damped manufacturing. Energy expansion was relatively brisk but not as vigorous as in 2011, reflecting reduced natural gas drilling, as gas prices remained near historical lows.

Only North Dakota and Utah exceeded Texas in job growth last year (*Chart 1*). A recent study of U.S. oil and gas production found that the six fastest-growing states from 2006 to 2011

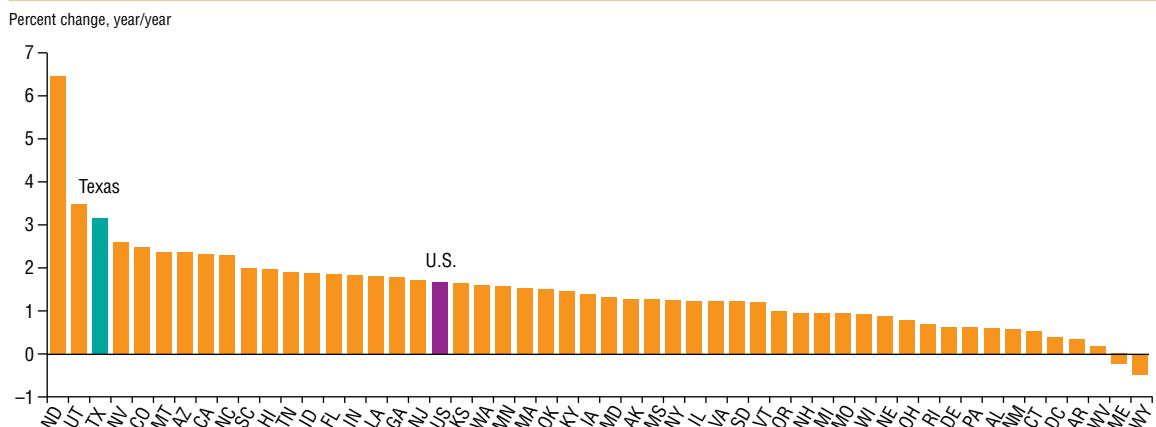
were the ones with the highest share of energy employment—Wyoming, Texas, Oklahoma, North Dakota, Alaska and Louisiana.¹ With oil prices generally stable at high levels but natural gas prices low, energy was important to state growth last year. Several states hit hard by the housing bust—most notably, Arizona, Nevada, Florida and California—bounced back last year to post job growth exceeding the national average.

In 2013, Texas is likely to see faster economic growth than most U.S. states, although the pace will slow somewhat as manufacturing reflects weak international demand and energy extraction continues its moderation. Ongoing acceleration in construction, however, will likely offset much of this weakness, with likely overall job growth for the year of 2 to 3 percent.

Government Jobs Uptick

Texas state government jobs began to rebound in 2012 even as Washington's budget woes became higher profile. While the federal "fiscal cliff" captured attention at year-end, many other states had already slipped off the edge. Most

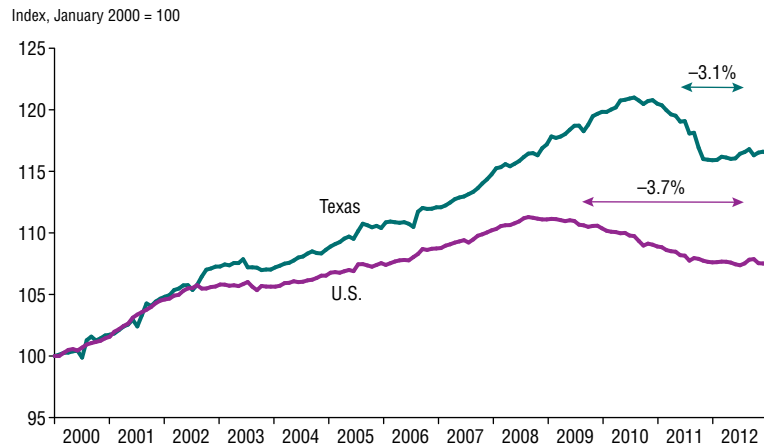
Chart 1 Texas Job Growth Third-Fastest in Nation in 2012



SOURCE: Bureau of Labor Statistics.

After declining 3.6 percent in 2011, state and local government jobs in Texas increased 0.8 percent last year—a swing of more than 4 percentage points.

Chart 2 Texas State and Local Government Jobs Increase in 2012



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

are constitutionally required to balance their budgets, and the steep recession in 2008 and 2009 prompted sharp spending and jobs cuts.²

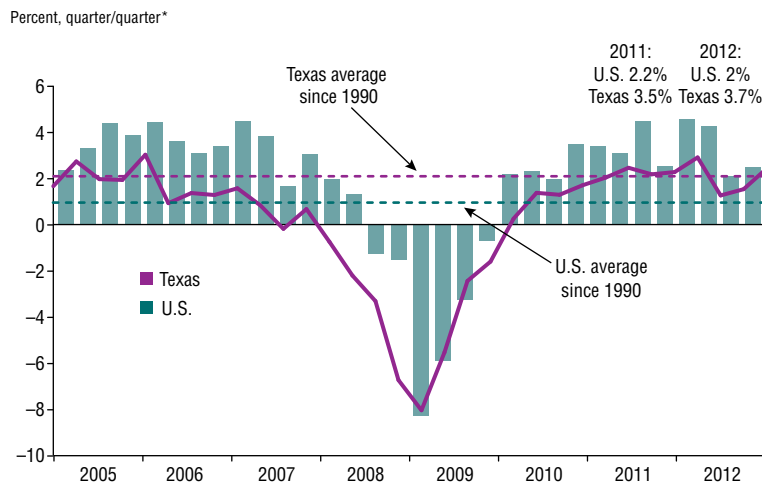
Nationally, state and local government revenues about equal those of the federal government. However, in terms of jobs, state and local jurisdictions account for about 82 percent of public sector employment. State and local government jobs peaked in early 2008, subsequently declining 3.7 percent (*Chart 2*).

In Texas, the sector reached a

high in early 2010 and fell a cumulative 3.1 percent through 2012. After declining 3.6 percent in 2011, state and local government jobs increased 0.8 percent last year—a swing of more than 4 percentage points.

Nonfarm job growth overall held steady in Texas in 2011 despite a sharp pickup in the private sector, but improving state and local government hiring and a steadily expanding private sector paced the state's increased activity in 2012 (*Chart 3*).

Chart 3 Texas Private Sector Job Growth Strong in 2012



*Seasonally adjusted annual rate.

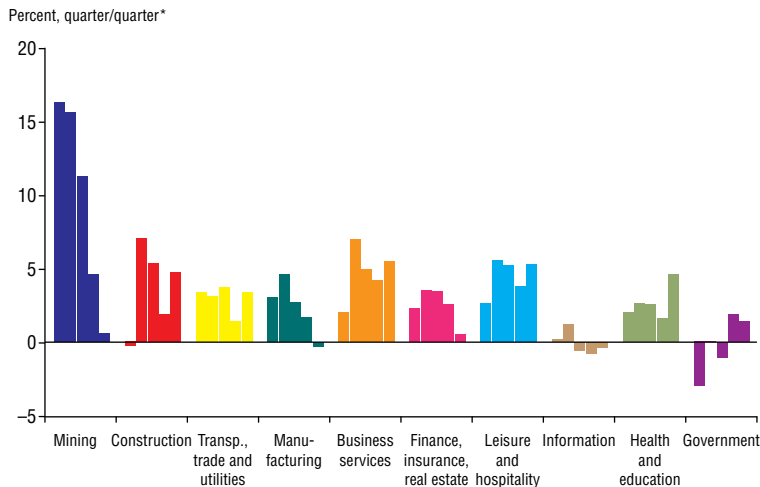
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Energy and Manufacturing Slowing

Energy and manufacturing grew briskly at the beginning of 2012, but as the year progressed, both slowed (*Chart 4*). Mining was particularly strong in the first half, with employment expanding at a more than 10 percent annual pace. As natural gas drilling declined, mining employment decelerated in the second half. The state rig count peaked at 938 in mid-June and dropped 12.4 percent to 822 rigs by the end of December.

Manufacturing, on the strength of exports, also started the year strongly. Petrochemical exports remained particularly robust due to low-priced natural gas, which is used as an input in production and as a source of power.³ Slowing international economic expansion suppressed export growth as 2012 progressed. The real (inflation

Chart 4 Mining, Manufacturing Job Growth Weakening; Construction, Government Improving in Texas



*Seasonally adjusted annual rate for five quarters (fourth quarter 2011 to fourth quarter 2012).
SOURCES: Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

adjusted) value of international exports from Texas, which advanced at a 7.4 percent annual rate in first quarter 2012, averaged only about 1 percent annualized growth in the remaining three quarters.

Construction Shows Strong Gains

Construction emerged as an area of strength, reflecting low mortgage rates and tight inventories. Job growth increased from 1.2 percent in 2011 to 4.0 percent in 2012, though the pace slowed in the second half of last year, as seen in Chart 4. Construction activity picked up in the industry’s three major sectors.

In residential building, multifamily grew rapidly earlier in the year and single family accelerated in the second half.⁴ With both key areas gaining strongly, the five-month moving average of real residential contracts in December 2012 was the highest since August 2007.

Nonresidential, which includes office, industrial and commercial buildings, began climbing near midyear (Chart 5). Much of this improvement reflects gradually declining office vacancy rates in major Texas metropolitan areas—from 18.3 percent in second quarter 2010 to 16.1 percent in third quarter 2012.

In the nonbuilding sector

(generally infrastructure), a sharp rise was due to the start of several major projects, including a large wind farm, two gas-fired power plants and a university stadium.

A Less-Robust 2013

While Texas economic growth has exceeded the national average in recent years, the state doesn’t perform independently of U.S. or global activity.

The Organization for Economic Cooperation and Development anticipates

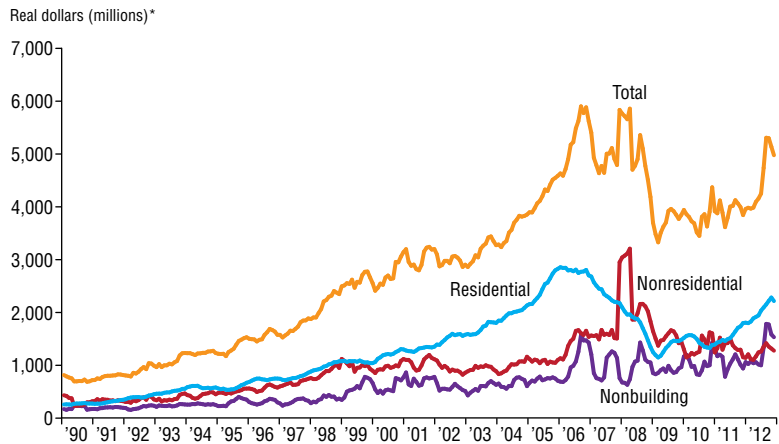
world real output growth will pick up from 2.9 percent in 2012 to 3.9 percent in 2013, with the euro area improving from a 0.5 percent contraction last year to a 0.6 percent expansion in 2013. In Mexico, Texas’ largest export destination, Banco de México predicted that real gross domestic product (GDP) growth should slow this year to 3.6 percent from 3.9 percent in 2012.

Meanwhile, the Blue Chip economic forecast, an average of about 50 U.S. estimates, showed in March that U.S. real GDP would expand 2.3 percent from fourth quarter 2012 to fourth quarter 2013, following a 1.6 percent rise in 2012.

Thus, while U.S. and world economic activity is expected to pick up somewhat, overall growth is likely to remain modest. That suggests Texas manufacturing may be weak in 2013.

However, construction-related manufacturing, which represents about 12 percent of manufacturing jobs in the state, rose at a 3.6 percent annual rate in fourth quarter 2012 and is likely to improve this year. The three top export-related industries, representing 15.4 percent of manufacturing jobs, declined in the final quarter of 2012—electrical equipment at an annual rate of -5.4 percent, transportation equipment at -4.9 percent and primary metals at -8.8 percent.

Chart 5 Texas Construction Contract Values Trending Higher



*Five-month moving average, seasonally adjusted.
SOURCES: F.W. Dodge; Federal Reserve Bank of Dallas.

Texas' energy sector will likely soften in 2013. The Energy Information Agency predicted in December that North Sea Brent crude prices would average about \$103 per barrel—a modest decline from the \$108 to \$111 prices near year-end 2012. Futures markets suggest that the price of West Texas Intermediate crude may be flat to slightly higher this year. West Texas Intermediate has been selling for about \$20 less per barrel than Brent because of booming oil production in Canada, North Dakota and parts of Texas that flooded the Midwest and midcontinent markets and led to distribution bottlenecks.⁵

A capacity expansion in January in the Seaway pipeline, which carries crude oil from the nation's major distribution hub at Cushing, Okla., to refining and petrochemical complexes around Texas City on the Gulf Coast, reduced the spread to about \$19. As new pipelines and other forms of energy transport move more oil from this region, the price spread will likely continue narrowing. A reduced spread would likely mean higher prices for Texas producers, particularly in areas such as West Texas, far removed from Gulf ports.

Natural gas prices inched higher from historical lows last year. Drilling in regions of dry gas in Texas (versus areas with natural gas hydrocarbons that turn to liquid as the gas exits a well) declined sharply in response to prices—a trend likely to continue in 2013. Permits to drill oil and gas wells in Texas declined 17 percent in the second half of 2012, indicating weaker energy extraction growth at least through the first half of 2013.

State and local government employment growth will likely be stable this year. The Texas comptroller's office in January estimated that the state will end its current two-year budget cycle with \$8.8 billion in unanticipated funds, and revenue available for the 2014–15 biennium will increase 12.4 percent. Energy extraction is responsible for much of the state's budgetary improvement. Although some of the available funds will likely

pay bills that were deferred, the budget has enough cushion for state and local jobs to increase at about the same restrained pace as in 2012.

Construction offers mixed prospects following a healthy second half of 2012. While nonbuilding activity is unlikely to continue at the recent pace, residential construction indicators suggest that growth is likely to stay strong in 2013.

The inventory of unsold homes relative to sales was 4.6 months in January—the lowest level since September 2000. Inventories below about 6.5 months of supply are historically consistent with rising home prices. Existing-home sales and single-family residential building permits shot up, with sales rising at an annual pace of 7.6 percent in the fourth quarter and permits rising at a 9.5 percent annual rate.

Office construction is also likely to increase this year in response to a decline in the vacancy rate to 16.1 percent—a vacancy rate of 16 percent or lower has previously prompted new building.

Texas Leading Index

The Texas Leading Index combines movements in key state economic indicators and is used to forecast job growth. In the three months ended in January, the index's components have been broad-based,

with six of the eight components contributing positively to growth. Positive contributions came from the Texas Value of the Dollar (meaning Texas-produced goods and services were more affordable abroad), the U.S. Leading Index, the real oil price, oil and gas well permits, the share prices of publicly held Texas-based companies and help-wanted advertising (*Chart 6*).

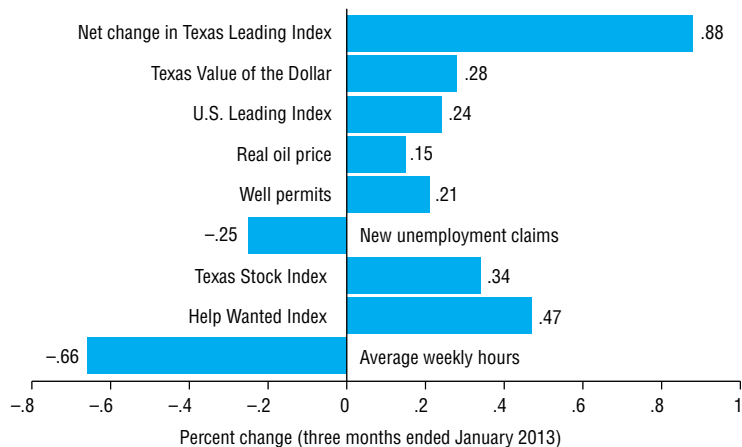
Negative contributions came from initial claims for unemployment insurance (claims rose) and average weekly hours worked in manufacturing. In general, most indicators continue to suggest positive growth in the state's economy, although some increases in claims for unemployment insurance and a decline of hours worked in manufacturing suggest some caution.

Recent movements in the Texas Leading Index are consistent with changes in Texas company outlooks as measured by the Texas manufacturing, service and retail sector outlook surveys from the Federal Reserve Bank of Dallas. The company outlook index for the three sectors reflects the difference between the percent of firms reporting an improved outlook and those saying it has worsened.

While manufacturing and retail showed some improvement in recent months, all three indexes softened in

Chart
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Changes in Texas Leading Index Components Mixed

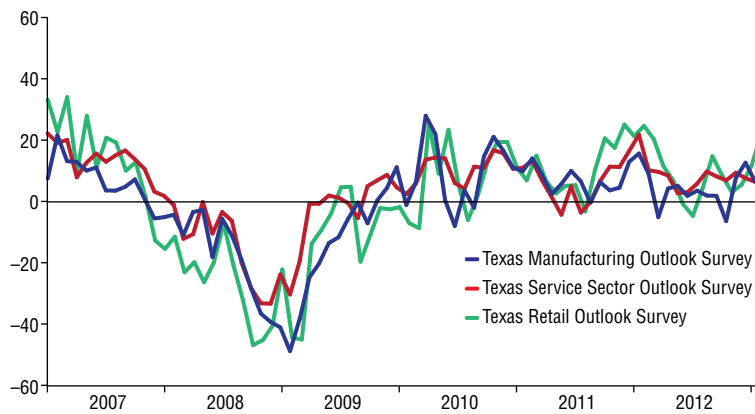


SOURCES: Federal Reserve Bank of Dallas; Conference Board; Haver Analytics; Texas Workforce Commission.

Chart 7

Company Outlooks Soften in Second Half of 2012

Index, seasonally adjusted



NOTES: A reading of zero means an equal number of respondents saw improving and worsening prospects. Data are seasonally adjusted and shown through February 2103.

SOURCE: Federal Reserve Bank of Dallas.

the second half of 2012 (Chart 7). The average index value in the second half was weakest for manufacturing. Overall, the three surveys anticipate positive outlooks, though not as much improvement as in early 2012.

State's Relative Strength

Texas should enjoy another good year in 2013, although job growth will likely be the same or moderately slower.

Private sector jobs in Texas expanded 3.7 percent after increasing 3.5 in 2011, exceeding the trend rate of 2.1 percent and the national pace of 2 percent. A significant bounce-back in government jobs in 2012 from sharp declines the year before helped overall job growth rise 3.1 percent from 2.3 percent in 2011.

However, private sector employment weakened in the second half of 2012 as a result of slowing in energy and manufacturing, as depicted in Chart 3. Continued expansion in construction should partially offset the decelerating trends in energy and exports.

Recent movements in leading indicators have been mixed, although the overall pattern of growth has been positive. Based on the recent momentum in job growth and changes in the Texas Leading Index, the Dallas Fed's forecasting model predicts that job growth this year will be between 2 and 3 percent.

Given expectations that the nation's

economy will continue expanding only modestly, Texas will likely grow faster than most other states and the nation this year.

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Notes

¹ See "Increasing U.S. Oil and Gas Production: Opportunities and Vulnerabilities," by Stephen P. A. Brown and Mine K. Yucel, prepared for the Council on Foreign Relations, January 2013.

² See "States Still Feel Recession's Effects Two Years After Downturn's End," by Jason Saving, Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2011.

³ See "Booming Shale Gas Production Drives Texas Petrochemical Surge," by Jesse Thompson, Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2012.

⁴ See "Texas Housing Market Finally Building a Solid Recovery," by D'Ann Petersen, Federal Reserve Bank of Dallas *Southwest Economy*, Third Quarter, 2012.

⁵ For a more complete discussion of the energy markets, see "A Conversation with Michael Plante: Increased U.S. Energy Supply Helps Offset Tight Global Conditions," Federal Reserve Bank of Dallas *Southwest Economy*, Fourth Quarter, 2012.

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