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HOUSTON ECONOMIC PERFORMANCE UPDATE

EDITED BY RICHARD ZIGLER **SPRING 2005**

Key Economic Indicators

Employment Growth[1]

↑ **13,600 jobs gained in February 2005**

↑ **Annual job growth up 1.0%**

Gross Domestic Product

↓ **0.2% to 3.8% over the last quarter**

↑ **4.4% over the past 12-month period**

Rig Count

↓ **3 rigs to 1,261 in February 2005**

Mortgage Rates

- ***30 year fixed rate = 5.91%***
- ***15 year fixed rate = 5.48%***

The Houston Metropolitan Statistical area, which prior to January 2005, was comprised of six counties: Chambers, Fort Bend, Harris, Liberty, Montgomery, and Waller, is quite literally growing. As of January 2005, the Bureau of Labor Statistics consolidated Austin, Brazoria, Galveston, and San Jacinto counties into the Houston MSA, which is now referred to as the Houston-Baytown-Sugarland MSA by the Texas Workforce Commission.

According to the **Texas Workforce Commission's** February 2005 release, the total number of nonagricultural wage and salary jobs in the ten-county Houston area stands at 2,268,400. This is an increase of 13,600 jobs, or 0.6%, since January 2005, and an increase of 22,400 jobs, or 1.0%, over the last year. Houston's unemployment rate, at 6.1%, is down from 6.3% over the past year. Because of downward revisions, these estimates are significantly lower than previously reported. Dr. Barton Smith believes the revised employment numbers underestimate true annual job growth in the Greater Houston area.

Dr. Barton Smith and Dr. Robert Gilmer spoke to a capacity crowd at the O'Connor & Associates Economic Forecast Luncheon held on April 6, 2005. The following sections provide a synopsis of their remarks. This is, however, not intended as a full transcription.

1. Texas Workforce Commission, 2/05, Total Non-agricultural Jobs

DR. BARTON SMITH

Director of the University of Houston's Institute for Regional Forecasting

With the addition of the four counties to the Houston MSA, in particular Galveston and Brazoria Counties, has increased the importance and influence of the refining and petrochemical industries on the area's economic statistics. Those industries now make up a quarter of Houston's economic base. With the current state of the market, combined with environmental restrictions that make it nearly impossible to build a new refinery, Houston needs the national economy to pick up steam for the region to experience dramatic growth.

The refining and petrochemical industries have undergone a productivity as well as a process modernization. The industry has been made more productive with advanced technology. The productivity gains have come with a cost, which is employment. Downstream jobs have been hit hard with the increases in productivity, and the shrinking of the sector is likely to continue into the future as research and development remains a top priority at all major companies. As for processes, technology has made refining 90% "cleaner" than the previous plants built in the 1970's and 1980's. Thus, new refining plants pose little environmental cost, but have the potential to provide great economic benefits. Unfortunately, shortsighted concerns have left our country with "terribly inadequate refining capacity."

Although the current high oil prices may seem like a positive for Houston with all of the area's refining and chemical companies, this is not entirely the case. Oil prices are so high as to serve as a drag on the national economy, which is outweighing nominal increases in energy jobs. Demand has increased and absorbed all of the previous excess capacity in the market. Inventories are now above their seven-year average, while OPEC continues to produce at full capacity. There is no room for disruptions, as any political, environmental, or economic disruption around the world could pose huge problems. In today's market even small disruptions, like the recent collapse of a Venezuelan refinery, can be felt in the form of a spike in prices. This error could be corrected with increased domestic refining, which would likely benefit the Houston economy, however, the environmental restrictions, that fail to take into account the technological advances that have made refineries significantly "cleaner", prevent this from happening. Restricted growth of 25% of Houston's economy due to refinery capacity limits compounds the effect of job losses in the industry brought on by productivity gains, which in turn makes Houston even more tied to the national economy.

Declaring "Houston cannot boom on energy along," Dr. Smith then focused his remarks on the national economy. What the Federal Reserve does with the federal funds rate will greatly affect the Houston economy. The Fed has been moving towards neutrality, as concerned with inflation and economic growth. The rate now stands at 2.75% and will likely continue to increase. There are three likely scenarios for future increases. One, the federal funds rate increases to the rate of inflation, which is about 3%. This is actually the best-case scenario, as little adjustment is required. Two, the rate increases to a more normal long-term rate near 5%, which he feels would be a mistake. Three, which is more inflation sensitive, calls for incremental increases to the federal funds rate until the inflation in the (primarily coastal) housing and commodity markets stabilize. This approach, although the most likely, does come with the risk of setting forth a "bust" in the markets if the rate is increased too high too fast.

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DR. ROBERT W. GILMER

V.P. & Senior Economist at the Federal Reserve Bank of Dallas, Houston Office

Although there has been growth in the Houston economy since the recession of 2001 as evidenced by increases in the Houston Index of Economic Activity, Houston's Purchasing Managers' Index, and the GDP, growth has not been particularly strong and job growth remains weak. Slower than expected growth in the U.S. economy is attributed to the decreased investment pace, a lagged effect from the high-tech bust, and the fact that the recession was relatively mild, and is thus not likely to spur dramatic growth. Signs the economy is moving in the right direction for the long run is the rapid productivity growth, expanding corporate investment, low consumer price inflation, expanded manufacturing, and growth in exports caused by the decrease in the value of the dollar.

Since 2001 oil prices have remained above $20 per barrel, and as of recently, significantly higher. Upstream energy jobs in Houston, however, have not experienced significant growth. There has been a cyclical rebound, but not the dramatic expansion that high oil prices would suggest. Again, the culprit is productivity gains, which are 50% higher in the oil producer segment than the economy as a whole. While drillers follow the oil cycle, producers – which are concentrated in Houston – have simply trended downward in terms of jobs. As a result, only 25% of Houston's energy employment is cyclical towards energy prices. With a modest national recovery, Houston is left with little job gains.

Houston's economic recovery is dependent on the national economic recovery. If the US recovery is slow and energy prices decline moderately, job growth will likely be near 1.5% this year. If the U.S. recovery is strong, energy prices remain stable, and the value of the dollar does not increase, job growth will likely be higher at around 2.5%.

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