

Southwest Economy

Economic Recovery Gains Steam in Texas

During 2003, the Texas economy bottomed out and began to grow again. Most sectors ended the year stronger than they began it, and there is reason to believe 2004 will bring substantial growth to Texas.

Judging only by the current job market, one might think Texas has entered a period of extremely slow growth. But the U.S. economy grew at a torrid pace in the second half of 2003 despite sluggish employment growth, and the same appears true for Texas. As the state economy's composition becomes more like the nation's, Texas and U.S. business cycles should be more closely tied, absent dramatic upheaval in the few sectors where the two economies continue to differ.

We will not have official 2003 output data for Texas until 2005, but strong U.S. growth, coupled with a relatively stable picture in Texas-centric industries such as energy and telecom, suggests the Texas economy is also growing faster than the sluggish employment situation implies. This is consistent with the Dallas Fed's coincident index for Texas, which has now clearly entered expansionary territory (*Chart 1*).

(Continued on page 2)



INSIDE:
*Have Mexico's
Maquiladoras
Bottomed Out?*

Small Banks' Competitors Loom Large

Small banks have long played a key role in the U.S. financial system. Sprinkled heavily across the country, they serve virtually all but the most isolated geographic areas. Built on personal contact, community ties and close lender-borrower relationships, these institutions traditionally have met the banking needs of individuals, farms and small businesses.

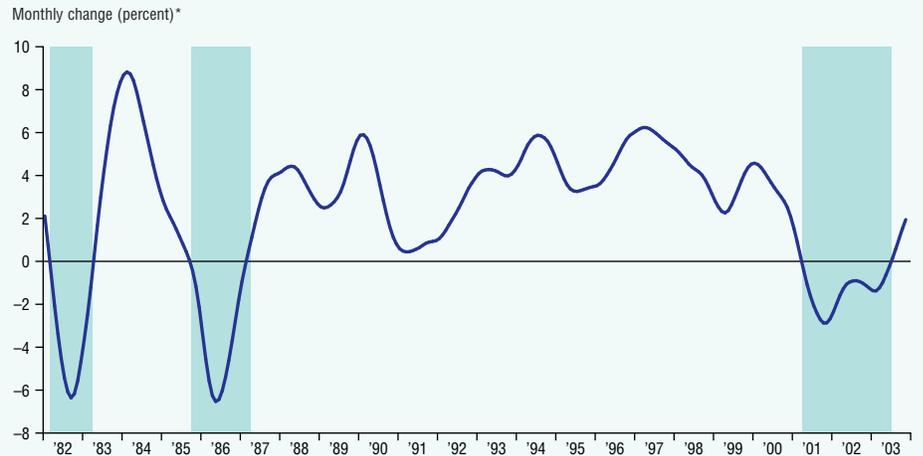
But small-scale banking has encountered rough going in recent years. Competitive forces, unleashed by technological advancement and financial deregulation, have led many small banks to combine or otherwise grow to achieve a larger scale, suggesting a reduced role for the traditional small bank. In addition, other types of financial institutions, such as credit unions, have made significant inroads into small banks' market segments.

(Continued on page 9)

Medical services continue to expand rapidly in Texas, with employment growing at a 3.5 percent rate in 2003.

Chart 1

Texas Coincident Index Signals Expansion



* Seasonally adjusted, annualized rate.
 NOTE: Shaded areas indicate recession.
 SOURCE: Federal Reserve Bank of Dallas.

This article presents a sector-by-sector look at the Texas economy, from hottest to coldest (see *Texometer* on page 4).¹ It concludes with discussions of consumption, labor-market conditions and the general outlook for Texas in 2004.

Health

Medical services continue to expand rapidly in Texas, with employment growing at a 3.5 percent rate in all of 2003 and a 4.4 percent rate in the fourth quarter. This is at least in part due to Texas' fast-growing population, including an increasing number of retirees from other states. According to the Milken Institute, Houston, Austin and Dallas are among the nation's 10 most popular large-city destinations for retirees. Anecdotal evidence suggests many are following their children, who have moved to Texas in search of economic opportunity.

Perhaps the biggest question for this fast-growing sector concerned Texas HMOs: Could they repeat their profitable 2002 performance or would they lose money as they did every year from 1996 to 2001? In the aggregate, it appears they ended the year in the black, and dire talk of the demise of the HMO in Texas has been replaced by at least cautious optimism that a leaner set of HMOs will remain in Texas' health-care marketplace. Although HMO participation declined 15

percent over the past year, HMOs continue to serve roughly 2.8 million Texans.

Energy

Energy employment rose 0.2 percent in 2003 as oil prices remained above \$30 a barrel—the highest sustained oil price since the early 1980s (*Chart 2*). Energy employment actually fell slightly in the second half, in part because of uncertainties about whether \$30-a-barrel oil was sustainable. Those fears turned out to be misplaced, although the Energy Information Administration is projecting a \$2 per barrel decline in the price of oil during the first half of 2004. On the natural gas side, prices surged 40 percent in the fourth quarter to a level that, if sustained over the medium term, will likely prompt additional drilling in Texas during 2004.

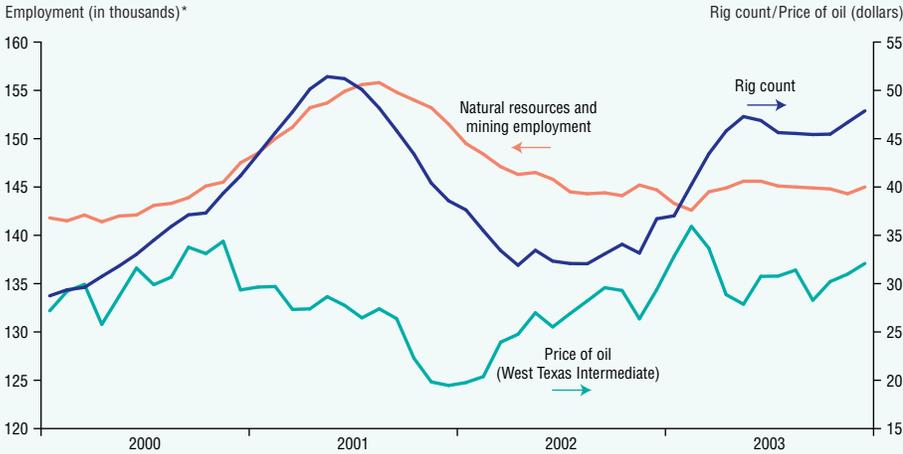
One interesting development from the energy sector is that San Antonio-based Tidelands Oil & Gas Corp. has begun exporting natural gas to the Mexican state of Coahuila through a new 12-inch pipeline. It is hoped that once Mexico more fully develops its natural gas reserves, the flow of the pipeline will be reversed.

Real Estate and Construction

Construction employment declined 0.8 percent overall during 2003 but rose at a 3 percent annual rate during the last half of the year. Housing starts are strong

Chart 2

Energy Sends Mixed Signals



* Seasonally adjusted.
 NOTE: Rig count is divided by 10.
 SOURCES: *Wall Street Journal*; Department of Energy; Bureau of Labor Statistics; Federal Reserve Bank of Dallas.

Texas exports posted their biggest gain in more than a year during third quarter 2003.

as well, suggesting construction is in good shape going into 2004 (*Chart 3*).

Home resales were especially strong, rising 14 percent in Houston, 9 percent in Dallas/Fort Worth and 4 percent in Austin over the past year. New-home sales were also strong, and even commercial real estate began to show signs of life. Consistent with this analysis, occupancy rates for the hard-hit Austin office market rose slightly in the third quarter. Moody's now rates Austin's

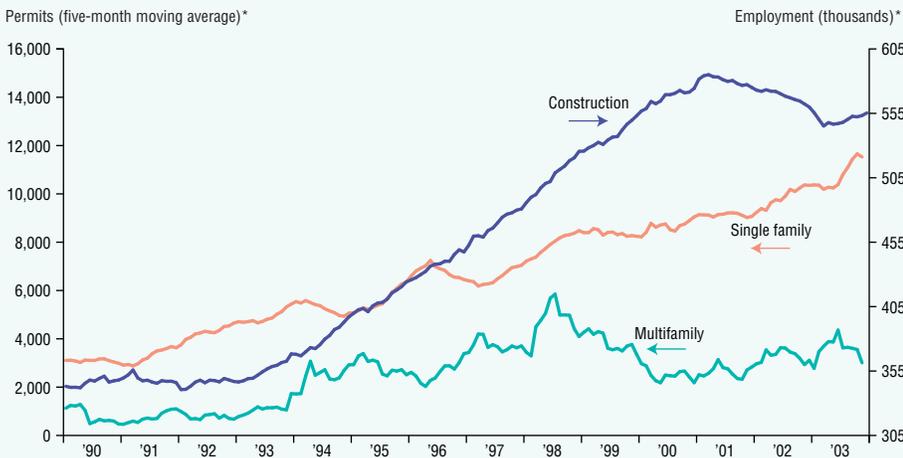
office market at 30 out of 100, which seems low but is nevertheless an improvement over the zero rating it received for 2002.

Exports

Texas exports posted their biggest gain in more than a year during third quarter 2003, rising at an annual rate of 14.1 percent (*Chart 4*). Most categories were up, including computers and electronics, transportation equipment and

Chart 3

Construction Remains Strong

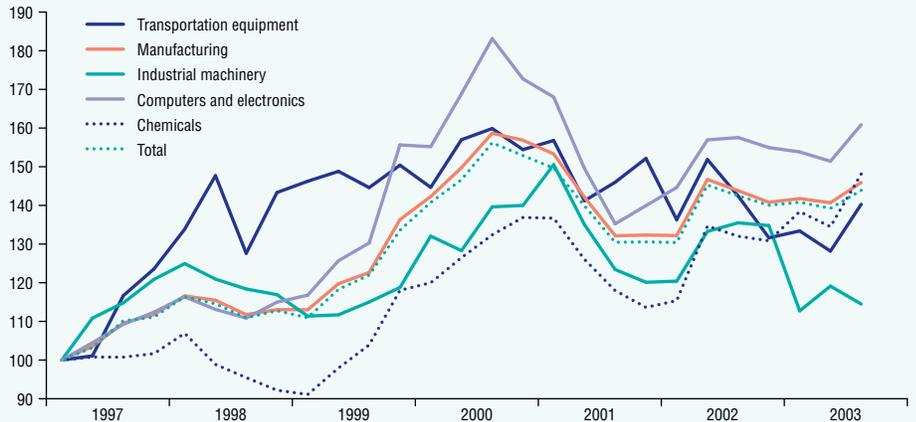


* Seasonally adjusted.
 SOURCES: Bureau of Labor Statistics; Census Bureau; Federal Reserve Bank of Dallas.

Chart 4

Real Texas Exports Begin to Rise

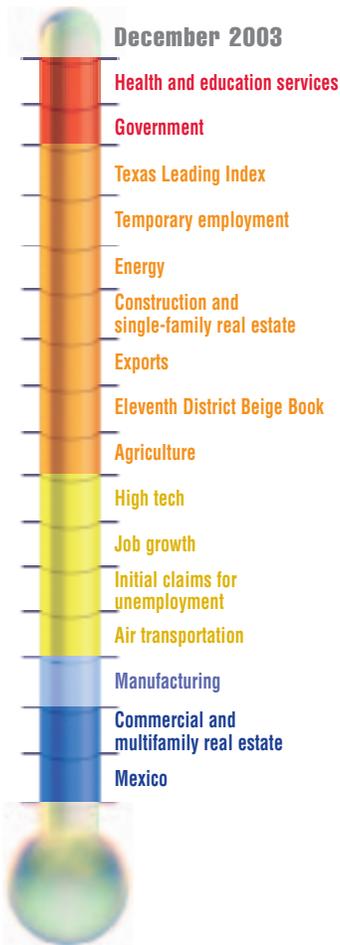
Index, 1997:1 = 100



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

Texometer

The Texometer is an unscientific depiction of how different indicators and sectors of the Texas economy are contributing to overall economic growth. The redder, or hotter, the indicator, the greater its contribution.



chemicals. Of the major categories, only industrial machinery declined.

On a country-by-country basis, exports to Japan rose a whopping 53 percent annual rate, followed by Taiwan at 21.6 percent. Exports to Mexico rose at an annual rate of 13.3 percent, roughly matching Texas' overall export growth in the third quarter. And exports to China declined 10.9 percent, contributing to an increase in the U.S. trade deficit in the third quarter.

↑ Agriculture

Agriculture has become increasingly globalized, and in 2003 Texas farmers felt

the effects of this trend. Heavy rains in China and Pakistan, plus unusually dry weather in parts of Australia, significantly reduced world production of cotton this season. At the same time, China's burgeoning economy is substantially boosting worldwide demand for cotton. As a result, Texas farmers enjoyed better-than-expected cotton prices.

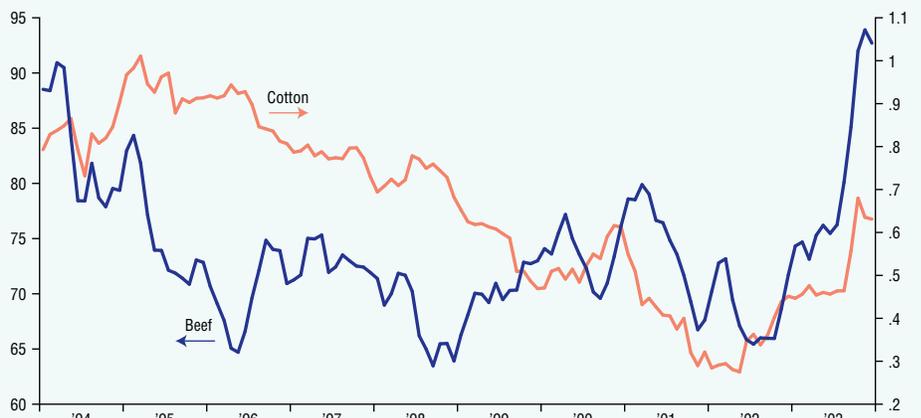
The beef industry was also poised for a strong 2004 as a sharp midyear increase in cattle prices put Texas cattlemen back in the saddle again (*Chart 5*). Droughts that reduced the cattle supply here and elsewhere, the growing popularity of beef-friendly diets and contin-

Chart 5

Farm Prices Soar for Much of 2003

Beef (real dollars per hundredweight)

Cotton (real dollars per pound)



SOURCES: Department of Agriculture; Bureau of Labor Statistics.

ued restrictions on Canadian imports all played a role in this rise. With one in every six U.S. steaks originating in Texas, ranchers were riding high—until a cow from the state of Washington was found to be infected with bovine spongiform encephalopathy (BSE, more commonly known as mad cow disease). Within a week the entire midyear price increase had evaporated. Although the infected cow appears to have no connection to Texas, our leading trading partners imposed bans on all U.S. beef, temporarily closing off a substantial market for Texas cattle.

High Tech

A comprehensive new study from the AeA (formerly American Electronics Association) finds that high-tech employment fell 11 percent in Texas during 2002 and venture capital fell 60 percent over the same period. The study projects a further employment decline of 4 percent in 2003.

But employment is not output, and economic activity was significantly stronger than the employment numbers indicate. Texas' high-tech exports actually rose 4.2 percent in 2002 and are expected to have risen at least as much in 2003, suggesting rapid productivity growth in this sector during the shakeout. This productivity growth did not help Texas' employment situation in the near term (the same could be said at the national level), but it certainly bodes well for future

employment and income growth.

The high-tech sector is much stronger today than a year ago. In third quarter 2003, worldwide chip sales were up 13.7 percent quarter-to-quarter and 17.5 percent year-over-year (*Chart 6*). Corporate IT expenditures also rose in the third quarter (by 4.3 percent), and a survey of corporate purchasers shows that more than 60 percent of firms plan to invest in their IT infrastructure in 2004. Only 12 percent had similar plans in 2003.

Forecasts are also optimistic about worldwide high-tech demand in 2004. International Data Corp. is forecasting a 5 percent growth rate in worldwide IT spending in 2004 and a 4 percent increase in worldwide telecom services. World Semiconductor Trade Statistics and the Semiconductor Industry Association predict double-digit gains in 2004 worldwide semiconductor sales. And with Texas' high-tech firms very much in the world marketplace, it's world demand that matters, not simply U.S. demand (though the pickup in the U.S. economy won't hurt either).

Air Transportation

Employment in the air transportation sector held steady in late 2003 despite a 9.4 percent decline for the year as a whole. Bookings, load factors and yields are all higher than they were at the end of 2002, and consensus forecasts call for airline industry growth of 2 to 4 percent in 2004.

Forecasts are optimistic about worldwide high-tech demand in 2004.

Chart 6

Computer Shipments Rise in 2003

Percent change*

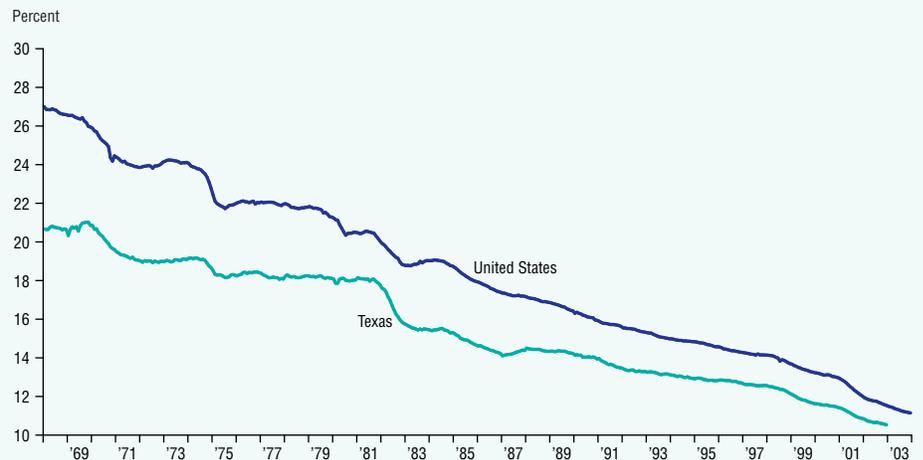


* Seasonally adjusted, three-month moving average.

SOURCE: Census Bureau.

Chart 7

Manufacturing Employment Declining as a Share of Total



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

Manufacturing output in Texas is rising even as employment falls.

At a time when low-fare airlines seem to be the wave of the future, analysts point to Dallas/Fort Worth-based American Airlines as a bellwether of traditional airline performance. Having shed 35,000 jobs over the past two and a half years and having endured several billion dollars of budget cuts, the airline cut its losses by two-thirds in 2003 and is expected to break even in 2004. Although no single company determines the fate of this sector, the fact that a bellwether is doing better than expected offers hope for the future.

General Manufacturing

The manufacturing sector as a whole continued to shed jobs in 2003, declining 4.1 percent. This does not come as a surprise; as a share of overall employment, manufacturing has been declining for a long time (*Chart 7*). And as the manufacturing sector continues to evolve, there is little reason to believe there will be a net increase in manufacturing jobs in 2004.

As is the case for the nation, though, manufacturing output in Texas is rising even as employment falls. Local purchasing managers indexes (which measure the health of the manufacturing sector) for Houston and Austin remain in expansionary territory. And the rate of employment decline in manufacturing slowed to 1.3 percent in the fourth quarter, which is consistent with substantial output growth.

Mexico

At midyear most analysts projected a relatively rapid turnaround for Mexico, but those expectations were repeatedly disappointed. GDP projections for Mexico were downgraded from 3 percent growth in early 2003 to 1.8 percent or even lower by year's end. The United Nations is now forecasting 2.8 percent growth for 2004, and most experts believe the U.S. recovery will help push Mexico into expansion. A smattering of favorable fourth-quarter figures suggests such an expansion may be on the way, though it is unclear whether this performance will be sustained in the coming months.

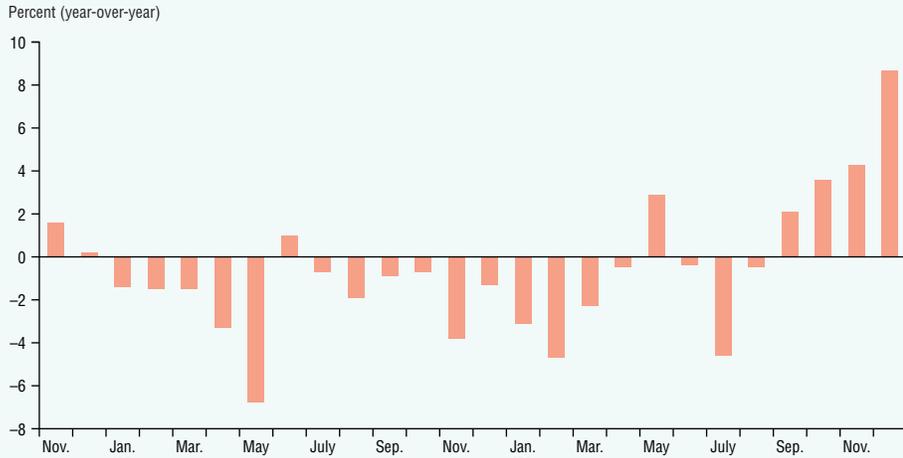
What is certain is that Texas will benefit once Mexico's economy recovers. The reason is simple: Mexico is the state's largest trading partner, accounting for 43 percent of Texas exports.

Consumption and Confidence

A key measure of consumer confidence is the extent to which consumers choose to spend, and there is generally positive news on the spending front. After declining at an annual rate of 1.3 percent in the first half of 2003, Texas sales tax revenues rose 2.2 percent in the second half to finish out the year in positive territory (*Chart 8*). Moreover, December 2003 marked the fourth consecutive monthly increase in sales tax receipts (compared with the same months in the previous year)—the first

Chart 8

Texas Sales Tax Collections Rising



SOURCE: Texas Comptroller of Public Accounts.

December 2003 marked the fourth consecutive monthly increase in sales tax receipts.

time this has happened since 9/11. This suggests consumers are gaining confidence in the strength and longevity of Texas' current expansion.

Confidence also seems to be rising among Texas businesses. The Texas Business Leaders Confidence Index, a statewide survey of business leaders conducted by Texas A&M University's Mays School of Business, rose to 62 in fourth quarter 2003, its highest level since the quarterly index was started in 2001. Like the better-known purchasing managers indexes, this index signals growth when above 50.

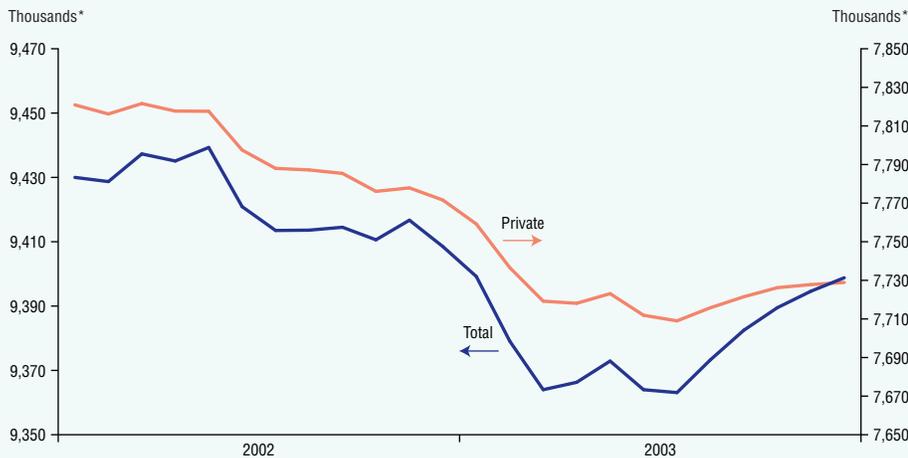
Labor Market

Private-sector payroll employment was essentially flat in 2003, falling 0.5 percent during the year (Chart 9). While it rose at an annual rate of 0.4 percent during the last three months of the year, employment growth remains far below the 2 percent annual rate we typically expect for Texas. This indicates the recovery has not yet fully reached the labor market—and the people who are currently seeking work.

But survey evidence suggests this may soon change. A recent Manpower

Chart 9

Private Sector Employment Slowly Rising



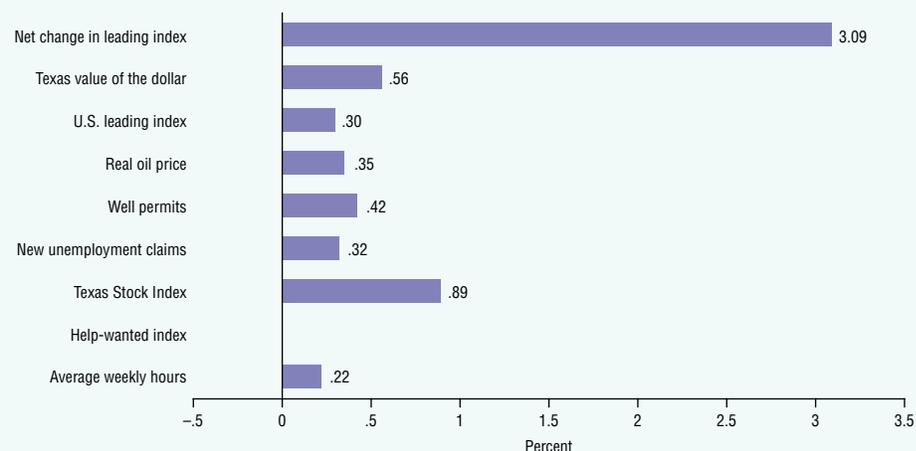
* Seasonally adjusted.

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

The Texas economy should return to form in 2004 and outperform the national economy.

Chart 10

Leading Index Points to Growth (October–December 2003)



NOTE: Help-wanted index data not available for November–December.
SOURCE: Federal Reserve Bank of Dallas.

survey finds that 19 percent of Texas firms plan to hire in first quarter 2004 versus only 11 percent who plan to reduce their workforces, which almost exactly matches business sentiment in the United States as a whole. While this doesn't suggest that sharp gains in employment are imminent, it is consistent with the view that hiring will gradually pick up in Texas during 2004. Beige Book reports also indicate optimism in this regard.

This optimism is echoed by recent population-growth figures released by the Census Bureau. Texas was the fourth fastest-growing state between mid-2002 and mid-2003. The state now has almost 3 million more people than New York. Even if a labor-market pickup in Texas is not yet readily apparent, people's willingness to relocate demonstrates their confidence in Texas' future.

📍 Outlook

The Texas economy is stronger now than it was six months ago and considerably stronger than it was one year ago. Texas labor markets seem to have firmed somewhat as well, though we await the kind of payroll employment growth that would signal a robust expansion of economic activity. Texas has not yet reclaimed its position as a national growth leader, but it seems to have caught up to the nation after spending a considerable

period behind it. Barring unanticipated negative developments in high tech or energy or Mexico, the Texas economy should return to form in 2004 and outperform the national economy.

The big question is whether we will see substantial employment growth in 2004. The Texas Leading Index indicates the employment picture should improve in the near future (*Chart 10*). Increased hours worked by current employees and a decline in unemployment claims traditionally signal the beginning of better days for employment. And increased corporate profits, as measured by the Texas Stock Index, also suggest businesses may start hiring again. While the lackluster employment growth of 2003 has been disappointing, the long-hoped-for recovery in the labor market should occur in 2004.

—Jason Saving

Saving is a senior economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

The author thanks Anna Berman and Priscilla Caputo for helpful research assistance.

¹ Compare with D'Ann Petersen, "Texas Economy Warming Up in 2003," Federal Reserve Bank of Dallas *Southwest Economy*, July/August 2003.