



Houston Business

A Perspective on the Houston Economy

The course of the world economy is crucial to job and income growth in Houston. This article offers a brief overview of the world's key economies, focusing on those most important to the current modest acceleration in world GDP growth.

World Economy Picks Up Steam

The world economy cooled sharply in 1997 in the aftermath of the Asian financial crisis. The world's GDP growth fell from 4.2 percent in 1997 to 2.5 percent in 1998. But a recent issue of the International Monetary Fund's (IMF) *World Economic Outlook* points to a gradual thaw in 1999, with growth increasing to 3 percent this year and 3.5 percent in 2000.¹ The pickup seems to be an uneven process, however, with improved performance led by the world's developing countries and great disparity between and within the world's largest trading blocs. (See Table 1.)

The course of the world economy is crucial to job and income growth in Houston. Much local activity depends directly on global expansion: the demand for oil services; billions of dollars worth of merchandise exports, led by machinery, chemicals and computers; activity at the nation's largest port in terms of foreign tonnage; and demand for global engineering and construction. This article offers a brief overview of the world's key economies, focusing on those most important to the current modest acceleration in world GDP growth.

THE DEVELOPED ECONOMIES

We commonly refer to the United States, Germany and Japan as the three great engines of world economic growth. In recent years, however, the United States has been the only working engine, with Germany and Japan left behind. The IMF outlook, which depends heavily on a tendency to revert to trend growth levels, sees steady

expansion among the world's most advanced economies, including Germany and Japan, but a slowdown in U.S. GDP growth in 2000.

United States. The United States seems sure to achieve 1999 GDP growth rates near 4 percent for the third year in a row. Driving this performance, according to the IMF, are fiscal discipline, adept monetary policy and extraordinary levels of private investment to modernize capital stock. Despite impressive productivity gains in recent years, the IMF sees an inevitable slowdown in U.S. growth in 2000 to 2.6 percent to match longer-term GDP trends. This is near the lower bound of the 2.5 percent to 3 percent growth forecast in July by the Federal Reserve's Open Market Committee.

Japan. A major change in the IMF outlook for 1999 is a turnaround from recession to weak growth in Japan. A 4-trillion-yen increase in public spending fueled strong growth in the first quarter, but both the first and second quarters saw real improvement in private demand as well.

Looking forward, the Japanese recovery remains in place but fragile: consumer confidence weak and unemployment still rising, business under pressure to restructure, public stimulus wearing off and exports teetering between recovering along with Japan's Asian trading partners and declining in the face of the strong yen. A framework for banking reform is in place but awaits implementation. Domestic corporate reform is lacking, especially in the retail, transportation, telecommunications and agriculture industries.

Euro Area. Sluggish growth in late 1998 has slowly picked up through 1999, and the out-

look has improved as a result of rate cuts by the new European Central Bank, a modest upturn in business confidence and support for demand from a depreciating euro. Growth rates have varied widely within the new monetary union, with the Netherlands, Portugal, Spain and Ireland growing rapidly, France growing well, and Germany and Italy sluggish. The IMF projects euro-area GDP growth at 2.1 percent this year and 2.8 percent next year. The IMF expects similar growth for the rest of Europe.

For Portugal, Spain and Ireland, solid growth is partly attributable to a natural process for relatively poor countries to move toward the average for the region as a whole, and both the Netherlands and Spain have made good progress in reforming labor and tax laws. Significant structural impediments in labor law, tax policy and public subsidies largely account for the euro region's high unemployment rates, and there is a serious need to reduce debt and cut debilitating tax rates. Slow-growing Germany is the outstanding example.

EMERGING MARKETS IN ASIA

Financial conditions have improved greatly throughout Asia and set the stage for growth in production and general business activity. Interest rates are below precrisis levels in most countries, exchange rate stability is now the norm and capital inflows have resumed. GDP growth in 1999 is expected to be positive in almost all countries in the region, and projections are being revised upward. For all of Asia, the IMF forecast for 1999 has risen by 0.6 percent since May, and for the ASEAN-4 crisis countries (Indonesia, Malaysia, Philippines and Thailand), the increase is 2.5 percent.

A major question overhanging the entire region is the extent of financial and corporate reform countries undertook in the wake of the 1997 crisis. The high growth rates enjoyed before the crisis were built on huge capital inflows—unlikely to return given the structural weaknesses the crisis exposed. The region has posted significant progress in banking reform, less for nonbank intermediaries and almost none for bankruptcy, foreclosure and other measures essential to corporate restructuring.

Korea. Korea has experienced the biggest turnaround among the crisis-affected nations, registering 10 percent GDP growth in the second quarter. Low inflation, falling interest rates

Table 1
GDP Growth Around the Globe
(Percent annual growth)

	Actual		Projected	
	1997	1998	1999	2000
World	4.2	2.5	3.0	3.5
Advanced economies	3.2	2.2	2.8	2.7
United States	3.9	3.9	3.7	2.6
Japan	1.4	-2.8	1.0	1.5
Euro area	2.4	2.8	2.1	2.8
Developing countries	5.8	3.2	3.5	4.8
Asia	6.6	3.7	5.3	5.4
Newly industrialized	5.8	-1.8	5.2	5.1
ASEAN-4	3.6	-9.8	1.4	3.6
Latin America	5.3	2.2	0.1	3.9

SOURCE: International Monetary Fund, *World Economic Outlook*, October 1999.

and a competitive exchange rate promote further growth. A large number of banks have merged or closed, although only 40 percent of the recapitalization needs have been met. So far, corporate restructuring has been slow and incomplete, particularly among the largest corporate conglomerates in Korea, the *chaebols*.

Malaysia and Thailand. Both countries have moved into economic recovery, with fiscal and monetary policy that is supportive. Bank reform is proceeding well in both countries, and both have a framework for corporate restructuring that needs to be implemented.

Indonesia. The Asian country hit hardest by the 1997 crisis, Indonesia has one of the few economies forecast to contract this year, and the IMF expects only modest (2.6 percent) growth next year. The crisis in East Timor and recent elections continue to raise fundamental political issues that forestall a quick return to financial stability. Bank reform is incomplete, and few procedures for corporate reform and restructuring have been implemented.

China. Regarded as a regional linchpin, China's ability to weather the Asian crisis with relatively strong growth—and without devaluing its currency—has been essential to Asia's return to financial stability. China continues to struggle with weak domestic demand, capital outflows and rising unemployment. Despite China's problems, growth is expected to be 6 percent in 2000, following a gradual downward trend from 8.8 percent in 1997.

LATIN AMERICA

Latin America was the last region to be infected with Asian contagion, and the effects are still being felt. Mexico continues to benefit from proximity and strong trade ties to the United States, and Brazil has come back very quickly from its 1998 crisis. However, Argentina, Chile, Colombia, Ecuador and Venezuela have all slipped into recession. Overall, the IMF sees no GDP growth in Latin America in 1999 but predicts improved performance of 3.9 percent in 2000.

Brazil. Brazil quickly bottomed out in the last quarter of 1998 and has enjoyed modest but positive growth since. Firm implementation of stabilization policies has kept the budget surplus above target, lowered interest rates and halted the exchange rate slide. Although recent policies have begun to reverse Brazil's huge debt, failure to undertake longer-term budget

reforms may point to renewed inflation ahead.

Mexico. Mexico is a beneficiary of the powerful U.S. expansion, since over 80 percent of its exports go to the United States or Canada. Second quarter growth exceeded 8 percent at an annual rate, and inflation has fallen back below 15 percent. Real GDP per capita has moved above the 1994 crisis level by about 4 percent.

Mexico's ability to survive the Brazilian crisis was partly because of its willingness and decisiveness in sharply raising interest rates. Rates have since come down, but monetary policy has remained relatively tight in the face of solid growth and the need to reduce inflation. As Mexico moves into its six-year presidential cycle, which often signals economic turmoil, it seems well positioned to avoid another crisis.

Other Latin American Countries. The common word here is recession—in each case the product of weakness revealed by the Brazilian financial crisis. Argentina, unable to devalue because of its currency's link to the dollar, saw Brazil's devaluation push industrial production down 10.5 percent between May 1998 and May 1999. Chile, with 40 percent of exports and 9 percent of GDP tied to copper, suffered from the global commodity price decline. Venezuela and Ecuador both faced high inflation, lack of fiscal discipline and a significant contraction in 1999. Colombia, suffering through its worst recession since the 1930s, devalued its currency by 9 percent in June.

SUMMARY

Financial conditions around the world have improved significantly in recent months, with the aftereffects of the Asian financial crisis fading away. The turnaround in production and business activity is following more slowly, however, with modest gains in world GDP foreseen for 1999 and 2000. Although we can characterize Asian economies as improving and Latin American economies as slowing, big differences remain in the performance of individual nations in both regions.

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¹ International Monetary Fund, *World Economic Outlook* (October 1999). Also see IMF, *International Capital Markets: Developments, Prospects and Key Policy Issues* (September 1999) and World Bank, *Entering the 21st Century: World Development Report 1999/2000* (August 1999).

Houston's economy is poised between the oil slump of 1998 and the revival of crude oil prices that began in March. Despite the jump in oil and natural gas prices, subdued oil field activity has held local employment growth over the past six months to less than a 2 percent annual rate. Prospects for 2000 are bright, however, and overall local job growth should improve once oil-related jobs are back on the increase.

RETAIL AND AUTO SALES

Retailers report good sales—on track with prior expectations—and no inventory problems. Home furnishings and electronics are the strongest performers. Retailers' concerns center on a very tight labor market, rising wages and the scarcity of workers for the holiday rush.

Auto sales remain strong, even as the summer and fall sales season comes to an end. Through September, Harris County auto sales were 4 percent ahead of last year, all but guaranteeing 1999 will be a record year.

ENERGY PRICES

World inventories of crude continue to decline. During early October the price of crude flirted with \$25 per barrel, then fell back to \$22 because of a modest rise in OPEC exports and increased European gasoline exports to the United States. OPEC compliance with its spring agreement is very high.

Wholesale gasoline prices rose along with the price of crude but weakened in October due to increased supply. Even with 5 percent to 10 percent of their capacity down for turnaround programs, U.S. refiners produced 8.8 million barrels of gasoline per day. Profit margins for U.S. refiners were poor in September and did not improve in October.

PETROCHEMICALS

The chemical industry remains split into haves and have-nots; the olefin product chain is passing price increases through to customers, while aromatics and other products

have absorbed most of the recent price increases in energy feedstocks. An unprecedented series of outages that limited capacity, coupled with extremely strong product demand, boosted ethylene prices. The ethylene price increases have spilled over into the market for polypropylene and other olefins that serve as substitutes. Rapidly expanding exports of chemicals to emerging Asian markets are reinforcing the strong domestic demand.

OIL SERVICES AND MACHINERY

The Baker Hughes rig count increased by 50, or 7.5 percent, in the last six weeks. Demand for oil service and machinery rose much less, however, because the added drilling has stayed in low-risk and inexpensive projects. Additional drilling has been gas-directed, onshore and relatively shallow; more lucrative work, either offshore or in foreign markets, remains depressed. Gulf drilling has picked up slightly but has had little effect on rig utilization rates and day rates.

With good prices for oil and natural gas in place, two factors contribute to the limited response in exploration. First, most of the major oil companies are tied up in mergers, with the direction of their exploration programs yet to be determined. Second, some independents find their ability to finance additional drilling crippled by a high-yield debt market that remains closed to the industry.

REAL ESTATE

Houston's new home market shows distinct signs of slowing down. September sales were flat with 1998, and year-to-date sales are now running 11 percent behind last year. Shortages of materials and skills are evaporating along with backlogs. The existing home market was forced to take up the slack for most of this year, when new homes could not be delivered in a timely way. Existing home sales slowed seasonally in September but were still 4 percent higher than last September and up 11 percent year-to-date.

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