Texas’ economic expansion remains quite strong, outperforming much of the rest of the country. The state’s growth has been slowing as expected, but a nationwide reassessment of lending risk has accelerated the decline in homebuilding and created additional headwinds for the state’s economy.

Data revisions show Texas’ job growth even stronger than initially reported over the past year. Employment increased 3.4 percent in 2006, slightly above the average for the past 35 years. This year, job growth has been close to its long-term trend and more than double the U.S. rate of 1.8 percent (Chart 1).

Declines in the dollar’s value have stimulated foreign demand for Texas products by lowering their relative cost. Texas exports increased smartly in July and August, due in part to brisk demand for chemicals and energy equipment.

The state’s energy sector continues to be robust, although even this hallmark industry shows signs of cooling. Well permits and rig counts saw little growth over the summer. While oil prices have risen to record levels, natural gas prices have seen less upward momentum. The Beige Book, the Dallas Fed’s regular survey of the district’s business activity, found concerns about growing natural gas inventories, which may restrain some activity.

The construction industry is still vibrant, with condominiums, hotels, offices, roads and entertainment facilities going up around the state. But housing markets have softened. Existing-home sales have drifted lower, returning to their April 2006 level (Chart 2). Existing-home inventories are still in relatively good shape at just under six months—back where they were in mid-2005 but still well below U.S. levels (Chart 3).

Typically, housing inventories have been higher in Texas than in the rest of the country. In recent months, however, the nation has eclipsed the state, a sign that builders elsewhere are facing a problem that plagued Texas real estate markets in the early 1990s—homebuilding running ahead of demand.

Texas home construction has been pulling back for a year, partly because excess supply nationally has transmitted financial problems to lenders and builders in the state. Housing permits continue to fall, reaching February 2005 levels.

The economy is still digesting the adjustment to tighter lending standards and slower homebuilding that has heightened uncertainty about economic growth. In the wake of the nation’s pullback in homebuilding, a number of the region’s builders, mortgage lenders and construction-related manufacturers have announced employment freezes or layoffs.

Still, the Texas labor market remains tight. The state unemployment rate inched up from 4.2 percent in August to 4.3 percent in September, staying below the U.S. rate of 4.7 percent (Chart 4).

There’s little evidence that the housing slowdown is significantly affecting the broader Texas economy. A model developed by Dallas Fed economist Keith R. Phillips expects job growth to be between 2.5 and 3 percent in 2007, with the probability of a Texas recession at less than 5 percent.

—Fiona Sigalla