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# Economic Currents: The State of the State Economy

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# Economic currents:

## THE STATE OF THE STATE ECONOMY

ALAN CLAYTON-MATTHEWS

ILLUSTRATION: NAOMI SHEA

**E**ach quarter we will use this column to assess the current economy in Massachusetts. Gathering a wide array of regional and national data, we will examine the most recent information available. We will look for trends and follow them: what do they indicate about the current state of the economy and about where it is headed?

In this inaugural issue, we start by providing a framework for future analysis. We review recent trends in the growth of the Massachusetts economy, contrast it to the national economy, compare the current recovery to the "Massachusetts Miracle" of the 1980s, and speculate on the near term future.

The summary measures which we use will include one or more composite indexes of the state economy. In this issue, we are using the experimental Massachusetts Coincident Economic Index (referred to below as the Massachusetts CEI). This index is constructed to grow at the long run rate of growth of real state product, but with more extreme cyclical swings. (The index is described in this issue's Endnotes article.)

The author wishes to acknowledge the support of the Department of Revenue, the Federal Reserve Bank of Boston, James Stock in the development of the Massachusetts Current Economic Index, and the Editorial Board for their helpful comments. Errors remain mine.

**T**he current economic situation in Massachusetts, like the nation, is healthy. Employment, income, and output growth are strong, and inflation is low. Over the last 12 months ending in July 1997, non-agricultural payroll employment (referred to below as "employment") grew 2.3 percent. At this rate, the peak employment of December 1988 will be surpassed by the end of this winter. The unemployment rate has been hovering at or below 4 percent for several months, a rate not experienced since 1989. Monthly initial unemployment insurance claims averaged 28,500 over the last 12 months, down from an average 31,400 a year earlier, and well below the average of 51,500 during the last year of the recession. Aggregate state real personal income grew 4.6 percent in the past year, and is 11.4 percent over its pre-recession peak in the fourth quarter of 1988. The Massachusetts CEI grew 4.7 percent in the past year, 7.1 percent above its pre-recession peak in April 1988. Consumer prices, as measured by the Boston CPI-U, grew a moderate 3.1 percent in the year ending in July.

By almost any measure, the economy is expanding. Residential construction, weekly hours worked in manufacturing, help wanted advertising, and consumer confidence are all continuing upward trends. The only contrary signal is the number of new business incorporations. The number of new business formations in the most recent 12 months available (October 1995 to September 1996) fell 10 percent from a year earlier.

## THE RELATIONSHIP BETWEEN MASSACHUSETTS AND U.S. GROWTH

In comparing the economy of Massachusetts to that of the nation, one must be aware of two commonly held beliefs:

1. The long-run rate of economic growth in Massachusetts is widely believed to be lower than that of the nation, both historically and for the foreseeable future, the result of slower population growth than the nation, which constrains the long-run rate at which the state can grow.

2. Growth is more volatile, that is, the swings in economic activity are proportionately larger in the state than in the nation. This volatility is not peculiar to Massachusetts. Regional economies are typically more specialized than the national economy, which is, after all, the sum of all its regions. Specialization allows a region to reap the benefits of comparative advantage, but has a downside. When national/international market forces devalue the region's products, its economy suffers disproportionately relative to the nation. This happened, for example, to Southwestern energy-supplying states in the early 1980s and to the Northeast's minicomputers and mainframe makers in the late 1980s.

These two points imply that although the Massachusetts economy is linked to the national economy, the two do not as a rule grow in lock-step with each other, neither in their rate of growth, nor in the timing or amplitude of their expansions or contractions. The structural changes in the state during the 1970s, with a secular long-term decline in nondurable industries such as apparel, and an offsetting growth in minicomputers and electronic components, were unique to this region. The severe national double-dip recessions of the early 1980s were relatively minor here. The state rate of growth during the 1980s outstripped the national rate. Eventually, Massachusetts and other Northeast states fell into a recession much earlier, and much deeper, than the country as a whole.

### THE CURRENT RECOVERY: IN STEP WITH THE NATION FOR NOW

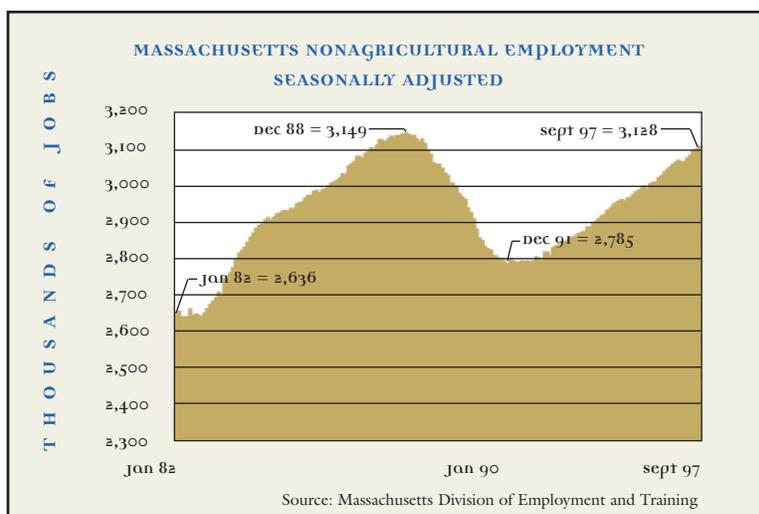
Our pattern of being out of sync with the nation changed with the current recovery. Since the recovery began, the

state has grown nearly in step with the nation. From October 1991 through June 1997, national employment grew at 2.4 percent annually, while state employment grew 2.1 percent annually. U.S. real gross domestic product (GDP) grew at an average annual rate of 2.7 percent from the second quarter of 1991 through the first quarter of 1997; for the most comparable period available, 1991 to 1994, real gross state product (GSP) for Massachusetts grew at a rate of 2.5 percent. (GSP is released only on an annual basis, and the most recently available data are for 1994). While these growth rates are not superlative by either state or national standards, this recovery is unique in recent memory for the apparent absence of inflationary pressures, despite low unemployment

rates, that normally would be manifest by the sixth year of an upturn. Also, as noted, it is not usual for Massachusetts and the U.S. to display such a high degree of synchronicity in both the timing and growth of their business cycles. What accounts for these good fortunes?

A set of hypotheses explaining the national phenomenon, collectively referred to as the "new economy" thesis, was

summarized by Federal Reserve Chairman Alan Greenspan in his recent Humphrey/Hawkins testimony to Congress. According to this view, several factors have accounted for the restraint in inflationary pressure. Federal budgetary policies to lower deficits, and tax revenue growth spurred by the strong economy made a balanced budget a real possibility. This has enabled long-term interest rates to decline, encouraging private investment. There has been a surge of investment in productivity-enhancing high-tech equipment. Since early 1993, purchases of computer and telecommunications equipment rose by more than 14 percent annually in nominal terms (25 percent in real terms as a result of falling prices). Worker insecurity, in an environment of continued downsizing, has restrained wage demands despite low unemployment. Increased globalization of trade and a strong dollar have held down import prices. Continuing deregulation of several sectors and restructuring of health care have contributed to lowering costs for business. Consequently, increases in per unit production costs have remained negligible, increasing by only half a percent in the year ending in the first quarter of 1997. The result has been rising profit margins even though price growth has remained low, suggesting stronger productivity growth than the conventional data show.

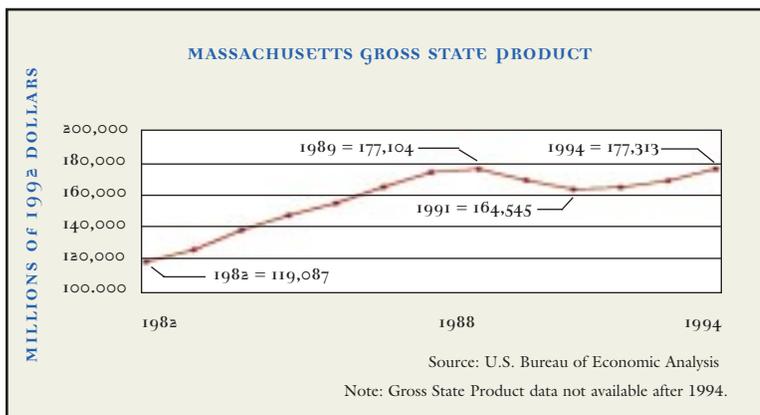


The keystone of the “new economy” thesis is that the nation is in an era of secular increase in productivity growth, largely driven by advances in computer and communications hardware and the complementary software technologies that unleash their power. Greenspan cautions, however, that it is too early to tell if the productivity hypothesis is true, or, if instead we are merely experiencing a confluence of favorable cyclical events.

These observations at the national level give a plausible explanation for the similar experience of the Massachusetts and U.S. expansions in the current recovery. In particular, as a producer of computers, communications equipment, software and Internet services, the state has shared disproportionately in supplying the national boom in high-tech related investment. The state has also shared in the increased globalization of world trade, as evidenced by growth in exports. According to data compiled by the Massachusetts Institute for Social and Economic Research (MISER), state merchandise exports grew by approximately 9 percent in the year ending in the first quarter of 1997, and 17 percent in the prior year.

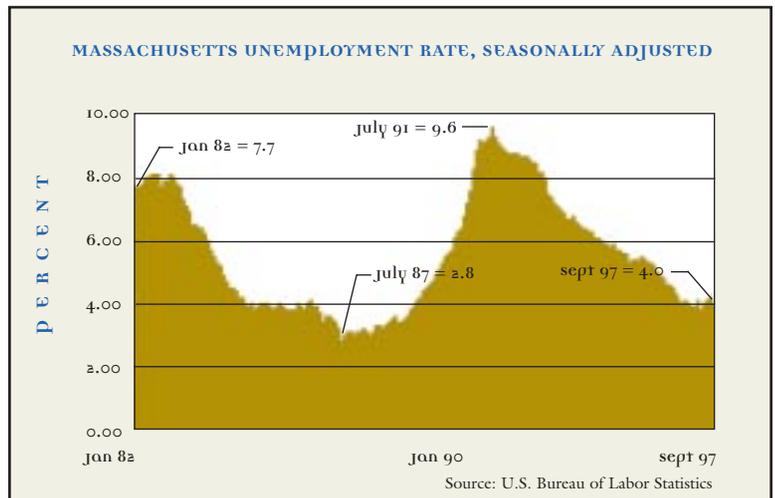
**LAST TIME AROUND:  
THE MASSACHUSETTS MIRACLE**

How does the current expansion compare to the “Massachusetts Miracle” years? Policy makers are interested in this question for two reasons. One, this unprecedented



period of rapid growth for the Commonwealth will serve as a yardstick of comparison for some time to come. Two, the calamitous finale to the period, the bust and severe recession, is the sort of disaster with which no policy maker would want to be associated. What makes the comparison timely is that we are now entering the 75th month of the current expansion (as dated by the Massachusetts CEI). The “Miracle” began in January 1982, and ended in April 1988, a period of 76 months (also as dated by the Massachusetts CEI).

The current expansion has proceeded at a significantly slower rate of growth than the “Miracle” years. During the



current expansion, employment grew at an average annual rate of 2.1 percent versus 3.1 percent in the prior expansion. Real personal income grew at a 2.4 percent annual rate versus 4.2 percent; real gross state product at 2.5 percent (1991 to 1994) versus 6.7 percent; the withholding tax base, a measure of aggregate wages and salaries, at 3.4 percent versus 5.6 percent; the sales tax base, an indicator of consumer spending, at 5.3 percent versus 10.7 percent; and the Massachusetts CEI at 4.3 percent versus 7.6 percent per year during the “Miracle” years. Although growth in the current expansion has been steady and robust, it pales in comparison to the spectacular rate of the earlier period.

**ON THE HORIZON:  
NO REPEAT OF THE 1980s BUST**

Fortunately, the seeds of destruction associated with the end of the “Miracle” do not appear to be present at this time; nor do they appear imminent in the near term. The “Miracle” ended because of a decline in the demand for minicomputers, a reduction in defense spending, unchecked speculation in real estate, and a regional demand/supply inflationary imbalance. Each cycle is unique, and identifying the factors responsible for the ultimate end of the current one will not be obvious until it has ended. We can, however, use hindsight to identify useful indicators of whether the current expansion is walking in the earlier one's final footsteps. The end of the “Miracle” was preceded by several observable signs: a decline in manufacturing employment that preceded the peak by several years; rapid housing price increases and overbuilding; a burst of inflation in consumer prices and wage rates; and a decline in the growth rates of several real measures, including employment, incomes, wages, and consumer spending.

According to these indicators, the current expansion is not in danger of ending in the next year — at least not like the “Miracle” years ended. Manufacturing employment has stabilized, and manufacturing labor input has actually been increasing during the past year as indicated by rising average weekly hours. Real estate activity in the housing market has accelerated recently, as evidenced by increases in sales, prices, and construction, but not at a pace that suggests a speculative bubble. Housing permits for the most recent 12-month period (July 1996 to June 1997) averaged 1600 per month. While this number is 20 percent above the prior 12 months, it is still only half the rate of the last year of the 1980s boom. Inflation has picked up only moderately in the last year. Consumer price inflation as measured by the Boston CPI-U has risen to 3.1 percent in the last 12 months from 2.7 percent in the prior year, and hourly earnings inflation in manufacturing has risen to 2.0 percent in the last 12 months from 1.3 percent in the prior year, but these rates are still moderate in an absolute sense, and less than half those experienced at the end of the last expansion. Finally, real growth does not appear to be slowing. On the contrary, the growth in employment and real income appear to have accelerated somewhat.

Another difference between the “Miracle” years and this recovery is that the U.S. and Massachusetts economies are currently in sync in a way they were not earlier. During the 1980s, Massachusetts experienced more rapid inflation than the nation; consequently, there was no brake on speculative forces in the state. Today, any pickup in inflation in the state would likely coincide with a pickup nationwide, so the Federal Reserve would step in before speculation could get out of control.

**WHERE ARE WE HEADED?  
POSSIBILITIES AND RISKS**

Aside from the absence of inflation and speculative activity that characterized the end of the “Miracle” years, there is another key factor that bodes well for the near term outlook of Massachusetts. In the prior period, minicomputers and defense dominated the state's high-tech industry. Today, the burden of the defense cutbacks is largely over. More significantly, Massachusetts computer and computer-related manufacturers have learned an important lesson from the 1980s, and are more diversified in a crucial respect. They no longer build machines composed chiefly of proprietary parts, but

strive for compatibility. The trend in software too has been towards interoperability. These developments have mitigated the downside of specialization. As a result, as long as demand exists for communications and computer equipment, and the software that runs the equipment, Massachusetts is more likely to get its share of that demand (as are other high-tech states) than before.

Another development likely to be favorable to the state is the impending deregulation of the electric utility industry. Since the region has above average electricity generation costs, deregulation of this sector should lead to a greater decline in energy costs here than in other regions, with the associated long-run business location effects.

There are, however, several unfavorable risks. Anything that lowers aggregate investment demand in computer and communications equipment will have an adverse impact on the state. A slowdown in growth could result simply because the “new economy” hypothesis is wrong, meaning that the high rate of growth in investment for these products is a temporary phenomenon. Investment could also decline in response to higher interest rates, say, in response to increases in wage rates due to a more confident and demanding work force. A substantial stock market correction is likely to have direct adverse affects on the mutual funds industry, which has been a high-growth sector for Massachusetts. Indirectly, a Wall Street downturn could curtail investment by diminishing the ability of companies to raise capital, particularly those that rely on Initial Public Offerings (IPOs) and secondary stock offerings.

Growth may be constrained by shortages and ensuing wage and price pressure. High-paying technical occupations, such as software engineer and systems analyst are exhibiting shortages. Commercial office vacancy rates in the Boston metropolitan area are among the lowest in the nation. Financing problems with the Big Dig could ultimately raise state taxes or borrowing costs, or divert public spending from other projects, though probably not in the near term. Finally, business productivity could receive a shock when the year 2000 problem causes widespread disruptions in legacy computer applications.

There is little to suggest that these downside risks are impending, or will be of sufficient magnitude in the near term to derail the current expansion from its present course over the next year. ▀

