4-1-1998

Economic Currents: The State of the State Economy

Alan Clayton-Matthews
University of Massachusetts Boston

Alan Clayton-Matthews

economic currents

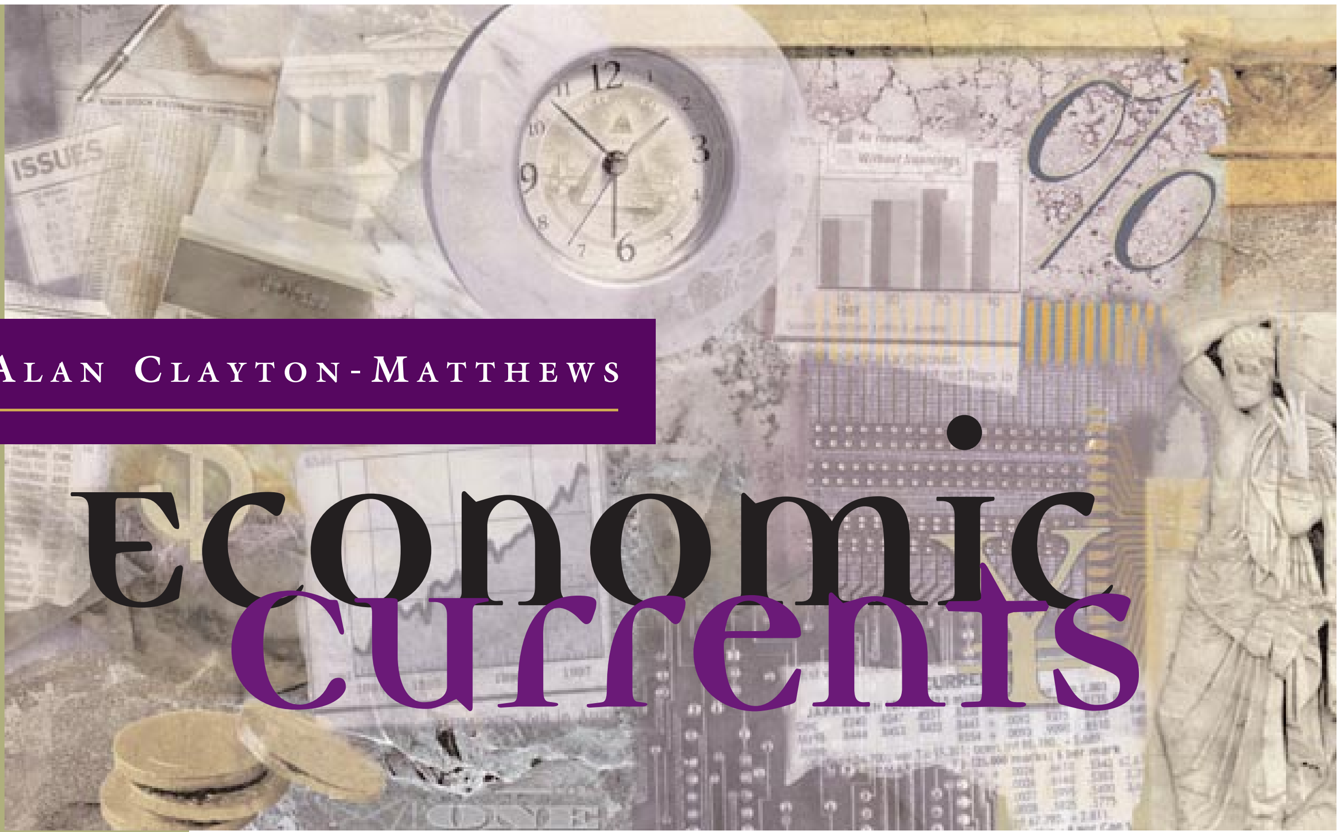


ILLUSTRATION: NAOMI SHEA

The Massachusetts economy continues to perform well, with high growth and low inflation. The question is, how long can this continue? In this issue we review the state's current economic performance. We also look at the financial crisis in Asia and the volatility in the stock market, which add some uncertainty to the outlook.

The Current Situation: Massachusetts Job Growth in High Gear

Over the last 12 months ending in December 1997, Massachusetts employers led the region in job creation. Nonagricultural establishment employment grew at an annual rate of 3.1%.[1] During the same period, the nation's employment grew at a 2.6% rate. Over the long term, employment in the state has historically grown less than in the nation as a whole. And, for several years, New Hampshire and Vermont were the employment growth leaders in New England, making the recent strength in Massachusetts notable.

The number of Massachusetts residents who are working, commonly called "household" employment, is another measure of employment. By this measure, employment grew at the more moderate – but still strong – rate of 1.7% over the last 12 months ending in December 1997.

Two differences in the definitions of these employment measures most likely account for the discrepancy between these two growth figures. First, establishment employment counts the number of employees on payrolls of Massachusetts establishments, wherever these employees may live. Household employment counts the number of Massachusetts residents who are working, wherever they work. Secondly, a person who works two jobs would be counted twice in establishment employment, but only once in household employment.[2]

Both differences appear to play a role. In three of our bordering states, growth in household employment from 1996 - 97 exceeded establishment growth over the same period: in New Hampshire by 3.6 percentage points; in Rhode Island by 0.7 percentage point; and in Vermont by 1.1 percentage points. This data suggest that workers from these states have been finding new jobs in Massachusetts. Evidence also indicates that increases in the number of second jobs, "moonlighting," accounts for part of the difference in the two employment measures for Massachusetts. For New England as a whole, establishment employment growth over the last 12 months exceeded household employment, suggesting growth in secondary jobs. Since Massachusetts accounts for roughly half of New England, it is reasonable to assume that many workers found second jobs in the state.

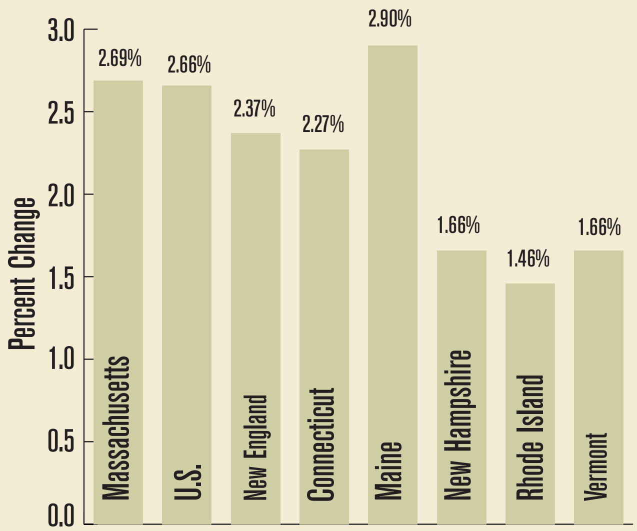
The length and strength of the recovery continues to keep unemployment low. The unemployment rate, at 3.8% in December 1997, has hovered at this level for over a year, and is nearly a percentage point below the national rate. Initial unemployment claims, another closely watched measure of employment conditions, have continued their downward trend. The seasonally adjusted level for December 1997 was 27,400. For the 12-month period ending in December 1997, initial claims fell at a rate of 8.1%. For the recovery period which began in late 1991, claims have fallen at an average annual rate of 7.6%.

Recent Employment Growth by Sector

Over the twelve months ending in December 1997, the annual rate of employment growth has been particularly strong in the broad services (4.2%), finance, insurance and real estate (FIRE) (4.8%), wholesale trade (4.3%), and construction sectors (3.6%). Especially noteworthy is a turnaround in manufacturing employment. Since the recovery began, manufacturing employment declined at an average annual rate of nearly 1%, but during 1997, grew at a 1.5% annual rate. When increases in the work week are taken into account, labor input in manufacturing grew at a 2.4% rate during 1997.

1997 Employment Growth Comparison

Massachusetts employment grew as fast as the nation, and faster than all other New England states, except Maine.



SOURCES: U.S. Bureau of Labor Statistics; Massachusetts Division of Employment and Training

Within services, the growth has been concentrated in business services (December 1997 employment is 9.4% higher than a year earlier), which include temporary employment agencies and engineering and management services. In the broad FIRE sector, growth has been strongest in the non-banking finance sector (December 1997 employment is 9.2% higher than a year earlier), essentially the state's mutual fund and money market industry.

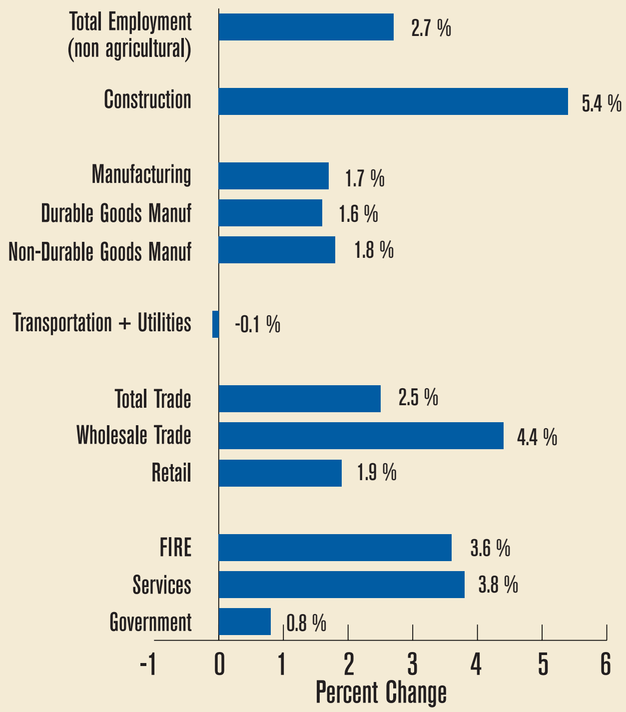
The reversal in manufacturing is not solely or principally a high-tech phenomenon. Employment grew in high-tech sectors such as electronic components and chemicals. Growth also occurred in areas not considered high-tech: durables such as supply structures and equipment investment; and non-durables such as printing and publishing, plastics, and food.

Employment has been lagging and even declining in a few sectors, reflecting the continual restructuring of the economy. Hospital employment continues to lag non-hospital health service employment. Employment in the state's power-supplying utilities declined 4.7% between December 1996 and December 1997, reflecting deregulation. Retail trade employment has been sluggish, particularly in general merchandising and apparel stores, both of which had lower employment in December 1997 than a year earlier.

Massachusetts Employment Growth by Sector

December 1996 - December 1997

Except for public utilities, employment growth was widespread, even in manufacturing.



Seasonally adjusted, establishment-based data
SOURCE: Massachusetts Division of Employment and Training

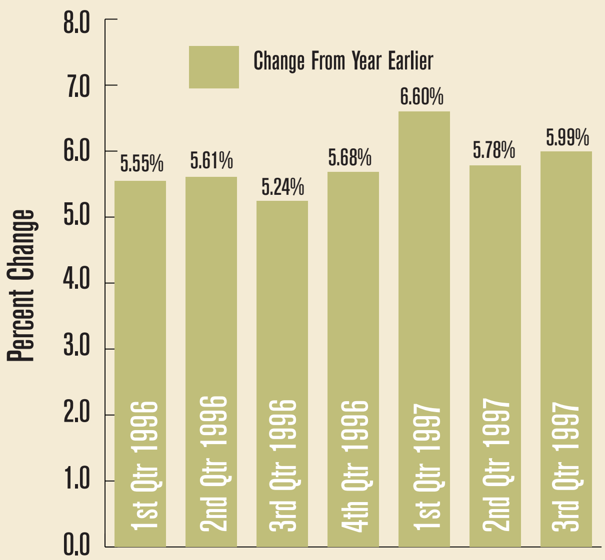
Non-employment Measures of the State's Performance

Non-employment indicators are consistent with the view that the state's economy has continued to expand without overheating. Incomes continued to grow robustly. Nominal state total personal income grew 6.0% in the year ending in the third quarter of 1997 over the prior year, while the aggregate state wage and salary total grew 7.4% over the same period. In real terms, these growth rates were 2.7% for personal income and 4.0% for the wage and salary component. Subtracting job growth from nominal wage and salary growth implies a per-job increase in wage and salaries of approximately 5% in the year ending in the third quarter of 1997. To the extent that such wage increases exceed the sum of productivity growth and the growth in hours worked, neither of which are measured at the state level, they contribute to inflationary pressures. Manufacturing wage rates, on average, were a moderate 3.3% higher in December than a year earlier. Inflation has been surprisingly low given the length of the economic expansion. Consumer prices in November 1997, as measured by the Boston consumer price index, were only 1.9% above those of a year earlier. Presumably, high growth in productivity, low growth in non-wage employment benefits, and the strong dollar have restrained price increases.

Massachusetts Personal Income Growth

From Year Earlier

Income growth continues to be strong.



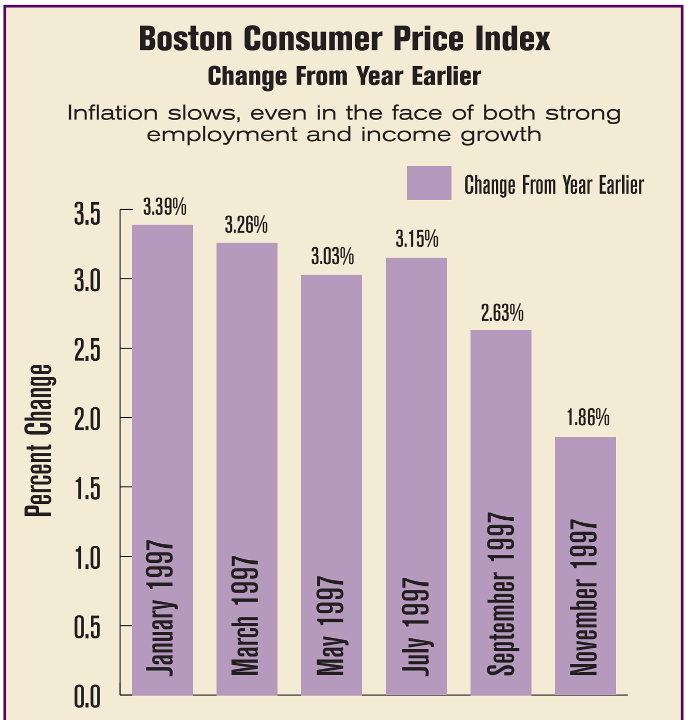
SOURCE: U.S. Bureau of Economic Analysis

Housing markets remain in good shape, and without signs of speculative pressures. Sales have been brisk, with prices rising moderately. The Fannie Mae Freddie Mac housing price indexes show Massachusetts home prices rising by 4.4% from the second quarter 1996 to second quarter 1997. This increase is the largest among the New England states, and higher than the national rate of 3.6%. Permits for new housing averaged 1500 per month in the year ending in November 1997, versus 1400 per month in the prior year. Permits have been in the 1200-1600 range for several years, less than half the rate of the speculative boom at the end of the 1980s.

State tax revenues for calendar year 1997 were a healthy 5.8% higher than in 1996. The Massachusetts current performance index grew 3.1%[3] from December 1996 to December 1997. The slowdown in the growth of consumer spending in 1997 does not reflect any deterioration in consumer confidence. Mass Insight's consumer confidence index for Massachusetts, patterned after the Conference Board's index, was 126 for October 1997, the highest recorded value since the quarterly survey began in 1991. The Conference Board's monthly consumer confidence index for New England delivers the same message. The November 1997 value of 133.3 was the highest since the peak of the cycle in the late 1980s.

New Uncertainties: The Stock Market and the Asian Crises

Since the last issue went to press, new developments have increased uncertainty in the national economic outlook. These developments are likely to result in a slowdown of growth. First, the stock market has experienced high volatility of late and suffered what, in the best of circumstances, is a correction; in the worst of circumstances, it is an end to the long bull market. Second, a financial crisis of panic proportions has engulfed the fast-growing, Asian, "tiger" economies. National and state economies may experience small repercussions from the situation, perhaps reducing growth by a fraction of a percentage point, although we will only know the actual extent as the situation unfolds. The increasing uncertainty about the future state of the economy is mirrored in guesses about Fed policy. In September 1997, economists held a consensus guess that the Fed was on the verge of tightening policy. Now, these guesses are split between an easing of policy or a tightening of policy.



SOURCE: U.S. Bureau of Labor Statistics

The Stock Market

The rapid growth of equities markets in the 1990s had salubrious effects on the economy. According to anecdotal evidence, capital gains boosted both federal and state revenues, lowering the national deficit and overflowing the state's rainy day fund. Higher stock valuations mean increased wealth of national households, resulting, at least theoretically, in higher consumer confidence and spending. Since Massachusetts residents are wealthier than the national average, and also keep a higher proportion of their financial portfolio in stocks, this "wealth effect" of rising stock prices has probably contributed significantly to our robust rate of growth during this recovery. What happens to the stock market is important to Massachusetts: Boston is the second largest mutual fund center in the nation. The mutual fund industry has been one of the leading sources of growth in the state's employment and income. Employment in the securities brokers and dealers, and security and commodity services industries, which now comprise over 1% of state employment, grew at an average annual rate of 10% per year since 1980, with average per-worker earnings in 1996 of $90,000. That figure represents a total wage bill of $3.5 billion, or 3% of all wages and salaries in Massachusetts.

The fortunes of the stock market may be changing. A year ago, Fed Chairman Alan Greenspan warned of "irrational exuberance" in the stock market. Since then, many analysts have worried that the stock market is overvalued, or that the forces driving stock prices upward – growing profits and falling interest rates – are due for a turnaround. A fall in the stock market would adversely impact the state's economy in three ways. First, if history were to repeat itself, employment and wage growth in the securities industry would take a hit. In the fall of 1987, the stock market crashed: it then recovered lost ground in a year. Employment growth in the state's securities industry ground to a halt in 1988 before resuming its trend rate of growth in 1989. Second, the "wealth effect" would work in reverse, slowing aggregate consumer spending. Third, equity financing would be more expensive for firms, especially those seeking initial or secondary stock offerings. One recent analysis presented at the last New England Economic Project (NEEP) Outlook Conference by Regional Financial Associates (RFA) suggested that stocks were overvalued by 20%. According to RFA's analysis, if a sharp correction of 20% occurred, Massachusetts would be harder hit than any other state in the nation. Growth in the state's economy would slow to a standstill for a couple of quarters before resuming. This scenario is speculative, with wide disagreement among analysts whether stocks are actually overpriced and where they are headed. The exercise does, however, highlight the importance of the fortunes of the mutual fund industry to Massachusetts.

Since August, the bull stock market has stumbled, but not crashed as in 1987. At the end of the year, local stock prices, as measured by the Bloomberg stock index for Massachusetts, were still well below their peak in fall 1997. While the stock market has not yet adversely affected Massachusetts, this sector bears watching, especially in light of developments in Asia.

The Asian Crisis

The Asian crisis is characterized by speculation and misallocation of investments by central governments and financial institutions, leading to loss of confidence in financial institutions, collapse of currency values, and crashes of equity markets. The fallout, which began last summer, spread through Thailand, the Philippines, Indonesia, Malaysia, Hong Kong, Singapore, Taiwan, and came to a head recently as the Korean economy, the eleventh largest in the world, collapsed. To give the reader a feel for the magnitude of the crises, the Korean currency, the won, fell by 50% in value in the last three months of 1997, and the stock market in Korea fell 50% from July through December (valued in Korean won).

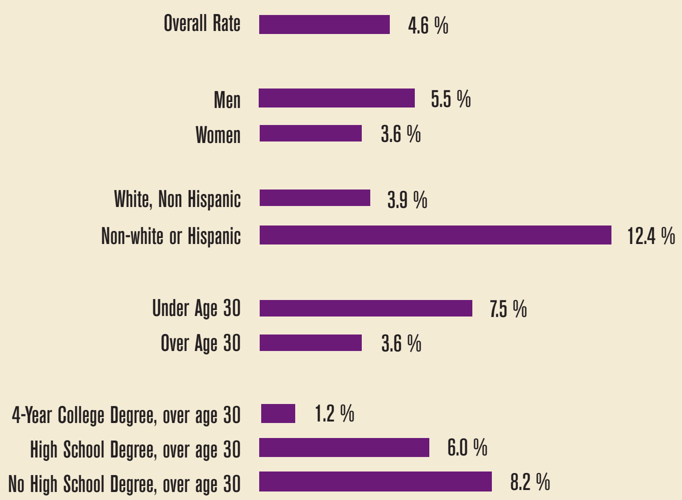
According to conventional economic analysis, the effects on the U.S. economy are expected to be small, though these expectations may change as events unfold. Immediately prior to the International Monetary Fund (IMF) aid package agreement with Korea, estimates were that the Asian crises would shave the U.S. economic growth rate by about one-half percentage point in 1998. Recently, some analysts have raised this to a full percentage point. In these analyses, Asian exports are reduced and imports increased because of the dramatic change in exchange rates. The impact is small because the magnitude of trade with these countries relative to U.S. output is also small. The exposure of New England and the nation to the export impact is similar: 14% of our exports go to the eight "tiger" countries, compared to 16% for the U.S.

Revisions increasing the effect of the Asian situation are based on three factors: the impact of the crises on Japan; the indirect impact due to trade with the rest of the world; and the effect of falling import prices on profits of U.S. firms. As a major creditor to the Asian hemisphere, the already unsteady Japanese banking sector has been dealt another major blow. The weakness of the yen relative to the strong dollar is now exacerbated, worsening the U.S. trade deficit with Japan. Our exports to other regions, including Europe and South America, may be adversely affected as they substitute Asian imports for U.S. imports. As import prices of consumer goods fall due to the stronger dollar, downward pressure is applied to prices of domestic firms, bringing lower profits. Lower profits lead to lower stock prices and less investment, with dampening effects on U.S. economic growth. Still, the consensus is that this crisis will pass. Market reforms are expected to "fix" the financial institutions in Asia. The short-term credit crises that firms in these countries face are alleviated by agreements from creditor banks worldwide to roll over short-term debt for a period of time and accept a conversion of some debt to longer term securities. According to the plan, investor confidence will be restored, resumption of international capital flows will resume, currencies rebound, and the pre-crises trading situation return. As events unfold, the story will be told in the quarterly earnings reports of Massachusetts firms, and in financial markets, as payment deadlines of Asian firms approach.

Massachusetts Unemployment Rates

Percent of residents unemployed*

Minorities, youth and the less-educated are much more likely to be unemployed.



* Refers to unemployment rate of March 1997
SOURCE: U.S. Census Bureau, Current Population Survey, March 1997

[1]Unless otherwise noted, we use a trend rate of growth for periods of 12 months or more for seasonally adjusted data like employment, calculated as the slope of a regression line fitting the logarithm of the data series to a linear time trend. Although this is not a straightforward measure to calculate, we find that most of the time it conforms better to a graph of the time series in question than other common single measures of growth, such as growth over the same period in the previous year, or the growth in a 12-month moving average over the prior year. Employment data do not reflect the 1997 *Massachusetts Benchmarks* revision.

[2]A third difference, that the self-employed are counted in household employment but not in establishment employment, is not likely to account for the difference in growth rates due the relative small proportion of workers who are self-employed.

[3]The Massachusetts performance economic index is a composite index composed of withholding taxes, sales taxes, establishment employment, the unemployment rate, and weekly hours in manufacturing. See the previous issue of *Massachusetts Benchmarks,* p. 19. (Previously referred to as the current economic index.)