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Economic Currents: The State of the State Economy

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Economic currents

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ILLUSTRATION: NAOMI SHEA

The Asian Crisis Arrives on Massachusetts Shores

What will the damage be?

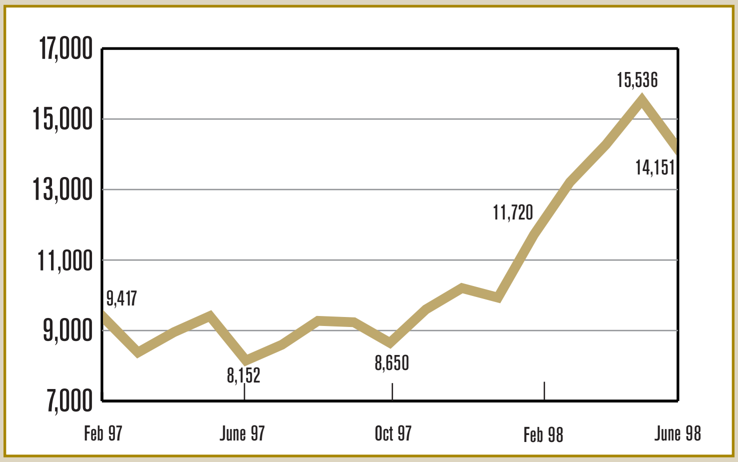
Economic Ups and Downs

The rising trade deficit that originated in the Pacific Rim Tiger economies in the summer of 1997 and then spread to Japan is now inundating the Massachusetts economy. For months we felt its benefits: lower import prices due to the relatively strong dollar; lower raw materials prices, thanks to the drop in worldwide demand; and lower interest rates because of the flight to quality U.S. securities. Now the flip side has become evident. East Asian purchases of American goods have plummeted; they are simply too expensive for these countries to afford. The strong dollar is causing American-made goods to be more expensive compared to foreign-made goods, not only for our trading partners, but for our domestic firms as well. As a consequence, exports are falling and imports are rising, catapulting trade deficits, slowing output growth, and reversing the recent growth in manufacturing employment.

Other recent economic currents adversely impacting the U.S. and Massachusetts economies, particularly manufacturing, include a build-up of excess inventories during the first quarter of the year, a glut in the semiconductor market, and the General Motors Corporation/United Auto Workers strike. These are less worrisome than the events in Asia, as their effects are expected to be temporary. The strike is over, and strong consumer spending should eradicate the inventory problem. Also, the rapid pace of technological change limits the duration of the chip cycle downturn, as obsolete chips depress neither the price nor demand for new ones. The length and depth of the Asian crisis, however, are still uncertain, and the magnitude of its effects on our economy, difficult to predict.

U.S. Deficit: International Trade in Goods and Services

Millions of Dollars
The trade deficit has increased dramatically in recent months as imports rise and exports fall.



Source: U.S. Bureau of the Census

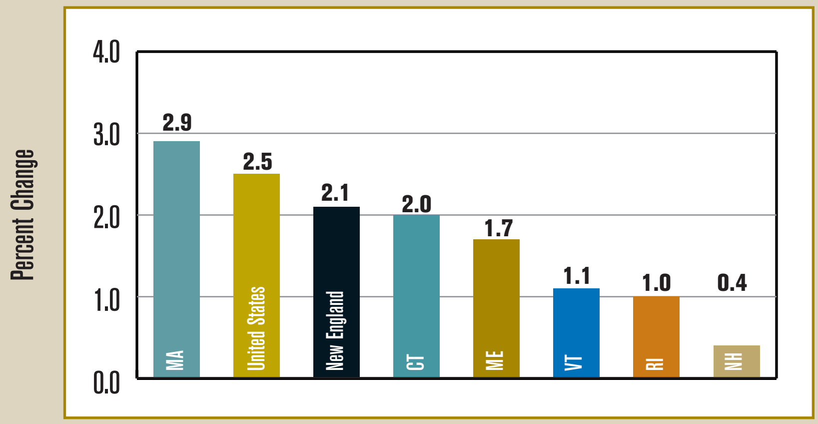
In Spite of This, The Economy Remains Strong

So far, the only sector feeling the brunt of these shocks is manufacturing. In fact, the rest of the state's economy seems untouched by the crisis. In the 12-month period ending in July, the Massachusetts jobs engine continued to outperform both the region and the nation. The number of jobs in the state grew 2.9 percent, compared to 2.5 percent for the nation and 2.1 percent for New England. The commonwealth's growth rate exceeded that of all other New England states during this time.

The unemployment rate is still low. At 3.1 percent in July, it was well below the national 4.5 percent rate. The only wrinkle in the state's unemployment

Employment Growth Rates Compared, Year Ending July 1998

Massachusetts grew faster than the nation and all other New England states.



Source: U.S. Bureau of Labor Statistics

situation is in initial unemployment claims, which have stopped declining. On a seasonally adjusted basis, they are up in the second quarter over the first quarter, probably a reflection of the downturn in manufacturing.

Another overall indicator of the economy, state tax revenues, grew 8.9 percent in the fiscal year ending in June, substantially exceeding expectations and resulting in a surplus of $1 billion.

Shock in Manufacturing Sector

Despite the overall growth, manufacturing lost jobs in the second quarter at an annualized rate of 2.5 percent from the first quarter of the year. This is a sharp reversal from the positive annualized growth rate of 4.3 percent in the first quarter. Both durable and nondurable goods manufacturers were affected. So far, the year-over-year employment growth in total manufacturing is still positive, at 1.4 percent from July 1997 to July 1998, but as recently as March, the year-over-year growth rate had been 2.4 percent.

The state's largest export industry, industrial machinery (which includes computers) lost jobs in the second quarter, wiping out most of the employment gains of the past year. The same can be said for the state's second largest export industry, electronics. A good portion of the slowdown can be attributed to Asia's declining demand for machinery and computers. Part of the problem, however, resulted from a fall-off in the computer chip market. Many of the machines that make these chips are built in Massachusetts. Companies are facing reduced shipments and orders and are cutting back on overtime and employment. Other export sectors have not been overwhelmed by these problems, at least as of July. Employment in both the transportation equipment and instruments sectors is still expanding, as sales of aircraft components, power equipment, and medical and pharmaceutical equipment have been brisk.

Employment Growth in Manufacturing: Selected Sectors in Massachusetts

	Annualized Growth Rates (seasonally adjusted, percent)	
	First quarter 1998	Second quarter 1998
Major Divisions		
Manufacturing	4.3	-2.5
Durable Goods	4.6	-1.5
Nondurable Goods	3.8	-4.1
Detailed Sectors		
Fabricated Metals	4.1	-3.0
Industrial Machinery and Equipment	5.6	-5.6
Computer and Office Equipment	6.7	-6.9
Electronic and Electric Equipment	4.1	-4.9
Transportation Equipment	5.0	5.6
Instruments	6.3	3.5
Food and Kindred Products	9.3	-0.6
Textile Mill Products	6.8	-22.1
Apparel	-1.5	-9.6
Paper and Allied Products	5.7	-4.4
Printing and Publishing	3.4	1.3
Rubber and Miscellaneous Plastic Products	7.1	-1.0

Source: Massachusetts Division of Employment and Training; author's calculations. Detailed sectors seasonally adjusted by author.

In the textile mill products industry, several companies that produce specialized fabrics or products continue to fare well. Even this sector, however, was hit by employment declines in the second quarter as a result of events and conditions beyond its control. First, the General Motors Corporation/United Auto Workers strike hurt those companies that supply upholstery products to the automaker. Second, the warm winter of 1997–98 hurt sales of specialized fabrics, such as Malden Mills' POLARTEC®.[1]

The problems in manufacturing are reflected in a small decline in average weekly hours worked and in surveys conducted by the Federal Reserve Bank of Boston, the Associated Industries of Massachusetts, and BankBoston. These surveys are consistent with recent employment trends. The Fed's *Beige Book* reports mixed results from its informal survey of manufacturers, with several companies citing "double-digit reductions in sales to Asian markets." Both AIM's Business Confidence Index and BankBoston's Instant Reading Index have exhibited sharp declines.

Incomes, Consumer Spending, and Trade

Strong income and earnings growth are keeping households confident and consumption spending growing. In the first quarter of 1998, personal income was 6.5 percent higher than in the prior year, and wages and salaries were

8.2 percent higher. In real terms, adjusting for inflation as measured by the Boston Consumer Price Index, these growth rates were 4.4 percent and 6.1 percent, respectively. Consumer spending appears to be growing hand-in-hand with income. The Massachusetts sales tax base, a proxy for consumer spending, is up sharply in recent months, and is consistent with national retail sales growth of over 6 percent in the year ending in June. Consumer confidence surveys by Mass Insight for Massachusetts and the Conference Board for New England reflect consumers' income and spending levels. Both indicate substantially higher confidence about present conditions than those a year ago.

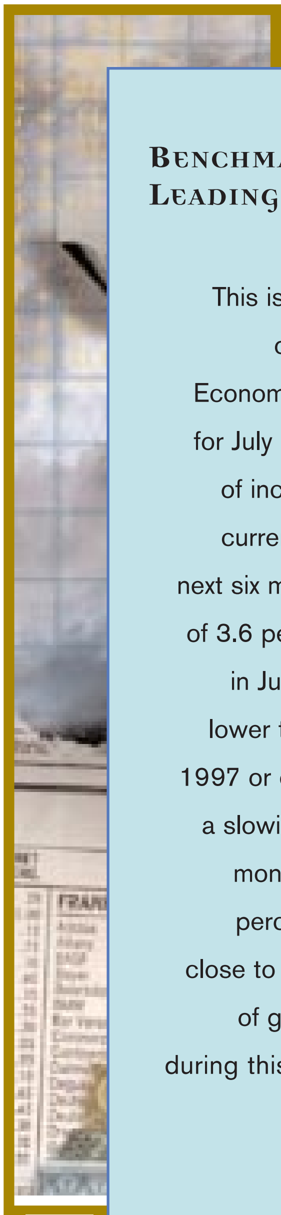
Consumers are tempering their enthusiasm about the future, though. The Mass Insight index shows a significant decline in expectations about future conditions since January, and the Conference Board index for New England indicates a consistent, though less striking pattern, as future expectations in the second quarter are 6.8 percent below the first quarter average. In addition to the impact of the Asian crisis, consumers may also be worried about the increasing volatility in the stock market.

Inflation Is Still at Bay

The expectation that labor market shortages will lead to a burst of wage inflation that will lead to higher general inflation has still not materialized, at least as far as one can tell from the available data. Consumer price inflation in the Boston area has been higher than in the average U.S. city recently, but does not appear to be accelerating. The Boston Consumer Price Index grew by 2.2 percent in the year ending in July, while the average for U.S. cities was 1.7 percent over the same period. Prices rose moderately faster here than in the nation for food purchases and transportation services, and substantially faster for apparel and medical services. It is difficult to discern any trend in overall inflation in the Boston area. However, the higher recent inflation in Boston versus the nation is consistent with a relatively tighter labor market here than in the nation as a whole.

The primary transmission of labor market shortages to inflation is through wage rates. Data on wage rates at the state level are meager, but are consistent with the view that wage rates are rising faster than prices and are therefore contributing to inflationary pressures. The Massachusetts manufacturing hourly wage rate grew by 3.1 percent in the year ending in June. The Boston Fed's *Beige Book* (June 17), based on a small, informal survey of employers in the New England region, reports wage rate growth of 2 to 4 percent in manufacturing, 3 to 5 percent in retailing, and 10 percent in temporary employment.

Another source of information is the Department of Employment and Training's census of employers contributing to the unemployment insurance system (commonly referred to as the "202" data), which represents roughly 95 percent of establishment employment and wages and salaries paid in the state. The average annual wage in the private sector rose 4.9 percent in 1997 over the prior year.[2] The growth varied by industry: 11.3 percent in the small mining sector, 8.6 percent in construction, 8.6 in manufacturing, 5.5 percent in retail trade, and 5.5 percent in the large service sector. These include increases in hours worked as well as wage rate growth, so the numbers don't reflect just wage inflation — but they are consistent with the anecdotal evidence of



Benchmarks Leading Economic Index

This issue marks the introduction of the Benchmarks Leading Economic Index. The leading index for July projects an annualized rate of increase of 4.5 percent in the current economic index over the next six months. This follows a value of 3.6 percent for the leading index in June. These growth rates are lower than those that prevailed in 1997 or earlier in 1998, suggesting a slowing in growth in the coming months. Although slower, a 4.5 percent rate is substantial, and close to the 5 percent average rate of growth of the current index during this long expansion. For more details about the index, see pages 11 and 24.

Sources: Massachusetts Department of Employment and Training and author's calculations

the *Beige Book*, and with the view that wage rates have been rising faster than prices.

Slower Growth and Higher Inflation Likely

For several reasons, growth is likely to slow in the near future. First, the labor supply shortage should constrain employment growth markedly. Even with employment growth slowing to a rate consistent with population growth, the Massachusetts economy could still grow at a healthy rate of 2 to 3 percent in real terms, the sum of productivity and population growth. This is somewhat slower than the annual average growth in real gross state product of 3.7 percent during the 1992–96 period (1997 is not yet available).

Second, many of the circumstances keeping business costs and, therefore, inflation low — in spite of rising wage rates — are temporary. Falling import prices, raw material costs, and interest rates will reverse direction as Asia recovers. Nearly all the potential savings in non-wage employment costs, such as health insurance, have been realized.

Until now, these falling business costs have offset rising wage rates, but when these temporary circumstances abate, the underlying latent inflation due to wage rate growth will be unmasked. Indeed, these other business costs may even rise proportionately faster than wages. When, and if, this happens, the Fed will apply the monetary brakes to slow the economy until costs come back in line.

Third, Massachusetts, with its concentration in the mutual fund and money management industries, is vulnerable to a sharp correction in the stock market. The effects would be felt primarily through wealth-induced reductions in consumer expenditures, and through reductions in bonuses paid to securities industry workers.

Finally, there is the demand shock of the Asian crisis-induced trade deficit. If we are lucky, the shock will simply cancel what might have been a wage-induced reemergence of inflation. If we are less lucky, the Fed has room to offset imbalances in either direction. There is a remote possibility that the trade shock will be too big for the Fed to overcome, tipping the nation and Massachusetts into recession. Less remote is the possibility of an imbalance between the manufacturing and nonmanufacturing sectors that could lead to both increases in unemployment and inflation. So far, the consensus of firms and economists both is that the economy can withstand the Asian crisis with a temporary slowdown in the second half of 1998. Thereafter, inflation may be a problem, but one the Fed can handle. This seems to be the most likely scenario for Massachusetts as well.

1. Source: Andre Mayer, Associated Industries of Massachusetts (AIM).

2. The annual wage growth rates reported here are weighted by 1996 average employment at the three-digit SIC level, in order to control for the influence of employment shifts among industries.

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