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Economic Currents: The State of the State Economy

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ILLUSTRATION: NAOMI SHEA

Economic currents

The State of the State Economy

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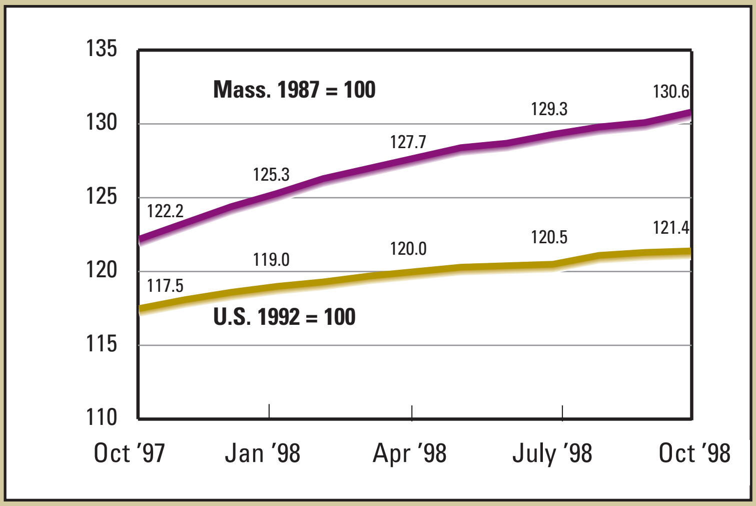
The state and national economies are now feeling the brunt of the global economic crisis. So far, the pattern of events in the Commonwealth has mirrored that of the nation. This is not surprising, since the source of the problem — the global slowdown and financial uncertainty — is an external shock that affects all the nation's regions through international trade and financial markets.

A little more than a year ago, the state's economy was moving forward at a full gait. The plus side of the economic indicator ledger was full; the minus side was empty. Even overall manufacturing employment was growing for the first time in a decade. The only impediment to continued robust growth appeared to be a looming shortfall of available workers. Now the economic indicator ledger contains a mix of positive and negative entries, from strong consumer spending to layoffs in manufacturing.

To help make sense of these often conflicting signals, we have developed a pair of summary indicators of the Massachusetts economy. The current index is tracking a slowing, but still growing, economy. The leading index projects that, over the next six months, the trend will continue, with yet slower — but still positive — growth. These indexes should be interpreted as suggestive, rather than definitive. As such, they allow for a range of near-term scenarios, from a sustained rate of moderate growth to a mild recession. Although we believe the latter probability is small, it is higher than it has been since the expansion began early in the 1990s.[1]

Figure 1
Current Economic Index
U.S. and Massachusetts

The economy continues to grow.



Sources: The Conference Board; University of Massachusetts; Federal Reserve Bank of Boston

Manufacturing Export Sectors Battered

National exports of goods and services have fallen since the fourth quarter of last year, and are on a course to set a record trade deficit this year. The state's manufacturing exports are following a similar pattern. As a consequence, the decline in manufacturing employment, which began in full force in the spring, continued through the summer and into to the fall. The key high technology/high trade sectors of industrial machinery (computers, and electronics and electrical equipment, including semiconductors), continued to lose jobs, both locally and nationally. Other sectors, including textiles, apparel, paper, and food products, are losing sales and employment to cheaper imports. Only plastics, printing and publishing, and furniture remain unharmed by crisis. This represents a dramatic reversal in manufacturing employment, which grew by 2.7 percent between the beginning of 1997 and February 1998, but declined by 1.8 percent between February and September. When hours as well as employment are considered, total production worker hours in manufacturing fell by 3.7 percent over the same period.

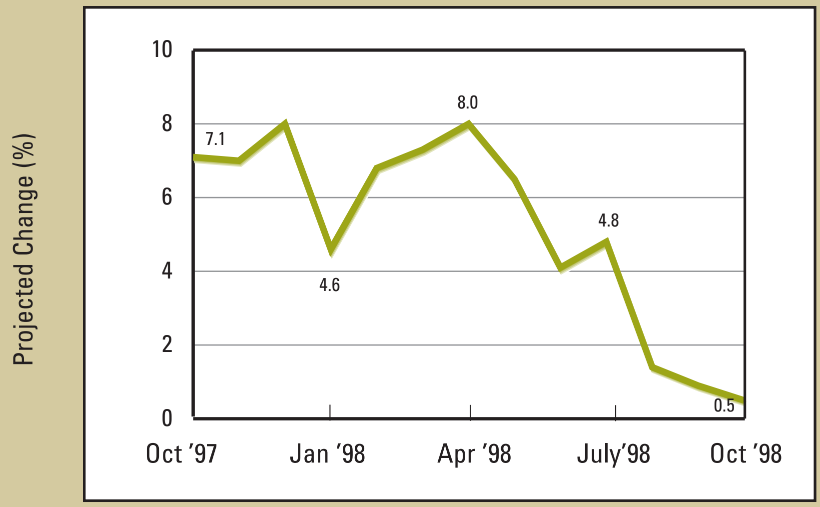
Indicators Point to Slowdown

Except for the interest-rate sensitive housing market and some service sectors, such as health, education, and engineering and management services, several indicators point toward a slowdown in the overall economy. First, overall employment growth slowed dramatically in the face of labor markets, which continue to be tight, as attested to by a still very low unemployment rate (3.3 percent in September). As recently as the fourth quarter of 1997, employment grew at a 3.9 percent annual rate. By the second quarter of 1998, growth slowed to 2.5 percent, and in the third quarter, to 0.9 percent.

Second, the reversals in manufacturing, the stock market decline that followed the Russian collapse and the Long Term Capital Management

Figure 2
Massachusetts Leading Economic Index

The leading index is the annualized, six-month projected change in the Massachusetts Current Economic Index. It suggests that the slowing of the economy will continue in the coming months.



Sources: The Conference Board; University of Massachusetts; Federal Reserve Bank of Boston bailout, a tightening of lending, and continual news of a worsening global economic outlook affected business and consumer confidence. Business confidence, as measured by the Associated Industries of Massachusetts and by BankBoston's instant Reading Index for New England, are down substantially. In both indexes, a value of 50 marks the critical level that divides expected expansion and contraction. The AIM index fell to 52.7 in October from record highs in the spring. BankBoston's index has been below 50 for most of the year. Consumer confidence has also fallen, especially for future expectations. In October, the Conference Board's overall index for New England was off 14.2 percent from the prior year; for future expectations, the drop was 35.5 percent. The October Mass Insight index for the state was down 7.9 percent from the prior year and down 16.5 percent for future expectations. Since October, stock markets have rebounded, and consumer confidence and AIM's Business Confidence Index have followed, but confidence levels, though above average historically, are still well below those of the beginning of the year. Main Street may still be feeling good, but it is now looking over its shoulder.

The fear is that declines in confidence reflect decisions to cut back on spending because of producers' expectations of reduced demand, workers' fears of layoffs or smaller pay increases, or the wealth effect of lower stock market valuations. Confidence measures are not always reliable indicators, but they seem to be consistent with current trends in investment and consumer spending.

Nationally (in real dollars), non-residential investment declined in the third quarter, and producers' durable equipment spending rose a meager 1.1 percent. Real retail spending[2] was strong on a year-over-year basis as of October, up 4.2 percent for the U.S. and 5.9 percent for Massachusetts. (The Massachusetts measure is derived from state sales taxes.) However, both measures have slowed recently. In the most recent three-month period ending in October, real U.S. retail sales declined at an annual rate of 0.8 percent. For Massachusetts, the data are too volatile for reliable quarterly comparisons, but they do show a decline in the corresponding most recent three-month quarter. As we go to press in the middle of the critical holiday season, the most recently available information suggests that even though businesses are tightening their belts, consumers are not.

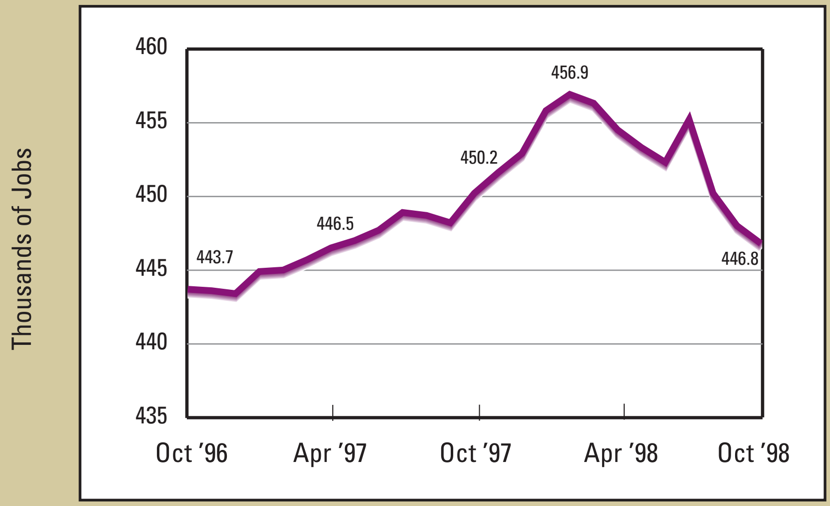
Third, employment growth in the dynamic business services has moderated substantially. In the current long expansion, growth has averaged 9.4 percent annually, and in 1997, was 9.2 percent. In the third quarter of 1998, employment growth slowed to an annual rate of 3.8 percent, its lowest quarterly growth in five years.[3] Part of the decline is no doubt due to supply shortages of workers with computer-related or other technical skills, but part most likely reflects the demand side as well.

Fourth, several other measures of business conditions point to slower growth. Initial unemployment claims have been rising since last spring. On a seasonally adjusted basis, initial claims in October were 18.6 percent above the prior year. Help-wanted advertising was down in the summer; its trend for the past year has been downward. New business incorporations, which are available with a lag of several quarters, also show a downward trend for the most recent 12-month period ending in January 1998.

Some Remaining Bright Spots

Some sectors and indicators are still exhibiting strength. Residential real estate, buttressed by low interest rates, continues to shine. Housing permits grew by 0.9 percent in the 12-month period ending in September. Sales of

Figure 3
Massachusetts Manufacturing Employment
Export problems lead
to declines in manufacturing employment.



Source: Massachusetts Division of Employment and Training existing homes were at record levels in the second quarter, exceeding the prior year's record by 14.1 percent. Home prices continue to rise. First-quarter 1998 prices, as measured by Fannie Mae/Freddie Mac, were up 6 percent over the prior year, while the National Association of Realtor's price index for Boston was up 6.3 percent in the second quarter over the prior year.

Auto purchases, another sector affected by low interest rates, are doing well. Real sales, as measured by motor vehicle sales tax revenues, were up 6 percent in the 12-month period ending in October.

One fear relatead to the stock market decline in late summer was its impact on Boston's mutual fund/ money management sector. So far, the industry has not blinked. On the contrary, employment in the sector (non-depository finance institutions) grew at an annual rate of 8.3 percent in the third quarter, close to the average annual rate of 8.8 percent during the current long expansion.

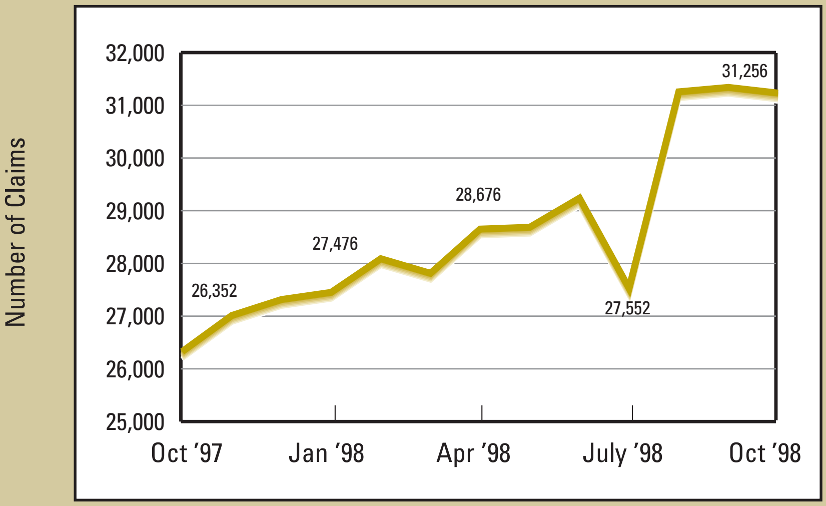
Wage and income growth are still solid. Real personal income in the second quarter was 2.9 percent above the prior year, and real wage and salary disbursements in the second quarter were 4.1 percent above the prior year. These rates of increase are slightly above the average for the current expansion. Withholding taxes suggest even stronger — much stronger — wage growth. The second quarter real withholding tax base was up by 7.1 percent from the prior year, and the year-over-year growth rate in the third quarter was also 7.1 percent. A discrepancy of this magnitude between the tax-based and BEA wage estimates is rare. The tax-based measure has been very reliable, but the surprisingly high growth is not in accord with the overall weight of evidence, including low employment growth in the third quarter and a slower pace of retail sales. If the withholding data are correct, they suggest that, where labor shortages exist, wage rates or hours are rising substantially. One place this is not occurring on a wide scale is in manufacturing, where hourly earnings of production workers rose only a modest 1.9 percent in the year ending in September.

> So far, the economy has withstood the global shock, and there are several reasons to believe that domestic demand will prevail.

Figure 4

Initial Unemployment Claims, Massachusetts

Numbers are seasonally adjusted at annual rates.



Sources: Massachusetts Division of Employment and Training
Adjusted by the author

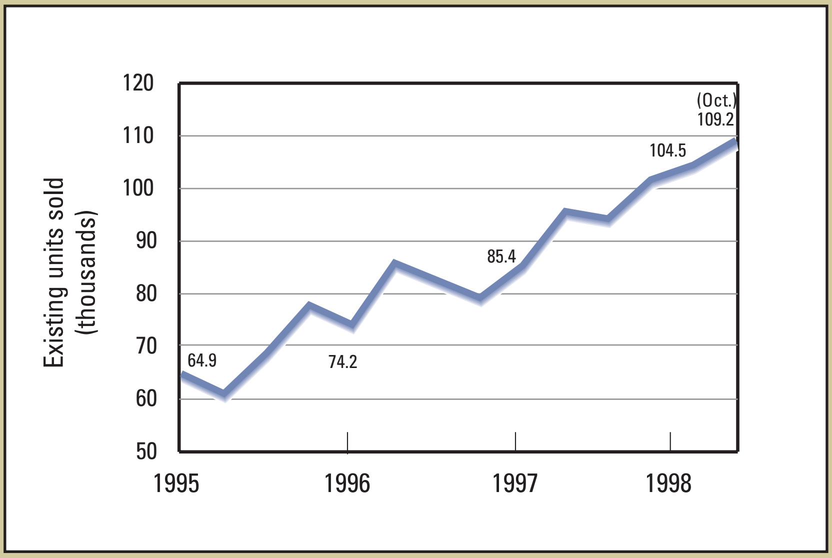
Components of the Current and Leading Indexes

As mentioned earlier, several of these indicators are combined into current (coincident) and leading indexes for Massachusetts. The current index is

Figure 5

Home Sales In Massachusetts

Quarterly numbers are seasonally adjusted at annual rates.



Source: National Association of Realtors

based on four series — employment, the unemployment rate, withholding taxes, and sales taxes, re-trended to grow at the average rate of real Gross State Product, and normalized at 100 in July 1987. In the year ending in October, the index stood at 130.6, or 6.9 percent above October 1997. The index is consistent with a slowing rate of growth in the state's economy. On an annualized basis, October's value was only 4.4 percent above where it was six months before. This projected growth rate has been falling steadily since the spring. In the three-month period ending in October, the unemployment rate and withholding taxes contributed to above-average growth, while employment and sales taxes contributed to below-average growth.

The leading index is constructed to forecast growth of the current index over the coming six months, expressed at an annual rate. It has moved downward from a value of 8 percent in April to 0.5 percent in October, suggesting that the economy will continue to grow, but at a slower rate in the near future. The index is composed of the coincident index plus six additional indicators. In the three-month period ending in October, one of the indicators, motor vehicle sales taxes, grew at its average rate. The other five indicators: consumer confidence for New England, the spread between 10-year and 3-month yields on treasury securities, the Bloomberg Stock Index for Massachusetts, initial unemployment claims, and construction employment, contributed to below-average growth.

Close, but No Recession

The state and national economies are being pulled in two directions: one, a fall in global demand for our exports; two, a steady, if not robust, domestic consumer demand, bolstered by low interest rates and low inflation. In the balance lie corporate earnings and domestic financial markets. So far, the economy has withstood the global shock, and there are several reasons to believe that domestic demand will prevail.

Perhaps largely in response to lowering interest rates and calming financial markets, stock markets have rebounded since September. The nation's business and household sectors are not over-leveraged or burdened with debt. Indeed, low interest rates have lowered debt-payment burdens. Finally, there is some evidence that conditions for export-sensitive manufacturing sectors are improving. Based on the Department of Commerce's "M3" survey, the value of shipments, new orders, unfilled orders, and inventories in manufacturing overall, and in the critical machinery and electronics equipment and component industries in particular, improved over the first two quarters of the year. These data are national, but the similarity of the recent trends in state and national employment in these critical industries suggests that they are facing common market conditions. The risk of recession may be low, but it is greater than it has been since the recovery began in 1991.

1. As we go to press, these indexes are undergoing final analysis and calibration; revised numbers will appear in our spring issue. We expect the qualitative implications to remain unchanged.

2. Nominal spending deflated by the U.S. Consumer Price Index for All Urban Consumers. Unless otherwise specified, the U.S. Consumer Price Index is used to deflate nominal state series.

3. Detailed employment data are seasonally adjusted by the author.