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Economic Currents: The State of the State Economy

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The State of the State Economy

Economic Currents



ILLUSTRATION: LAURA RADWELL

ALAN CLAYTON-MATTHEWS

Nascent signs of imbalance are appearing in the Massachusetts economy. Wage rates and housing prices are beginning to rise at an unsustainable pace as a result of labor shortages and strong consumer demand. At the same time, the manufacturing sector continues to suffer from the economic crisis in Asia.

As of March, manufacturing employment had fallen in twelve of the thirteen previous months. Although these developments are a cause of concern, it is still too early to worry about a repeat of the end game after the 1980s expansion; the scale of the current imbalance is much smaller.

The short-term outlook is for continued growth, supported by well-paid workers and businesses gearing up for the passage of the Y2K dateline. The challenge for the state's economy at the turn of the century will be how to extend the current expansion, a feat that will be possible only if the signs of emerging imbalances abate.

SHORTAGES AND IMBALANCES IN THE LABOR MARKET

Employment. After years of growing faster than the population, the state's employment capacity is about to be constrained by basic demographics. In March, the unem-

ployment rate was at a cyclically low level of 2.8 percent. The labor force has not grown in more than a year. This means that only under increasingly limiting conditions can employment growth exceed the slow rate of increase in the working-age population, roughly one-half percent per year. Furthermore, sustained growth above this rate would almost certainly engender higher rates of wage inflation.

Indeed, employment growth has slowed from its rapid pace in 1997 and the first half of 1998. The quarterly growth in nonagricultural jobs fell from an annual rate of 2.9 percent in the first quarter of 1998 to 1.2 percent in the first quarter of this year. Nationally, employment growth has fallen less dramatically, from 2.8 percent in the first quarter of 1998 to 2.3 percent in the first quarter of this year. Since population in the United States is growing at roughly twice the Commonwealth's rate, the employment growth potential for the nation is correspondingly higher.

The recent slowdown in employment is not solely due to labor shortages. Manufacturing continues to shed jobs. As of March, factory employment was down 3.9 percent from a year earlier. When declines in weekly hours are factored in, the drop in labor input over the past year

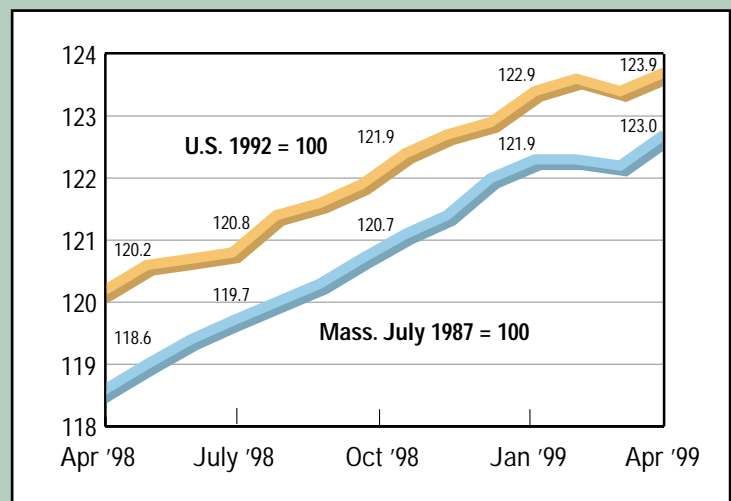
The Current and Leading Economic Indexes for Massachusetts

The Commonwealth's Current Economic Index for April was 123.0, up 3.4 percent from March (at annual rates), and up 3.7 percent from April of last year. The index is normalized to 100 in July 1987 and calibrated to grow at the same rate as the gross state product over the 1978–1996 period. (The last year for which GSP is available is 1996.)

The Leading Economic Index for April was 5.0 percent, and the three-month average for February through April was 4.6 percent. The leading index is a forecast of the growth in the current index over the next six months, expressed at an annual rate. Thus, it indicates that the economy is expected to grow at an annual rate of 5 percent over the next six months. The outlook has taken an about-face since last summer and early fall, when the collapse of the Russian economy, the bailout of the Long-Term Capital Management hedge fund, and the steep drop in domestic stock markets occurred. The index now suggests that the economy is moving ahead with considerable momentum, despite a tight labor market, increasing the risk of overheating.

Current Economic Index United States and Massachusetts

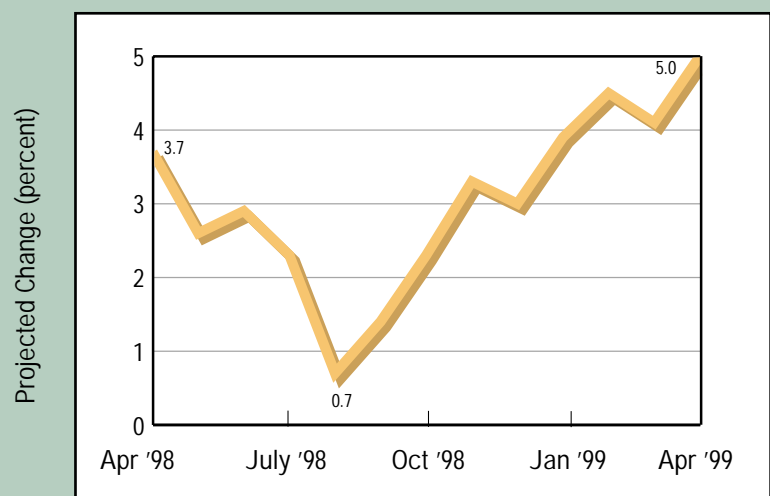
The trends rather than the levels of these indexes should be compared, due to different formulations and base points.



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

Massachusetts Leading Economic Index

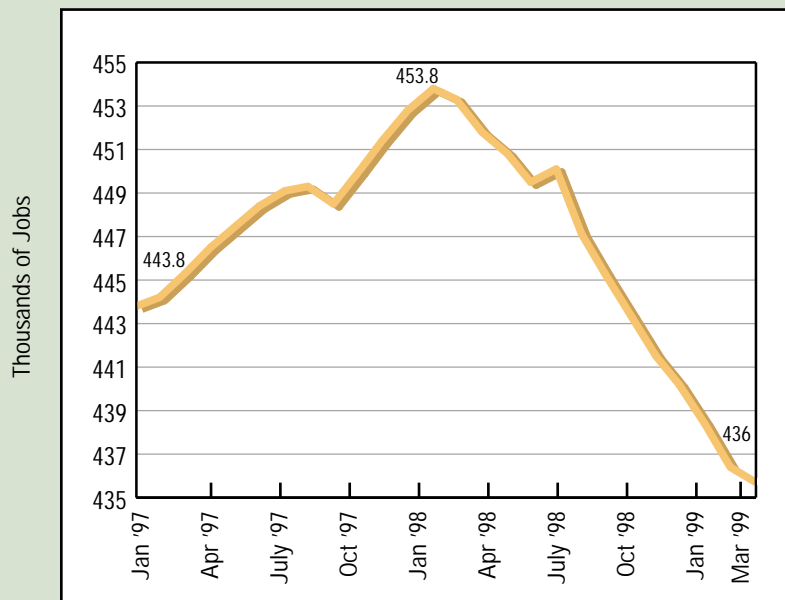
The leading index is the annualized, six-month projected change in the Massachusetts Current Economic Index.



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

Manufacturing Employment in Massachusetts

Manufacturing continues to shed jobs.



Source: Massachusetts Division of Employment and Training

amounts to 5 percent. The losses are concentrated in the export sectors, which are still suffering from the crisis in Asia.

Merchandise exports for New England in the fourth quarter of 1998 (the most recent quarter available) were 3.2 percent less than a year before. The only industries in which manufacturing employment grew in the year ending in March were plastics and lumber & furniture; the latter was spurred by strong housing activity.

Even though total nonagricultural aggregate employment growth has slowed, it is still growing faster than the potential suggested by population growth. Demand is particularly strong in some sectors, such as construction, finance, and business services, and for workers with information technology skills.

Wages. When demand exceeds supply, basic economic principles suggest that prices should rise, and it appears that this is precisely what is happening in the labor market. Anecdotal evidence suggests that, for technology-related workers, firms are paying bonuses not only for new hires, but also to retain existing staff.

Reliable, timely data on wage-rate growth at the state level are hard to come by. We look at three sources of state data on earnings: quarterly wage and salary disbursements from the U.S. Bureau of Economic Analysis, quarterly wages from the Massachusetts Division of Employment and Training,¹ and monthly withholding taxes from the Massachusetts Department of Revenue.² For each source,

an estimate of the wage rate is formed by dividing total wages by nonagricultural employment. This is not a true wage rate, since it includes the effects of changes in the intensity of work—weeks worked and weekly hours worked per employer—but it gives the most reliable picture available of recent trends in paid compensation.

These three sources indicate that wage-rate growth accelerated from 1994 to 1996, rising from an annual rate of less than 3 percent to a 5 percent rate. A major part of this growth may have been due to increases in hours of work. In 1996 and 1997, growth remained at roughly the 5 percent level. Data sources for 1998, though not in complete agreement, suggest that wage inflation was on the rise again. At best, wage inflation crept up to 5.5 percent per year. Withholding tax data, which are more recent, suggest that wage-rate growth has been accelerating rapidly.

According to this data, wage inflation was 6.4 percent from the fourth quarter of 1997 to the fourth quarter of 1998, and it rose to 8.2 percent in the year ending in the first quarter of 1999. These rates of wage growth are above the sum of productivity growth and current inflation, and so place upward pressure on inflation. More important, wages are rising much more rapidly here than in the nation as a whole. According to a comparable measure estimate using U.S. total wages divided by U.S. employment, the national wage rate rose by only 3.9 percent in the year ending in the first quarter of 1999.³

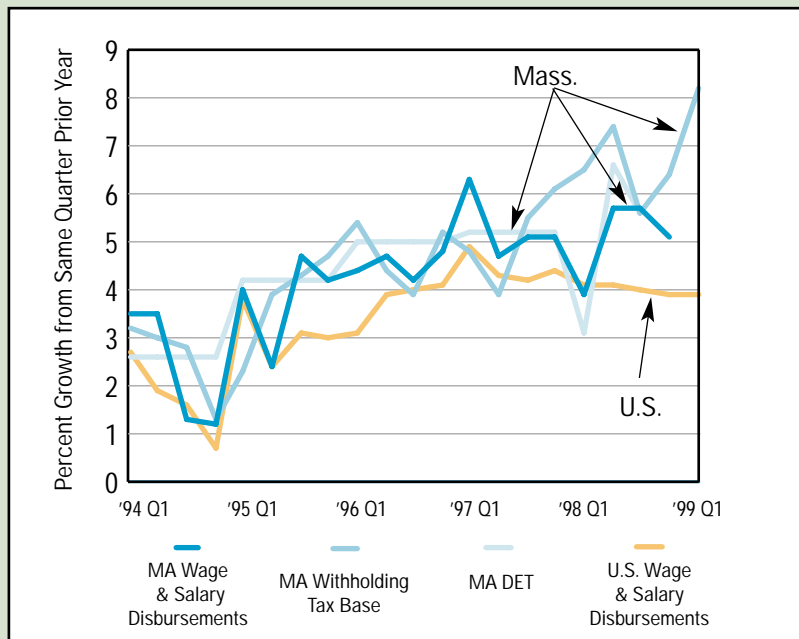
Nearly every sector is experiencing rapidly increasing wages. According to the DET data, the growth in wages per worker in the third quarter of 1998 over the third quarter of 1997 was 5.8 percent in construction, 8.3 percent in communications, 6.7 percent in retail trade, 7 percent in services, and 6 percent in finance, insurance, and real estate. Wage-rate growth was a more moderate 5.2 percent in utilities, which have been undergoing restructuring and shedding workers. Weakness in manufacturing has kept wage rates at the slow growth rate of 3.5 percent. Measured wage rates grew only 1.9 percent in transportation, but this anomalous figure is a statistical artifact of the UPS strike that affected the industry in the third quarter of 1997.

REAL ESTATE AND CONSTRUCTION HEAT UP

The residential housing market is heating up. Prices of existing homes in Massachusetts rose 6.8 percent in the year ending in the fourth quarter of 1998, according to the Freddie Mac and Fannie Mae repeat-sales index. This is two percentage points faster than the

Growth in Wages per Worker

Wages are rising more rapidly in Massachusetts than in the United States as a whole.



Sources: Mass. DET; U.S. BEA; U.S. BLS; Mass. DOR; author's calculations

increase in the United States as a whole. For the Boston metropolitan area, the appreciation rate was 6.9 percent over the same period.

These estimates may actually understate the rate of price growth, since they exclude many higher-priced transactions that do not qualify for conventional mortgages. This is significant, because the top end of the market appears to be appreciating more rapidly than average. Thus, the National Association of Realtors median price index, which reports a gain of 9.7 percent for the Boston area over the same period, may be a more accurate indicator of current trends. Realtors report an increasingly popular practice of "tear-downs," whereby home buyers purchase older houses, demolish them, and build new—and bigger—ones on the lots. Because of this, existing price measures are not fully capturing the extent of demand pressures.

So far, rising house prices have not initiated a boom in speculative building. Housing permits for the 12 months ending in February averaged 1,575 per month, 7 percent ahead of the corresponding 12-month period in the prior year. This is within the 1,200 to 1,600 range that has prevailed for several years.

Boston is the fifth-largest office market in the country, behind midtown Manhattan, Chicago, downtown Manhattan, and Washington, D.C.⁴ Adequate office space is vital for the state's economic expansion. Vacancy rates in Boston are among the lowest in the nation, and rental rates for class A office space in 1998 were up roughly 20

percent over 1997. After several years of falling vacancy rates and no construction in 1993 through 1996, the city is in the beginning of a construction boom again. In 1997 and 1998, construction projects totaling 1.5 million square feet (MSF) were initiated. This represents approximately 3 percent of the city's 50 MSF of office space. In 1999 through 2001, another 3.5 MSF may be added.⁵

The residential and commercial building boomlet, the Big Dig, and other public construction projects account for the strong (8.7 percent) growth in construction employment in the 12 months ending in March. Given the high residential demand and pipeline of commercial and public projects, employment in this sector could remain at these levels into the future.

CONFIDENT CONSUMERS

KEEP SPENDING

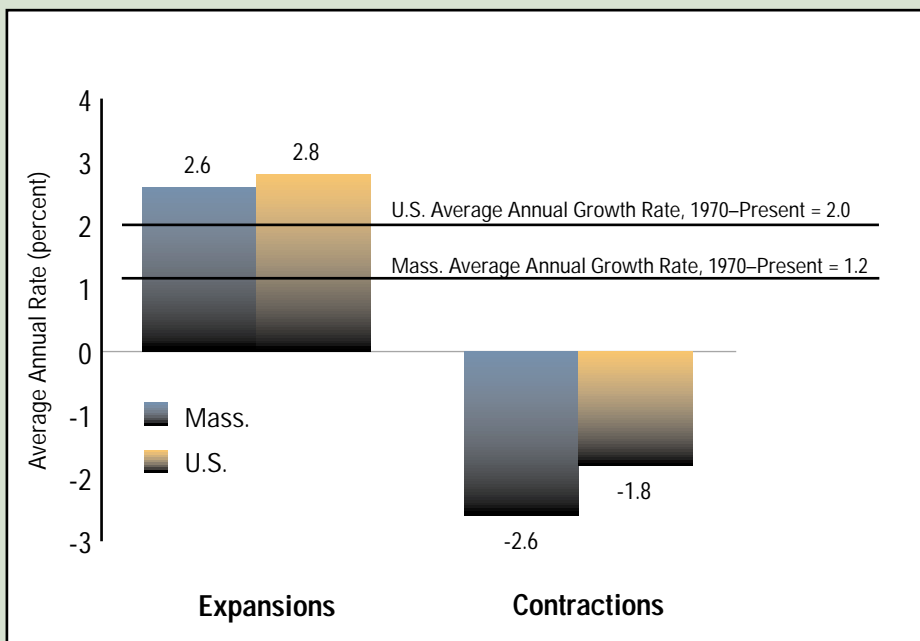
Consumer confidence in Massachusetts, as measured by the Conference Board index for New England, continues at the high levels that preceded the financial scare of last year, when Russia defaulted, the Long-Term Capital Management hedge fund collapsed, and stock markets underwent a sharp correction. Since

Change in Wages in Massachusetts 1997 Q3 – 1998 Q3

Industry	Percent Change
Mining	6.3
Construction	5.8
Manufacturing	3.5
Transportation	1.9
Communications	8.3
Utilities	5.2
Wholesale Trade	7.7
Retail Trade	6.7
Finance, Insurance and Real Estate	6.0
Services	7.0

Source: Mass. DET

Employment Growth by Phase of Cycle 1970 to Present



Source: BLS; NBER; author's calculations

that time, consumer confidence and stock markets have traveled back up together. It is probably no coincidence that the future expectations component of confidence has increased the most, since household sentiments about the future are driving both the confidence and stock indexes.

Consumption continues to grow unabated, driven by low unemployment, confidence, and stock market wealth. Nationally, retail spending in the 12 months ending in March grew 6.2 percent over the prior 12-month period. In Massachusetts, the sales tax base,⁶ which is weighted toward consumer durable spending, grew by 7.7 percent over the same period. Purchases of automobiles in Massachusetts, not included in the sales tax base, grew 11.3 percent over the same period.⁷ The forces driving consumer spending are more pronounced in Massachusetts than in the rest of the nation. Households in the Commonwealth own more stock, have faster-growing wages, and now have more rapid home-value appreciation than the average U.S. household.

PATHS OF RISK

The combination of several indicators suggests that Massachusetts is approaching the point at which its employment growth, which itself has slowed, will be effectively constrained. The unemployment rate is low, the labor force participation rate is high and steady, and wage rates appear to be accelerating.

There are few ways by which the constraint of natural population growth can be circumvented. In-migration

would bring people into the state, but since conditions are equally good elsewhere, this release valve is unlikely. Other ways to relieve the constraint involve a higher intensity of work by increasing hours or inducing those outside the labor force to seek work. Either of these means, however, will require a further acceleration in wage rates.

The point of the cycle that we may now be entering is full of risk. If the budding signs of a high-pressure economy persist in Massachusetts while they fail to develop in the rest of the country, the Commonwealth's economy is likely to travel down one of three paths over the next year or two.

One path, the path of wisdom, is one in which consumers, financial institutions, and workers act rationally in a manner according to the lessons learned from prior cycles. Remembering the real estate bubble of the late '80s, consumers would refrain from paying inflated prices for homes for fear of the market collapsing again. Financial institutions, whether regional or national, would resist overassessing the future value of property or earnings streams of businesses, and thus not accommodate the formation of speculative bubbles. Workers, having learned the painful lessons of deindustrialization in the '70s and '80s, would limit their wage demands in order to increase their job security.

In this scenario, each group would be acting in its own interest, in order to avoid capital, business, or job losses. The result could be a restraint of inflationary pressures and slowed but sustainable job and economic growth. Note that wage restraint may be difficult to achieve, because of a classic fallacy of composition: the group interests of labor and the self-interests of individual workers are in conflict with each other. In our unfettered markets, self-interests usually win out, making wage restraint unlikely.

A second path, the path of inflation, is one in which the state prices itself out of the market for businesses and households through inflation in wages, home prices, and consumer prices that exceed national rates of increase. Higher wage, real estate, and service costs in Massachusetts make it more profitable for firms to expand or

locate production in other regions. Higher home prices and the cost of living make it too expensive for prospective workers to move here or for young workers to establish households here, exacerbating the labor shortage. The economy would slow—and very likely contract—because of reductions in the supply of both capital and labor into the region.

A third path, the path of speculative excess, is one in which inflation in one or more markets evolves into a speculative bubble. This happened in the real estate market of the '80s. Though there are winners in bubbles—those who sell before the crash—the economy as a whole loses through the waste of misallocated resources and the collapse in asset values, confidence, and aggregate demand that inevitably follows.

Unfortunately, the record of recent cycles for Massachusetts favors the paths of inflation and speculative excess over the path of wisdom. Absent specific regional shocks not common to the nation as a whole, the path of wisdom would imply expansions and contractions similar in length and timing to those of the nation, with slower-than-national rates of employment growth in expansions consistent with slower-than-national rates of population and labor force growth. Since the end of the '60s expansion in December 1969, the employment growth in Massachusetts averaged 1.2 percent per year, 60 percent of the national growth rate of 2 percent. However, this slower-than-national growth relationship has not been maintained in the last five expansions of this century.

Instead, the average annual rate of growth for the post-'60s expansions was nearly the same for Massachusetts and the nation: 2.6 percent for the state, and 2.8 percent for the nation. For this to be consistent with their differing long-term rates of employment growth, it must be that the Commonwealth's expansions are shorter, its contractions deeper, or both. In fact, it is both. In the five cycles since December 1969, Massachusetts expansions have been seven months shorter, on average, and consequently its contractions have been approximately seven months longer. In those longer contractions, the average annual rate of job loss in Massachusetts was 2.6 percent, versus 1.8 percent for the nation.⁸

PROSPECTS FOR A SOFT LANDING

The three aforementioned paths of risk are conditioned on the national economy not slowing down in the near future. There are few, if any, signs of an immediate slowdown in either the national or the state economy. The leading index for Massachusetts, for example, suggests strong growth over the coming six months. It should be stressed, though, that the imbalances in the Commonwealth's economy are just beginning to appear, and it will take some time for them to develop the

momentum necessary to become a clear danger. A repeat of the '80s is not yet on the horizon. On the other hand, it might be just over the horizon, so economists will keep a vigilant watch.

There are several prospects for a slowdown in the national economy that would come in time to divert the state from the fates outlined above. Many of the possibilities would be transmitted to the economy via a slackening of consumer spending, business investment spending, or both. These include a mild correction in the stock market (through its effect on consumers' propensity to spend from wealth), or a rise in interest rates (the 30-year Treasury yield is up over 50 basis points from the beginning of the year). Higher interest rates may reflect rising inflationary expectations and a reversal of the "flight to quality," as foreign financial markets stabilize.

Consumers may be reaching the limits of their comfort level with consumer and mortgage debt. Given low-capacity utilization, firms may not need to maintain their currently high level of investment spending. Some industry sources worry that, after the Y2K dateline passes, spending on computers and related products—and on programmers and related personnel—may decline. Finally, if none of these events materializes, the Fed is likely to step in and attempt to engineer a soft landing. Thus, there are reasonable prospects for a soft landing that would prolong a balanced expansion for Massachusetts, albeit at a slowed rate of growth. ▮

ENDNOTES

1. These data are from quarterly reports required of all employers who contribute to the state's unemployment insurance system. The source is commonly known as the "202" series.
2. Withholding taxes are converted to an estimate of wage and salary disbursements by adjusting for changes in rates and exemptions. The data are then seasonally adjusted and smoothed.
3. The measure divides wage and salary disbursements from the BEA by establishment employment from the BLS.
4. According to CB Richard Ellis. They rank office markets by total square feet of space.
5. The office space figures and projects are from Fallon Hines & O'Conner, presented at the GBREB/NEEP annual Real Estate Conference, April 27, 1999.
6. The sales tax base reflects sales tax receipts, excluding meals and motor vehicles. The data are adjusted for tax law changes and seasonal patterns, and are smoothed.
7. Based on state motor vehicle sales taxes.
8. The dating of the U.S. cycles is defined by the NBER. Massachusetts cycle dates are defined by the author to be the same as the nation's if movements of employment in Massachusetts and the United States were similar, or they are chosen to reflect peaks or troughs in employment. The following dates for Massachusetts are different. The NBER trough date of November 1970 is set to August 1971 for Massachusetts. The NBER peak date of July 1990 is set to December 1988 for Massachusetts. The NBER trough date of March 1991 is set to December 1991 for Massachusetts.