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Economic Currents: The State of the State Economy

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ILLUSTRATION: NAOMI SHEA

Economic currents

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In the midst of continuing economic growth, we are seeing signs of a possible future slowdown in the Commonwealth's economy. June's Leading Economic Index for Massachusetts was down nearly a percentage point from its May level, and consumer confidence fell moderately in the same month. In the labor market, there is evidence that inflationary pressures may be building.

When Alan Greenspan presented his semiannual Humphrey-Hawkins testimony to Congress in July, he described the characteristics of the remarkable economic expansion and the risks and challenges that now face monetary and fiscal policymakers. He was speaking about the national economy, but what he said also applies to the Massachusetts economy. Both the state and the nation have enjoyed a long and robust expansion. Both have suffered from the fall in exports associated with the Asian crisis but have benefited from the inflation- and interest rate–lowering effects of that same crisis. Both are at risk of overheating in the presence of tight labor markets and insatiable consumer demand.

The two basic indicators of the economy's health, as specified in the Humphrey-Hawkins legislation, are employment and inflation. The state and the nation are in excellent health, according to these overall indicators. Unemployment rates declined to very low levels during the past

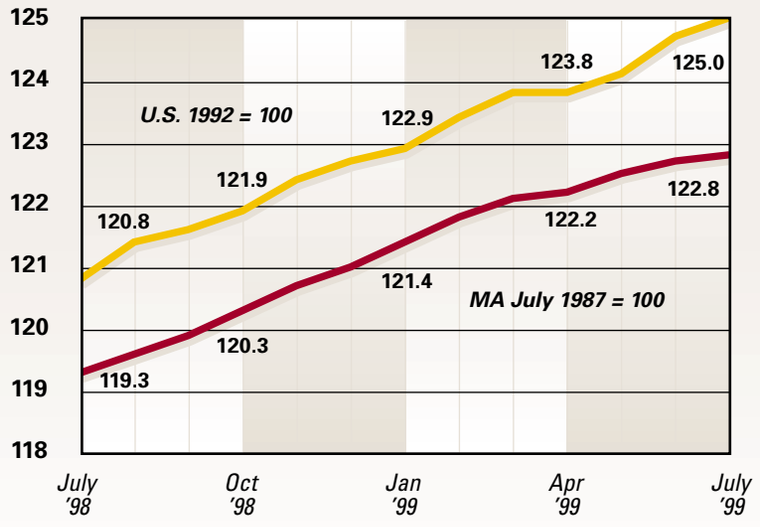
The Current and Leading Economic Indices for Massachusetts

The Current Economic Index for Massachusetts for July was 122.8, up 1.3 percent from June (at an annual rate), and up 2.9 percent from July of last year. The current index is normalized to 100 in July 1987 and calibrated to grow at the same rate as Massachusetts real gross state product over the 1978–1997 period. The index was recalibrated last month to reflect the recent release of gross state product through 1997.

The Leading Economic Index for Massachusetts for July was 1.9 percent, and the three-month average for May through July was 3.1 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 1.9 percent over the next six months. Because of monthly fluctuations in the data on which the index is based, the three-month average of 3.1 percent may be a more reliable indicator of near-term growth. The index suggests that the economy is slowing from its rapid pace of the last several years, as labor shortages are effectively restricting the growth in employment, incomes, and consumer demand.

Current Economic Index
United States and Massachusetts

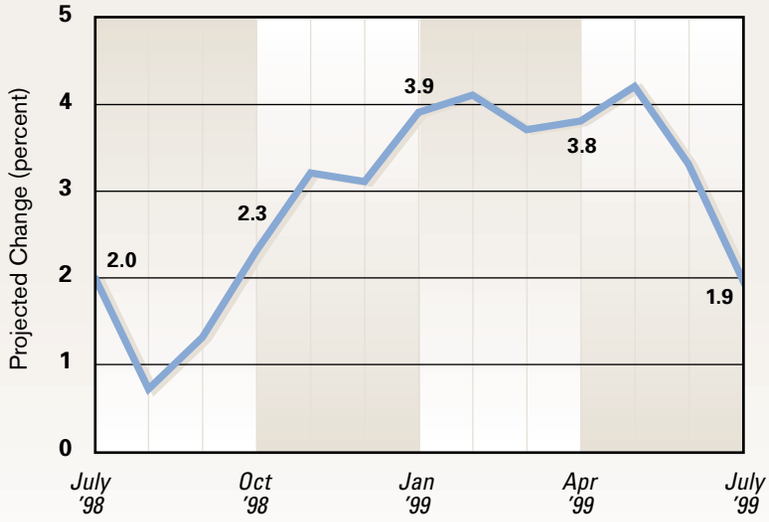
The trends rather than the levels of these indices should be compared, due to different base points.



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

year: 3.0 percent in Massachusetts and 4.3 percent in the United States (as of June). Consumer price inflation has remained uncharacteristically low in the face of such long and sustained growth: 1.9 percent in Massachusetts for the year ending in May, and 2.0 percent in the United States for the year ending in June.

Given the Commonwealth's much lower rate of population growth, it is remarkable that Massachusetts has managed to match the nation in its rate of expansion. Annual gross state product data through 1997, released by the Bureau of Economic Analysis in June, indicate that during this expansion (1991–1997) real GSP growth in Massachusetts matched the national annual average growth of 3.2 percent. Despite a small and shrinking pool of unemployed, job creation continues to exceed population growth. For the year ending in June, the number of nonfarm payroll jobs increased by 1.5 percent in Massachusetts. Over the same period, the Massachusetts working-age population grew by only 0.5 percent. As a consequence of these trends, the signs of nascent inflation are more pronounced here than in the nation as a whole, as evidenced by wage-rate growth and housing price appreciation.

The Employment and Inflation Picture Is Mixed

When one looks at the industrial composition of employment changes, along with other indicators of inflation, the bill of economic health is more mixed than is suggested by total employment and consumer prices.

First, the good news. In the year ending in June, employment growth in Massachusetts was particularly strong in construction (7.9 percent), transportation (3.1 percent), retail trade (2.7 percent), finance (4.8 percent), the broad service sector (2.4 percent), and public primary and secondary education (3.2 percent). Construction demand was supported by strong demand from the residential, commercial, and public sectors and in retail trade by the building materials, auto dealers, apparel, furniture, and dining sectors. In finance, employment expanded by 6.4 percent in nondepository institutions—essentially the money management/mutual fund industry.

Banks expanded employment until the second quarter. Consolidations, especially the proposed Fleet/BankBoston merger, may result in employment declines after the merger is approved. The employment impact of the merger will depend on who buys the divested branches. If the buyer is from outside the region, the employment impact may be quite small.

Business service employment, which includes temporary employment agencies and much of the software industry, grew by 4.1 percent. This is well below the sector's average annual growth rate of 8.7 percent during the expansion.[1] The slowdown in this sector is largely the result of a shortage of workers, rather than a decrease in demand by

Employment Growth in Selected Massachusetts Industries

June 1998–June 1999 (percent change)

Total Nonagricultural	**1.5**
Construction	7.9
Manufacturing	-3.4
Lumber & Furniture	1.1
Stone, Clay, & Glass	1.1
Machinery & Equipment	-8.1
Electronics & Electronic Equipment	-1.8
Communications Equipment	2.7
Transportation Equipment	-4.6
Instruments	-4.6
Textile Mill Products	-8.5
Apparel	-12.6
Miscellaneous Plastics Products	1.9
Transportation	3.1
Communications	-0.3
Electric, Gas, & Sanitary Services	-2.6
Wholesale Trade	0.8
Retail Trade	2.7
Finance	4.8
Nondepository Institutions	6.4
Banks	2.7
Services	2.4
Business	4.1
Health	0.2
Social	3.7
Engineering & Management	3.9
Federal Government	-0.7
State Government	-0.9
Local Government	2.6
Local Education	3.2

Sources: Massachusetts DET; U.S. Bureau of Labor Statistics

employers. The Fed's June 16 *Beige Book* for the Boston district encompassing New England reports that demand is strong for information technology workers, and that employment firms cannot find enough people to fill the IT vacancies. Other service sectors that exhibited strong growth were engineering and management (3.9 percent) and social services (3.7 percent).

Manufacturing Continues to Lag

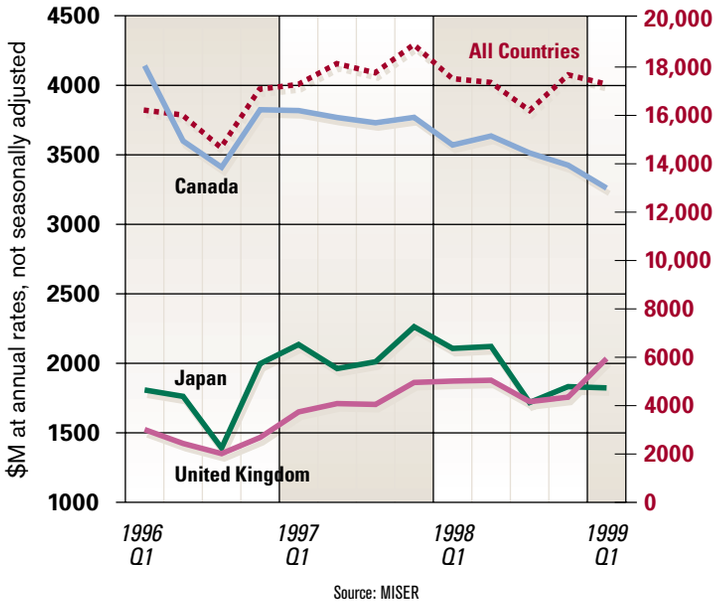
Manufacturing employment continues to decline, falling by 3.4 percent in the year ending in June. Measured in terms of production worker hours, the decline was even steeper, at 4.1 percent. Particularly hard hit were the Commonwealth's export sectors: machinery, electronics, instruments, transportation equipment, apparel, and textiles. While some portion of the decline can be attributed to productivity, it is primarily due to export declines engendered by weak economies in Asia and the strong U.S. dollar.

Before the impact of the Asian crisis was felt, the state's exports were growing at double-digit annual rates. By the second quarter of 1998, exports were declining.[2] In the third quarter, they were off by 8.8 percent over the same quarter in 1997. The reversal was most dramatic for trade with Japan, which, at the time, was our second-largest trading partner (it is now the United Kingdom). The most recently available export data for the first quarter of 1999 still indicate a declining trend for Japan and Canada (our largest trading partner in terms of exports). Exports to Canada have been hurt by a weak Canadian dollar, which makes them expensive for our northern neighbor. Industrial machinery, which was our largest export sector, was the hardest hit. Machinery exports declined from $5.3 billion in the fourth quarter of 1997 to $3.8 billion in the first quarter of 1999.

There are signs that the bottom of the export crash is near. Stock markets in Japan and East Asia have outpaced even domestic markets so far this year (as of the end of July), an indication that international investors are expecting business conditions there to rebound. Presumably, economic growth and demand for our exports will follow. Data for New England as a whole indicate that exports to South Korea and Singapore were up in the first quarter over a year ago.[3] The Canadian and European economies, including Germany, are also showing signs of renewed strength. Consequently, the declines in both exports and manufacturing employment have abated somewhat, even though they have continued downward.

Massachusetts Merchandise Exports by Country of Destination

Left-hand axis measures exports to individual countries.
Right-hand axis measures total exports.



Source: MISER

Exports to Canada and Japan show a decline from last year.

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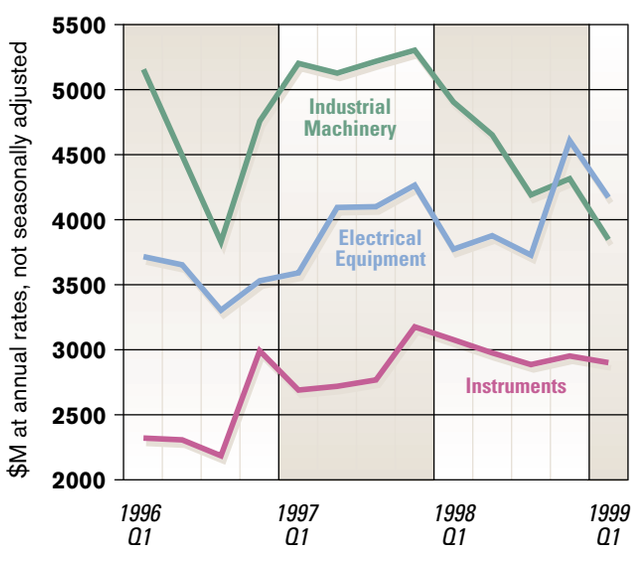
Massachusetts Exports by Industry



Source: MISER

Industrial machinery has lost its place as the state's leading export industry.

Superimposed on the Asian crises was a glut in the computer chip market, which appears to be over. Some companies in Massachusetts that supply computer chip–making equipment have been expanding production and overtime hours. Exports of electrical equipment have grown in the fourth quarter of 1998 and the first quarter of 1999 over the prior year, according to the most recently available data.

Not all manufacturing sectors have suffered. Those supplying primarily domestic demand—the real estate sector in particular—have done well. These include furniture; stone, clay, and glass; and plastics. Rapid expansion in the Internet, cellular phones, and related technologies has boosted employment in communications equipment.

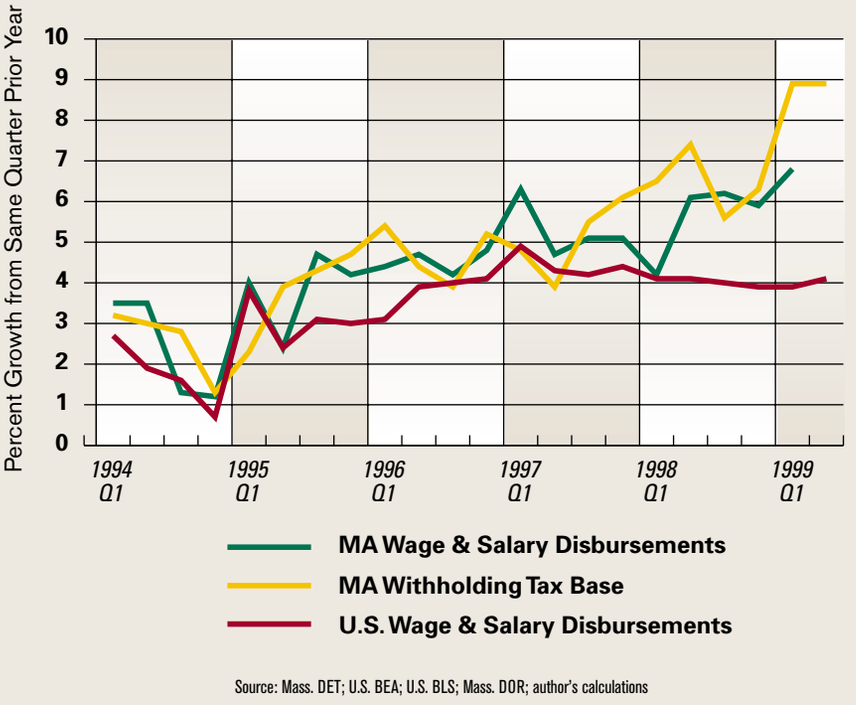
Signs of Nascent Inflation

Monetary policy analysts and regional economists are concerned about inflation, though their motivations may be somewhat different. The Federal Reserve Board of Governors, toward its objective of maintaining maximum sustainable economic growth, seeks to restrain the emergence of inflation. Experience tells them that inflation is difficult to halt, and success in halting it can easily result in initiating a recession.

Regional economists are aware that inflation is rarely uniform across regions; it often alters the balance of interregional costs for both businesses and households, with consequent disruptions in employment, unemployment, and migration. So though state governments do not possess monetary or fiscal levers to control inflation, regional analysts are keenly interested in it.

At the national level, policymakers are wary of several precipitators of inflation. Chief among them is the cost of labor, the major component of value-added in production. So far, at the national level, per-unit labor costs appear to be behaving well. This is not the case in Massachusetts, however. Without good state-level data on labor costs, we can only estimate the aggregate wage rate by dividing aggregate earnings by employment. This is not a true wage rate, since it includes the effects of changes in the skill mix of the workforce and the intensity of work effort (weekly hours worked per employee), but it gives the best indication of recent trends in paid compensation.

We use two measures of aggregate earnings: state quarterly wage and salary disbursements from the U.S. Bureau of Economic Analysis, and monthly withholding taxes from the Massachusetts Department of Revenue.[4] The former indicates that wage-rate growth accelerated in 1998. By this measure, first quarter 1999 wage rates were 6.8 percent above those of the prior year. In contrast, a similarly defined measure for the nation shows that wage-rate growth *decelerated* moderately in 1998. At the national level, first quarter 1999 wage rates were 3.9 percent above the prior year and rose slightly to 4.1 percent in the second quarter. The second measure for Massachusetts, using withholding taxes, shows an even more rapid growth in wage rates: 8.9 percent in the year ending in the first quarter of 1999, and also 8.9 percent in the year ending in the second quarter of this year.



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

These rates of growth, 6.8 percent to 8.9 percent, may overstate actual wage-rate growth in the state, as part of the growth probably reflects increases in hours of work. It is likely that hours of work increased more in Massachusetts than they did nationally, due to the Commonwealth's lower unemployment rate. It is unlikely, however, that hours alone account for the difference. Employers often pay workers more per hour for additional work and also pay higher benefits (which are not counted in the figures given here). These extra hours tend to be less productive. The upshot is that per-unit labor costs in the state are almost certainly rising faster than consumer prices plus productivity growth, and they are rising faster here than

nationally. They must, therefore, be putting upward pressure on the Commonwealth's business costs relative to other regions.

Housing prices, a major cost for newly formed households and in-migrants, are also ramping up. According to the Fannie Mae and Freddie Mac Repeat Sales Index, prices for existing homes increased by 7.8 percent in Massachusetts between the first quarter of 1998 and the first quarter of 1999. This represents a gradual acceleration since early 1997, when the appreciation rate was 3.1 percent. More recently, the Massachusetts Association of Realtors estimated that the median price of detached single-family homes rose by 12.3 percent in June from the prior year. Unlike the former measure, which controls for quality and size of house, the MAR measure probably reflects both appreciation and a shift toward larger/higher-quality homes. Over the same period, the MAR reported that the median price of condominiums rose by 17.0 percent.

Outlook: Slower Growth May Not Come in Time to Halt Inflation

June's leading index for Massachusetts suggests real output growth of 3.3 percent over the next six months. Given the very low unemployment rate and current rates of wage growth and real estate appreciation, a continuation of growth of this magnitude presents a danger of overheating the economy. The action by the Fed in June to raise interest rates is therefore welcome.

Unless these signs materialize soon as a clear slowdown in growth, an inflation-induced end to the expansion becomes increasingly likely in the next year or two.

Despite the overall danger of overheating, faster growth in the manufacturing sector would be welcome. A recovery in exports and manufacturing employment would help restore balanced growth without adding to inflationary tendencies, as wage-rate growth in manufacturing is running at a safe 3.6 percent annual rate. Restoring the incomes of these workers will forestall destabilizing effects of personal credit card defaults and mortgage foreclosures, help restore regions of the state hurt by recent worldwide events, and soothe the social ills of job loss, which must be all the more painful in an economy that is otherwise booming.

Some recent news can be interpreted as supporting a "soft landing" scenario. Consumer confidence for New England fell in June. Although the drop was moderate overall, it was somewhat steep in the future expectations component. Also, the surge in home sales and prices in the spring may largely reflect anxious homebuyers jumping into the market to avoid expected rises in mortgage rates, which have been moving upward. If this is so, speculative activity in the housing market may be restrained by rising mortgage rates. The Massachusetts Leading Economic Index for June is down nearly a percentage point from May, a trend that is welcome for now.

Until and unless these signs materialize soon as a clear slowdown in growth, however, an inflation-induced end to the expansion becomes increasingly likely in the next year or two. For the future of the Commonwealth's superb economic expansion to be secured, wage growth and housing price appreciation must be restrained. Thus, like Alan Greenspan, regional economy-watchers will be keeping a vigilant eye on inflationary pressures—albeit without Greenspan's monetary tool kit.

Endnotes

1. The expansion began in October 1991, as dated by the Massachusetts Current Economic Index.

2. The export data are from the Massachusetts Institute for Social and Economic Research (MISER).

3. Data on exports from Massachusetts to East Asian countries are not readily available to the author at this time.

4. 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.