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Economic Currents: The State of the State Economy

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Economic currents

The Massachusetts economy continued to create new jobs in 1999, despite tight labor markets. While there were only 1.6 percent more jobs in December 1999 than there were a year earlier, this is an impressive performance, considering that the working-age population has been growing by only one-half of one percent per annum for several years, and the unemployment rate averaged just 3.2 percent for the last two years.

ALAN CLAYTON-MATTHEWS

The Massachusetts economy grew by 3.1 percent in the fourth quarter of 1999 (in real output), as measured by the Massachusetts Current Economic Index. This is well below the corresponding estimate of 5.8 percent for the nation, but it is a solid performance, nonetheless.

The Massachusetts Leading Economic Index, in contrast, rose to 5.2 percent in December and averaged 4.7 percent for the October–December period. This is a measure of expected growth (in real output) over the next six months, expressed at an annual rate. The leading index was driven by strength in stock markets, wage income, employment, and consumer confidence. Its projection cannot be taken literally, simply because the state's economy is already growing at or above capacity. This capacity is roughly 3 percent, which includes 0.5 percent growth in the working-age population, plus roughly 2.5 percent productivity growth.

Two of the recent drivers of the leading index, stock markets and confidence, are expectational; a sharp stock market correction would result in a corresponding drop in the index. Given recent employment growth, the strong performance in the wage-income measure is indicating accelerating inflation, rather than accelerating real output growth. This indicator may be overstating wage inflation—

The Current and Leading Economic Indices for Massachusetts

The Massachusetts Current Economic Index for January was 126, up 4 percent from December (at annual rates), and up 3.8 percent from January of last year. The current index is normalized to 100 in July 1987, and calibrated to grow at the same rate as the Massachusetts real gross state product over the 1978–1997 period.

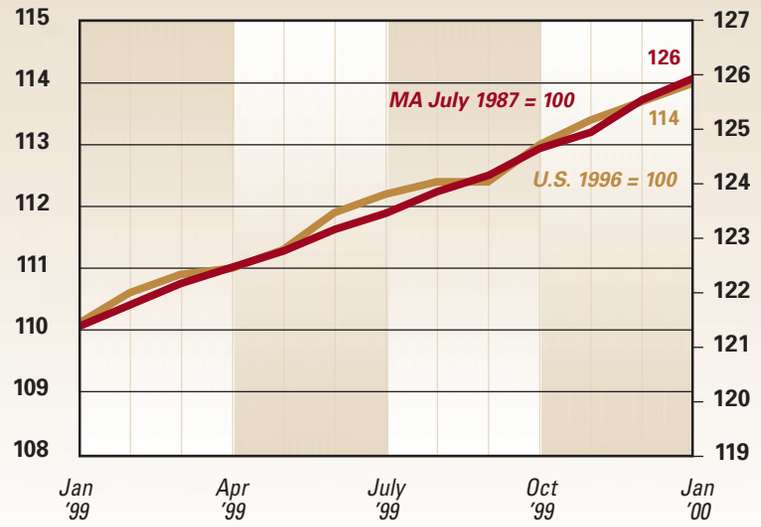
The Massachusetts Leading Economic Index for January was 6.4 percent, and the three-month average for November through January was 5.8 percent. The leading index is a forecast of the growth in the current index over the next six months, expressed at an annual rate. Thus, it indicates that the economy is expected to grow at an annual rate of 6.4 percent over the next six months. Because of monthly fluctuations in the data on which the index is based, the three-month average of 5.8 percent may be a more reliable indicator of near-term growth.

Soaring stock prices, strong growth in wages and salaries, continued job expansion despite low unemployment, and high consumer confidence indicate that the Massachusetts economy is still red hot.

Submitted March 2, 2000

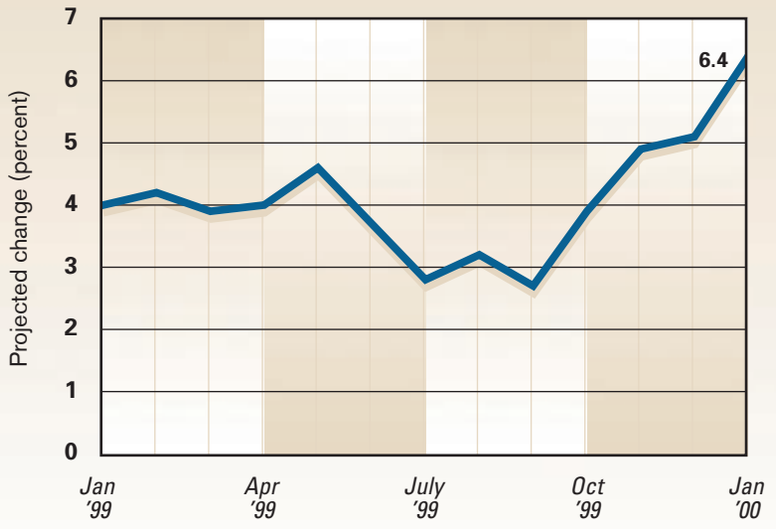
Current Economic Index United States and Massachusetts

The U.S. Current Economic Index is measured on the left vertical axis; the Massachusetts Current Economic Index is measured on the right.



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

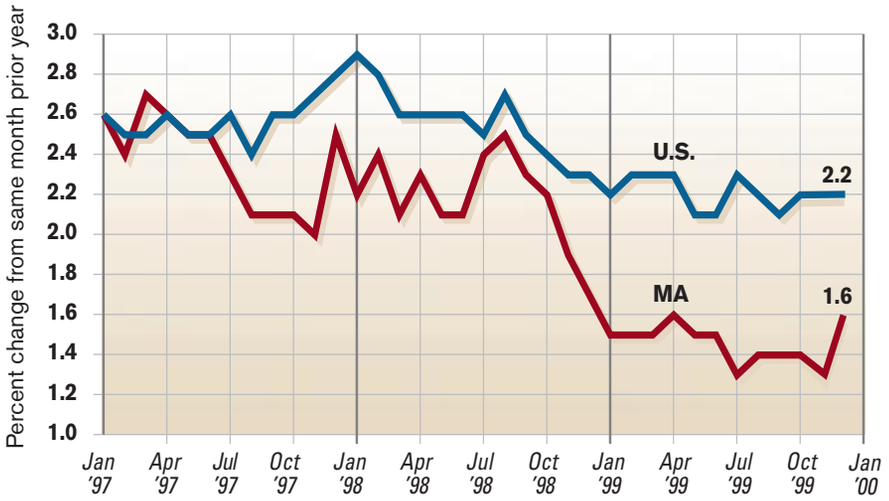
but it may not. In any case, the state's economy is going full throttle, and overall indicators suggest it will continue to do so, at least for the near future.

In 1999, the Massachusetts economy continued to create new jobs, despite tight labor markets. There were only 1.6 percent more jobs in December 1999 than there were a year earlier. This is an impressive performance, however, considering that the working-age population has been growing by only one-half of one percent per annum for several years, and the unemployment rate averaged just 3.2 percent in the last two years.

The economy has been wringing out new workers almost any way it can. In the past two years, the number of payroll jobs in Massachusetts grew faster than the number of working residents, suggesting that more people were working two jobs, net commuting into Massachusetts rose, or both.[1] More people are using child care, suggesting that more people are leaving the home to work.[2] The proportion of the working-age population in the labor force is as high as its peak at the end of the "miracle years." Even those without high school educations are having little trouble getting work.[3]

Employment Growth, Massachusetts vs. United States

In the past two years, the number of payroll jobs in Massachusetts grew faster than the number of working residents, suggesting that more people are working two jobs, commuting into Massachusetts, and leaving the home to enter the workforce.



Source: Bureau of Labor Statistics

The squeezing of additional work at a rate faster than the underlying demographics will allow in the long term appears to be about at its end in Massachusetts. First, it is difficult to see how the labor force participation rate, that is, the proportion of working-age people who are in the labor force, can go any higher. When times are as good as they are now, there is even an inducement for spouses of the well-paid, with children and a household to manage, to leave work. Such households can now afford to live a less-harried life. Second, there are already signs that the low underlying population growth is forcefully restraining employment. The growth rates of the labor force and the number of Massachusetts residents who are working are now approximately equal to that limit of one-half percent per annum. Third, the apparent slowdown in payroll employment growth that began in mid-1998 is now a clearly established trend. The question now is whether 1.5 percent growth, or even 1 percent, can be maintained in 2000.

Wage Pressures Build (or Do They?)

Basic economic theory, as well as common sense, says that in order to entice more workers out of a scarce pool, you have to offer them higher pay or benefits. After all, child care has to be paid for somehow. There are also anecdotes about employers raiding — stealing is another popular term — one another's employees, particularly technology workers.

Cisco, Sun Microsystems, and Intel, among other information technology firms, are rapidly expanding their presence in the state. The increased demand for the existing, fully-employed supply of such workers can only increase the upward pressure on wages. The available information on wage inflation in the state provides one of the toughest puzzles facing economy-watchers. Because there are no timely direct measures of state wage rates outside of manufacturing, the best available estimate of current wage rate trends uses payroll divided by payroll employment.

There are two usually reliable sources of payroll for the numerator of the wage-rate measure: wage and salary disbursements from the U.S. Bureau of Economic Analysis, and withholding taxes from the Massachusetts Department of Revenue. Usually in close agreement, these two measures diverged dramatically, beginning in the first quarter of 1999. According to the most recently available BEA measure, wages and salaries per worker grew 5.3 percent from the third quarter of 1998 to the third quarter of 1999, about one percentage point higher than a comparable measure for the nation. Wage-rate growth of this magnitude is cause for only mild concern with respect to inflation. Indeed, it is lower than earlier in the year and lower than in the last three quarters of 1998.

In contrast, the DOR-based measure *is* cause for concern. According to the wage and salary measure derived from withholding taxes, the average wage grew by 10.4 percent over the same period of time, and by 10.7 percent from the fourth quarter of 1998 to the fourth quarter of 1999. These figures may greatly exaggerate wage-rate inflation for

technical reasons: there was a change in withholding tax rates, and the actual phase-in of employers switching to the new withholding schedules may have lagged the phase-in timing assumed in the construction of the data series. However, even this explanation cannot account for the high quarterly rates of growth the measure gives for the third and fourth quarters of 1999, growth at an annualized rate of 9.9 percent in the third quarter, and of 12.5 percent in the fourth quarter. The latter may have been boosted by higher-than-usual year-end bonuses. On balance, the conflicting data, anecdotal evidence, and economic theory leave us concerned that wage-rate inflation, especially for highly skilled workers, is accelerating or is about to accelerate.

Consumer Inflation Is Simmering

Signs of nascent inflation are apparent in consumer prices. Consumer price inflation in both Boston and the United States is slowly creeping upward. In Boston in November, prices were 3.4 percent higher than a year earlier. Although this is a low rate historically, inflation crept up all year. In January of 1999, prices were only 1.7 percent higher than a year earlier.

The same trend is occurring nationally, though more slowly. Year-over-year inflation in the U.S. consumer price index rose from 1.6 percent in January 1999 to 2.7 percent in December 1999. Except for one big "if," inflation of this magnitude would not be a worry. The inflation creep of the last year could simply be attributed to a return to pre-Asian-crisis conditions. Economists attribute the lower level of inflation in 1998 largely to a fall in commodity and import prices associated with the East Asian crisis that began in the summer of 1997. Now that Asia's recovery is under way, commodity and import prices are returning to "normal" levels. The big "if" is oil prices, which have risen dramatically. Home heating oil prices in February were double what they were last year. Worldwide economic growth may keep oil prices high, and the higher cost of this input will percolate throughout the economy.

The Housing Market Is Nearing the Boiling Point

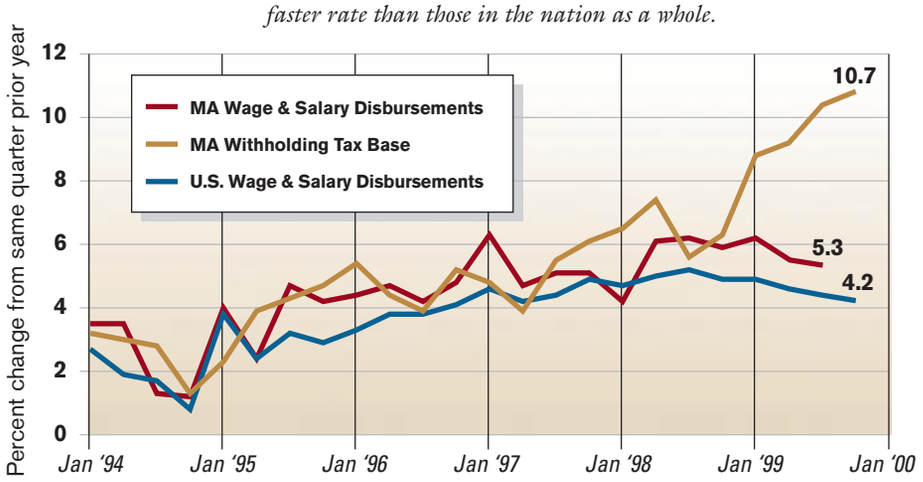
The rate of housing price appreciation has gradually accelerated since the mid-1990s. In the third quarter of 1999, housing prices, as measured by the Fannie Mae/Freddie Mac index (which controls for quality changes, but includes only purchases financed by conventional mortgages), were 11.6 percent higher than a year earlier. This is nearly double the rate of increase nationally. Sales prices for detached single-family homes, as measured by the Massachusetts Association of Realtors (which does not control for quality and could be biased upward by a shift to larger new homes), were 17.9 percent higher in December 1999 than they were a year earlier.

These trends are a cause for concern, because high housing costs discourage in-migration and encourage out-migration of households from the state, exacerbating the labor shortage. Fortunately, perhaps, there is no sign of a bubble mentality emerging in the housing market. Rising mortgage rates are keeping the supply of housing in check.

Housing permits for new construction remain at an annual rate of roughly 1,600, a stable level that has persisted throughout the current expansion. Sales of existing homes have declined moderately from the high levels of 1998. Employment growth in the lumber and furniture and stone, clay, and glass industries, which supply the housing sector, has dipped below their trends of the expansion. Tighter monetary policy will probably buttress this restraint in supply and should restrain demand, though that is not yet apparent in home prices.

Growth in Nominal Wages Per Worker

Wages in Massachusetts continue to grow at a faster rate than those in the nation as a whole.



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

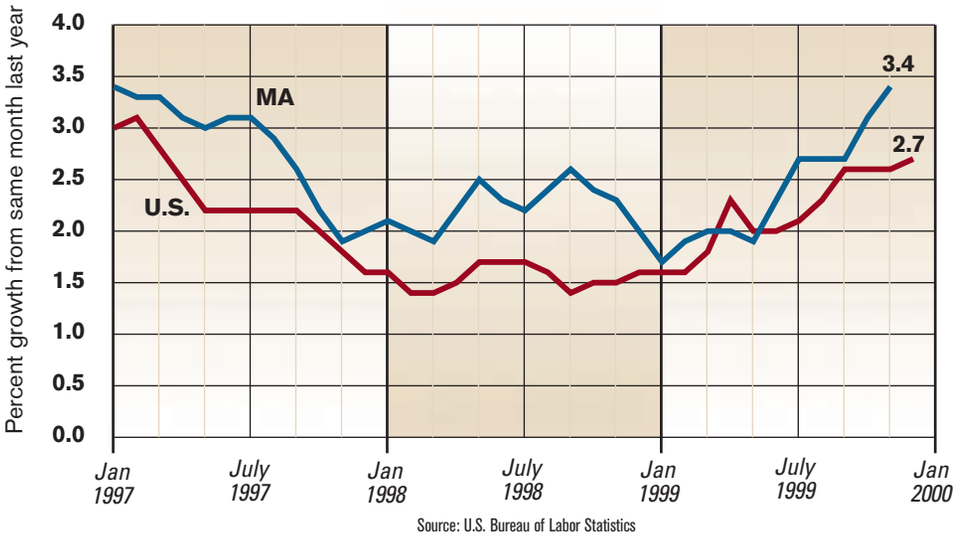
Manufacturing Is Back

The slide in manufacturing resulting from the Asian crisis is over. Exports and output are growing again, and employment has stabilized. After falling by 3.8 percent between February 1998 and February 1999, total manufacturing employment essentially remained constant for the rest of the year. The future for manufacturing is brighter than it has been since the early 1980s.

Approximately 20 percent of manufacturing, in terms of employment, is in the information technology (IT) sector, as defined by the Department of Commerce. This accounts for nearly 40 percent of total employment in the IT

Consumer Price Inflation

The inflation rise of the last year could be attributed to a return to pre-Asian-crisis conditions, but impacts of the higher cost of oil are also affecting the economy.



Source: U.S. Bureau of Labor Statistics

sector. Massachusetts will never be competitive in manufacturing that requires cheap labor, but it does have a comparative advantage in manufacturing that requires new technology, skilled labor, custom production, quick development time, and close integration of design, engineering, and production departments. This type of production characterizes almost the entire remaining manufacturing sector in the state, including traditional sectors, such as textiles and consumer goods. Over half (53 percent) of Massachusetts manufacturing workers are college-educated, versus 45 percent nationally. Thirty-one percent of manufacturing workers in Massachusetts have four-year college degrees, versus 21 percent nationally.[4]

Exports Regain Strength

The turnaround in manufacturing was made possible by a turnaround in merchandise exports.[5] After falling by 8.8 percent between the third quarter of 1997 and the third quarter of 1998, exports from Massachusetts did a U-turn and rose by 10.1 percent to the third quarter of 1999, the most recent quarter of available data. Exports of electrical equipment from Massachusetts were up sharply, by 25.8 percent, in the year ending in the third quarter of 1999; exports of instruments were up by 15.7 percent over the same period. On the other hand, exports in machinery, once our largest export industry, fell 4.7 percent over that period and are down more than 20 percent from their peak in the third quarter of 1997. This mirrors the continuing decline in the office and computing machinery industry in Massachusetts.

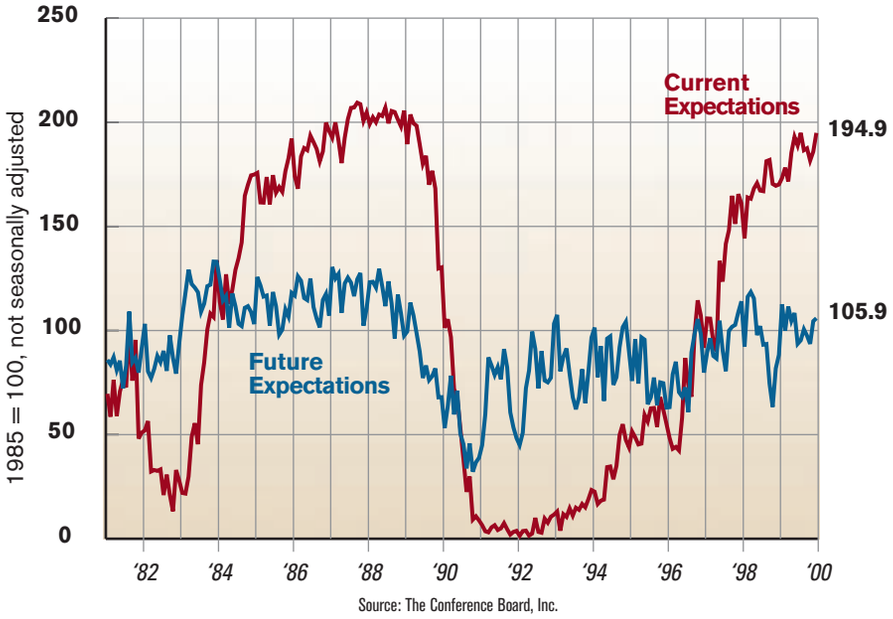
Business with most of our trading partners has improved. Exports to Asia appear to have recovered quite nicely and are close to pre-crisis levels. Exports to Europe are growing very strongly, especially those to the U.K., the Netherlands, and France. The exception is Germany, which is still recovering from the economic adjustments of reunification. In this hemisphere, Mexico is becoming an increasingly important destination. Exports from New England to Mexico are now as large in volume as those to South Korea. Exports to Canada, our largest partner in terms of trade, have been trending in the opposite direction, however, having fallen victim to the relatively strong U.S. dollar. Nevertheless, the overall export picture is bright.

Consumers Continue to Spend Confidently

Consumers continue to support the economy, as they have throughout this expansion. The Conference Board's Consumer Confidence Index for New England reveals levels near those reached during the peak of the 1980s "miracle years." Recently, confidence and the stock markets appear to be linked, as many more households are participating in equities markets via retirement plans or by direct stock purchases.

New England Consumer Confidence

Consumer confidence levels are near those reached during the peak of the "miracle years" of the late 1980s. Confidence is solid if it is above 125 and not falling.



Source: The Conference Board, Inc.

When stock markets fell sharply in response to the Russian collapse and the bailout of the Long Term Capital Management hedge fund, the future-expectations component of confidence followed. When markets recovered briskly later in 1998, so did confidence. The response of confidence to the phenomenal rise in the NASDAQ and Bloomberg Stock Indices in the final quarter of 1999 was subdued. Between mid-October and the end of the year, the Bloomberg Stock Index for Massachusetts rose 45 percent, and the NASDAQ rose 49 percent. (The Dow Jones Industrials rose "only" 15 percent.) Confidence, however, rose just 10 percent in the final two months, and in December 1999 was slightly below May's high. In fact, the future expectations component is lower than it was prior to the brief financial panic in 1998. It appears that households and economists are having the same reaction to the remarkable run-up: one of skepticism, yet self-satisfaction. Confidence remains at near-record levels.

Massachusetts households continue to spend more on autos and other consumer durables, as measured by motor vehicle and other sales taxes. The trend of dollar purchases on motor vehicles, which has grown at 10 percent per year over the course of the expansion, continued unabated in 1999. The noisiness of sales taxes on tangible property makes it difficult to determine short-term trends, but purchases seem to be growing slightly below the very strong national growth in retail sales of over 8 percent in 1999.

A Soft Landing...

The Massachusetts economy is slowing, due to supply constraints. Continuing increases in labor and housing costs, however, are hurting our future competitiveness. Fortunately for us, the labor-supply bottlenecks that have been compounding here for two years are also being felt across the country. The timing and magnitude of Fed policy to control inflation and allow the national expansion to continue should help Massachusetts, too.

...With Two Jolts

The long-term challenge of fostering faster labor-force growth by lowering the cost of living still remains, particularly with the recent spike in home fuel oil heating costs and the crisis for troubled HMOs and financially strapped hospitals. Oil prices are having an immediate impact on the region's pocketbooks and business costs, and the prices of restoring the fiscal health of health insurers and providers will also be borne by consumers and employers.

Finally, the Fed's soft-landing maneuver entails risks of its own. This is especially true on market valuations of IT-sector firms, in which Massachusetts is relatively concentrated. We might find out how sensitive growth in IT is to stock market valuations. With luck, this question will remain unanswered.

Submitted February 9, 2000

1 Yet another possibility is that more self-employed workers are becoming employees than vice versa.

2 Employment in child care services has grown 8 percent per annum for several years.

3 According to the Current Population Survey, the unemployment rate for persons over 30 with less than a high school education was 2.7 percent in March 1999. See *Massachusetts Benchmarks,* Vol. 3, Issue 1, Winter 1999/2000, p. 9.

4 Author's tabulations of the March Current Population Survey. In order to get a reliable sample size, five years (1995–99) were used.

5 Merchandise export data in current dollars for the United States, New England, and the New England states are available from MISER via the Federal Reserve Bank of Boston. Data are available for total merchandise exports and for selected industries and countries of destination. Only very limited industry and country-of-destination details are available for Massachusetts, so some of the analysis in this section is based on data for New England. The data are seasonally adjusted by the author.

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