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Economic Currents: The State of the State Economy

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Economic currents

The State of the State Economy

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Even as we are experiencing the full effect of the Asian crises that began in the summer of 1997, the United States and Massachusetts economies are displaying a surprising robustness.

We shuddered last August at the collapse of the Russian economy and the near collapse of the Long-Term Capital Management hedge fund. These events, along with plummeting domestic stock markets, tightening credit availability, and falling consumer and business confidence indicators, led to a near-term economic outlook that was characterized by significant downside risk. For some time, we held our collective breath, but our fears have failed to materialize. Instead, the national and state economies continue to grow with low unemployment and inflation, while realizing record levels in several stock indexes. Brazil's more recent devaluation should have little direct impact on Massachusetts, given the Commonwealth's limited trade with that and other Latin American countries.

The immediate threat of recession may be past, as our economy appears to have bounced back from its late-summer decline (see economic indexes, page 5). Still, risks remain. Manufacturing exporters will continue to suffer from lower foreign demand, and manufacturers supplying domestic markets will face stiff competition from foreign producers into the near future, at best. On the supply side, employment growth is now effectively constrained by low population and labor-force growth.

The Resilient Economy

The economy's strong performance in the face of the world economic crisis is evident in numerous aggregate indicators. Massachusetts employment in December was 1.8 percent higher than it was a year earlier; for the corresponding period, U.S. employment grew by 2.3 percent. The state ended 1998 with an unemployment rate of 3.1 percent and the nation, 4.3 percent. Consumer prices grew 2.3 percent in the Boston area in the year ending in November 1998 and 1.6 percent in the United States as a whole. The sum of the unemployment and inflation rates, commonly known as the Misery Index, is currently near the all-time low for both the state and the nation.

The Current and Leading Economic Indexes for Massachusetts

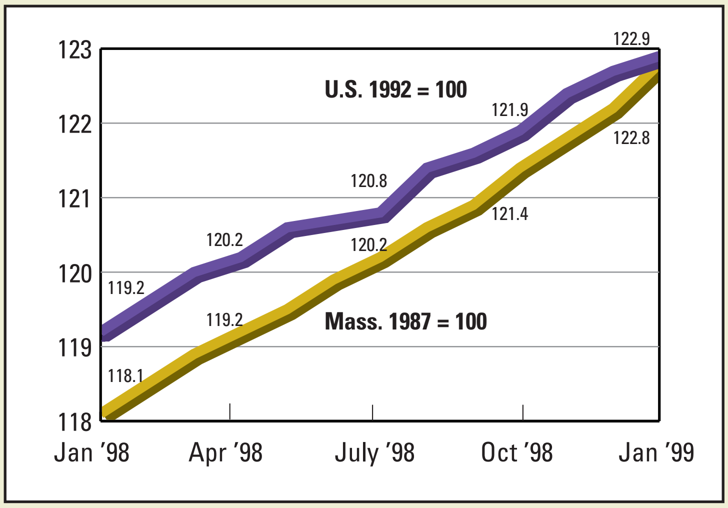
The Massachusetts Current Economic Index for January was 122.8, up 5.8 percent from December (at annual rates) and up 4 percent from January of last year. The current index is normalized to 100 in July 1987 and calibrated to grow at the same rate as the Massachusetts gross state product (GSP) over the 1978–1996 period. (GSP is not yet available beyond 1996.)*

The leading index is a forecast of the growth in the current index over the next six months, expressed at an annual rate. The January index indicates that the economy is expected to grow at an annual rate of 4.4 percent over the next six months. Because of monthly fluctuations in the data on which the index is based, the three-month average (November through January) of 3.9 percent may be a more reliable indicator of near-term growth.

The outlook is much improved since August, when the collapse of the Russian economy, the bailout of the Long-Term Capital Management hedge fund, and the precipitous drops in domestic stock markets occurred.

Current Economic Index
United States and Massachusetts

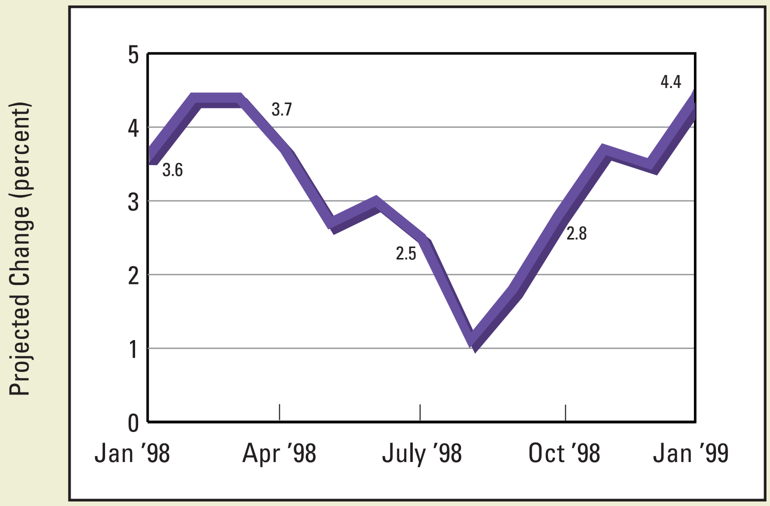
The trends rather than the levels of these indexes should be compared, due to different formulations and base points.



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. It suggests that the economic outlook has improved in recent months.



Sources: University of Massachusetts; Federal Reserve Bank of Boston

**Since the last issue of* Benchmarks, *both the current and the leading indexes have been rescaled. Though the qualitative indications of the indexes have not changed, they are not directly comparable to previously reported values. For more information about the leading index, see Endnotes on page 20.*

Misery Index

This index tracks the combined inflation and unemployment rates for Massachusetts and the United States. It is currently running near an all-time low.

Sources: Bureau of Labor Statistics; Massachusetts Division of Employment and Training; author's calculations

higher productivity growth trend. Another factor is low interest rates, supported in part by the world financial crisis itself, as investors worldwide have reallocated portfolios in favor of U.S. stocks and securities. These lower rates act to reduce debt burdens and borrowing costs for households and businesses.

Perhaps the most powerful underlying factor is demographics. The post–World War II baby boom generation is now in its most productive years. Moreover, this generation is better educated than are its predecessors. The education-age profile peaks for people in their late forties. Nationally, nearly 30 percent of people in this age group have a bachelor's degree or higher; in Massachusetts, close to 40 percent of this group have college degrees.

This double boost to productivity may be an important contributor to the economic good fortune of the 1990s. High productivity leads to high incomes, which in turn lead to high levels of consumption. These factors have kept the U.S. economy afloat in spite of the world's troubles. U.S. workers have been producing like ants and consuming like locusts. High incomes and spending also generate high tax revenues and, through budget surpluses, lower inter-

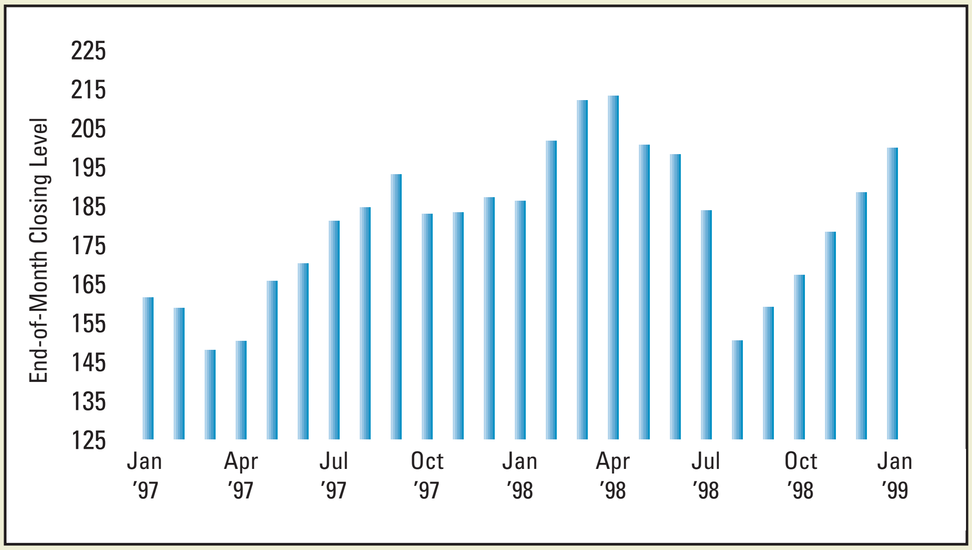
The U.S. stock market performed well and ended the year strong. The Dow–Jones average ended 1998 up 20 percent from a low point on October 1, while the Bloomberg Stock Index for Massachusetts[1] was up 39 percent from its low point on October 8.

Consumers played a major role in buttressing the economy. Nationwide, real consumer spending in 1998 was 3.4 percent higher than in 1997. In Massachusetts, the sales tax base, a retail spending proxy weighted toward durable spending, grew 5.4 percent over the same period.[2] This consumption binge was supported by strong earnings and income growth: Massachusetts real earnings in 1998 were 6.9 percent higher than in 1997.[3] Housing markets in the state achieved record sales, as housing prices appreciated 5.5 percent in Massachusetts and 5 percent in the United States for the year ending in September.

What accounts for this resilience? One explanation, according to the "new economy" thesis, is that the nation is on a technologically based,

Bloomberg Stock Index for Massachusetts

The index hit a low point on October 8 (not shown).
By the end of October, the index had recovered strongly.



Sources: Bloomberg L.P.; author's calculations

est rates and more funds for private investment. Higher productivity and investment boost corporate profits. These higher profits lead to increased asset valuations, capital gains, and more household wealth, which result in more tax revenues and more consumption, and so on—the "virtuous" cycle.

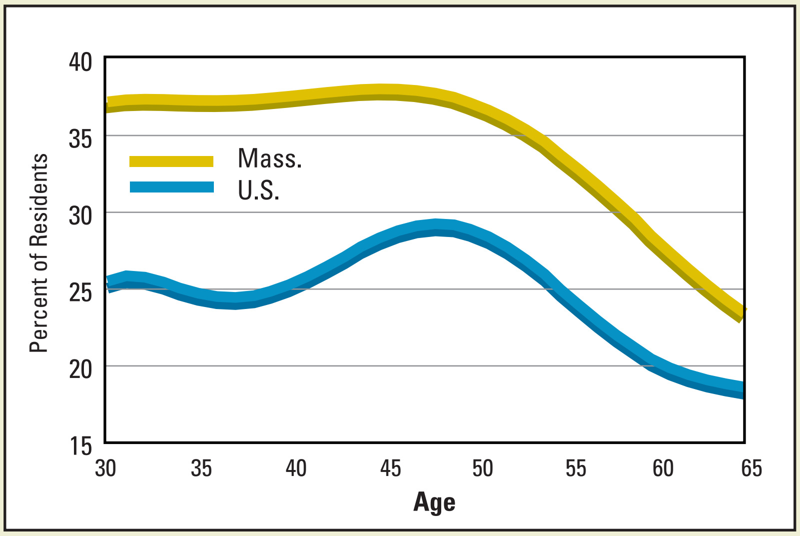
Countervailing Factors Are Leading to Slower Growth

Two countervailing factors are contributing to the slowdown of the economy's growth: the worldwide economic crisis, through its effects on manufacturing and corporate profits; and labor shortages, which are constraining employment and output growth. So far, Massachusetts has been harder hit by these factors than has the nation as a whole. For 1996 through the first half of 1998, employment growth in both Massachusetts and the United States averaged 2.5 percent. In the second half of 1998, employment growth slowed to just over 2 percent for the nation and just under 1 percent for Massachusetts.

Rising imports and falling exports caused the U.S. trade deficit to increase by 50 percent in 1998 over 1997.[4] U.S. and Massachusetts manufacturers were hard hit. In the Commonwealth, manufacturing employment declined steadily for most of 1998, with employment ending the year at 1.9 percent below the prior year. The state's key export sectors—industrial machinery (which includes computers), electrical machinery and components (which includes semiconductor equipment), and instruments—all had significant employment declines throughout most of 1998. Manufacturers faced problems not only from losses in export sales but also in competition from cheap imports.

Percent of Residents with BS/BA Degree or More, by Age, 1998

Residents currently in their late forties hold the highest percentage of college degrees. Their higher employment levels and incomes boost both production and consumption aspects of the economy.



Source: U.S. Census Bureau; author's calculations

Only a handful of the Commonwealth's manufacturing sectors avoided employment declines in 1998. These included furniture, transportation equipment (aircraft and automotive suppliers), printing and publishing, plastics, and chemicals. With the exception of aircraft, these industries serve almost exclusively domestic customers.

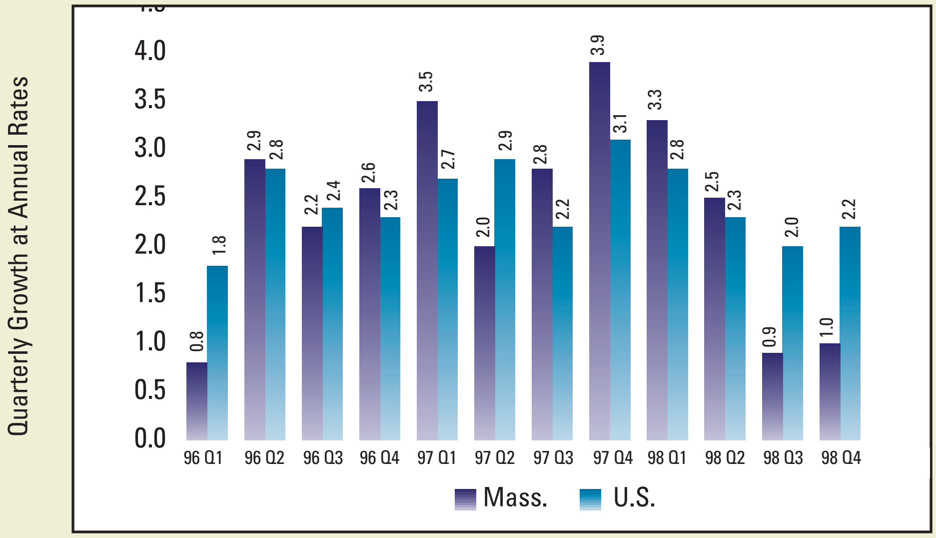
The problems manufacturers are facing are not unique to Massachusetts. The same patterns are occurring nationwide, although the declines have been proportionately less. And the slowdown is not limited to manufacturing. Since different sectors grow at different rates, it makes sense to compare recent performance with average annual growth rates during the expansion that began in mid-1991. Construction employment, bolstered by strong residential and commercial markets, continued to grow at about its 1990s expansion-average annual rate.

Excluding manufacturing and construction (as well as agriculture and fishing, which are not counted in the establishment employment survey), the service-producing sector is growing at about one percentage point below its expansion average. Employment in 1998 actually declined in communications, electric utilities, and insurance—three sectors affected by mergers and restructuring. Employment growth remains positive, but below trend, in trade, transportation, and business services. Although some of the slowdown in business service growth may be due to demand-related cutbacks in manufacturing, the primary reason for slower growth in these sectors is simply that the pool of available workers is nearly empty. The job market is particularly tight for scientists, engineers, and "information technology" workers (those with computer-related skills). In many low-wage sectors, from restaurants to nursing homes, employers are having trouble maintaining staff levels, because their workers are upgrading to better jobs elsewhere.

A few sectors have managed to grow at or above their expansion-average rates. In the state's financial sector, money management and mutual fund firms have continued to increase employment at the expansion-average (7 to 8 percent) rate, and banks, which had shed employment for years, are now hiring at a robust pace. Hospitals have also reversed direction and are increasing employment again. Despite the labor shortage, engineering and

Employment Growth, Massachusetts vs. United States

In the second half of 1998, the combination of labor shortages and worldwide economic events slowed the Massachusetts economy more dramatically than it did the U.S. economy.



Source: Bureau of Labor Statistics

consulting firms continue to add workers at rates above the expansion average.

Slow Growth Ahead, with Some Positive Signs for Manufacturing

There are some hopeful signs for manufacturing. Nationally, the fall in exports seems to have abated, in line with reports of stabilizing conditions in some East Asian countries. There is promise in the latest national data on shipments, orders, and inventories for the last half of 1998 in some key export industries. In computers, inventories fell rapidly as new orders rose, setting the stage for expanded production in the near future. Shipments, new orders, and unfilled orders in electronic equipment and components were all rising, as inventories declined moderately.

AIM's Business Confidence Index (including the portion for manufacturers) and BankBoston's Instant Reading Index—weighted heavily toward Massachusetts manufacturers—were both measuring levels above 50 in late 1998, consistent with expectations of better times ahead. Additionally, the Federal Reserve's *Beige Book* report of January 20 reveals that while half of New England manufacturing contacts reported level or declining business from the prior year, half reported expanding sales. The decline in manufacturing output, if not employment, may soon be over.

Although there is some upside risk that tight labor markets and strong consumer demand will rekindle inflation, more risk still remains on the downside. Consumer confidence, though still high by historical standards, remains below its peak levels of early 1998, especially with regard to future expectations. There is also a well-publicized concern among experts that slower corporate profit growth and cash flow will lower both investment and stock market valuations. Through the wealth effect, stock market losses would negatively impact consumer spending. Finally, we do not yet know how severely Brazil's devaluation and impending recession will affect world financial markets and aggregate demand.

The expected outlook is for continued slow growth in the near term. This results from a protracted softness in exports, preventing an employment rebound in the affected manufacturing sectors, and a general labor shortage restraining employment growth in most of the rest of the economy. With population and labor force expanding at an annual rate of approximately .5 percent, Massachusetts will do well to maintain the 1 percent per annum rate of employment growth maintained during the last half of 1998. Adding real productivity growth of roughly 1.5 percent, the state's economy can expand at 2 percent to 2.5 percent this year.

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Endnotes

1. The Bloomberg Stock Index for Massachusetts is a price-weighted average of stock issues of companies that are either headquartered in the state or doing substantial business in the state. As of September 1998, 338 companies were included in the index.

2. Figures are based on sales tax receipts converted to a real sales tax base. Sales tax receipts include business purchases of taxable items not directly related to production, and exclude purchases of automobiles and boats.

3. Figures are based on withholding tax receipts converted to a real wage and salary tax base.

4. Increases in seasonally adjusted exports in the September–November 1998 period over prior months are suspected to be statistical flukes due to a change in underlying seasonal patterns.