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Economic Currents: The State of the State Economy

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Economic currents

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Between June 1999 and July 2000, the Federal Reserve raised the federal funds rate six times, for a total increase of 175 basis points. For this and other reasons, the national — and state — economies appear to be growing at a slower rate.

The changing economic situation in Massachusetts is not unlike the economic situation nationally: some indicators are consistent with a slowdown, while others indicate continued strong growth. One important difference between Massachusetts and the nation is the mounting evidence that inflation is taking hold here. If this continues, the economic "landing" in the state may be comparatively rougher or take longer.

So far, deceleration in the pace of activity in Massachusetts has been minimal. As proxied by the Massachusetts Current Economic Index, the real gross state product grew at an annual rate of 3.8 percent in the second quarter of 2000, down from 4.3 percent in the first quarter and 3.9 percent in the fourth quarter of 1999. The corresponding figures for U.S. real GDP growth are 5.2 percent in the second quarter of 2000, 4.8 percent in the first quarter, and 8.3 percent in the fourth quarter of 1999.

The Massachusetts Leading Economic Index, however, is projecting slower growth ahead. The index for June suggests that growth over the second half of this year will slow to a 2.5 percent annualized rate. This is the lowest the leading index has been since the financial scare in the fall of 1998, following the collapse of the Russian ruble.

The Current and Leading Economic Indices for Massachusetts

The Massachusetts Current Economic Index for July was 128, barely up from June 2000 (at annual rates), and up 3.6 percent from July 1999. 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 July was 1.4 percent, and the three-month average for May through July was 2.3 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 1.4 percent over the next six months. Because of monthly fluctuations in the data on which the index is based, the three-month average of 2.3 percent may be a more reliable indicator of near-term growth.

The indicators that constitute the leading index were evenly split, with four of the ten supporting faster-than-trend growth, four supporting slower-than-trend growth, and two consistent with a 2.6 percent trend rate of growth. This is an indication that overall growth is beginning to level off.

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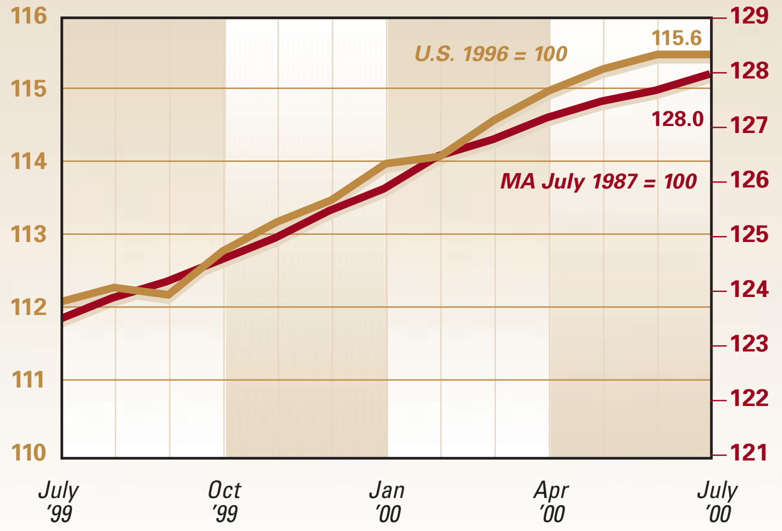
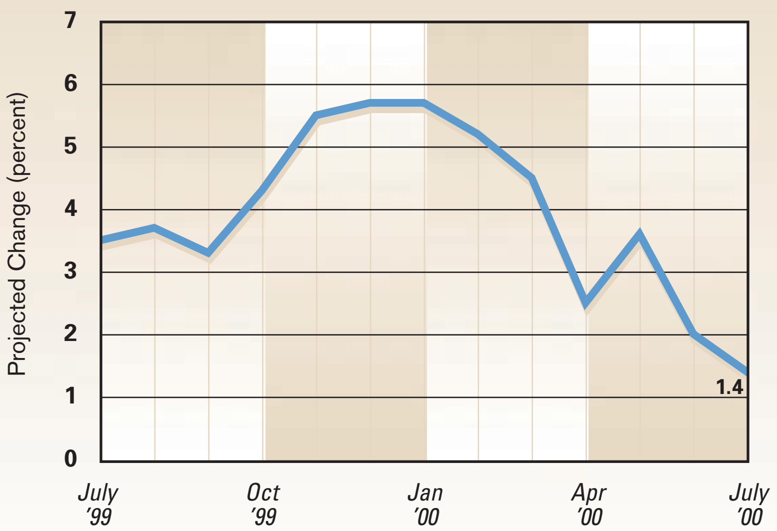
Current Economic Index United States and Massachusetts

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

Fast- and Slow-Growth Indicators Are Evenly Split

The indicators that constitute the leading index were evenly split, with four of the ten supporting faster-than-trend growth, four supporting slower-than-trend growth, and two consistent with a 2.6 percent trend rate of growth. The four positive indicators were consumer purchases as proxied by state sales taxes, the unemployment rate, the Bloomberg Stock Index for Massachusetts, and construction employment. The four negative indicators were consumer confidence, the interest rate spread between 10-year and three-month Treasury securities, initial unemployment claims, and automobile purchases, as measured by motor vehicle sales taxes. Total nonagricultural employment, and withholding taxes — a measure of aggregate wages and salaries — grew at the long-run trend rate.

One characteristic of the Benchmarks indices is that, in being composites of several indicators, they often give a clearer signal of trends than do the individual indicators that constitute them. For example, though motor vehicle sales taxes enters negatively in June, one cannot be certain—at least yet—that automobile purchases slowed below their trend rate of growth. Therefore, in the discussion below that addresses whether a soft landing is under way, the evidence for and against a slowdown versus continued strong growth does not neatly correspond to the positive and negative indictors of the leading index. This discussion will follow a brief theoretical summary of what we might expect will happen if the Fed policy works as planned.

Massachusetts Should Slow with the Nation

The Fed's attempt at a soft landing should slow the Massachusetts economy for the same reasons it is expected to slow the national economy. Higher interest rates should slow all activity that relies on credit, including housing, investment, and consumer spending. The policy is also supposed to restrain consumption through the wealth effect, by its impact on stock prices.

We should look for declines in housing permits and construction employment, a reduction in the rate of growth of shipments, orders, and employment in investment-supplying sectors, and a slowdown in the growth of consumer spending. These will give evidence that monetary tightening is working to bring the pace of expansion in demand in line with the growth of potential supply. As these direct impacts work themselves through the economy, overall employment growth should slow, labor shortages should ease, and unemployment rates should rise moderately.

There are good reasons to expect that policy impacts in Massachusetts will be in keeping with those in the nation with respect to timing, as well as direction. States today are tightly interconnected through trade and national markets, so economic shocks, such as those arising directly or indirectly from Fed policy, spread quickly throughout the country.[1]

The magnitudes of the policy impacts may differ somewhat from state to state, however. For example, Massachusetts has a relatively high concentration of suppliers of high tech and IT investment goods and services. So, to the extent that this investment sector has not yet slowed in response to higher interest rates, Massachusetts has been less affected by Fed policy than has the nation on this score. Since Massachusetts residents have larger stock portfolios on average, any downward movement of the stock market should result in proportionately larger consumption declines attributed to the wealth effect.

Finally, there are other economic shocks affecting the country that may impact Massachusetts more or less intensely than other states. Foremost among these is the rising price of oil. Higher fuel prices act just like a higher sales tax that is received, primarily, by foreign oil producers, leaving less income or profit to spend on everything else. New England's relatively high reliance on home heating fuel implies a disproportionately larger drag on non-oil spending than we find in other parts of the nation.

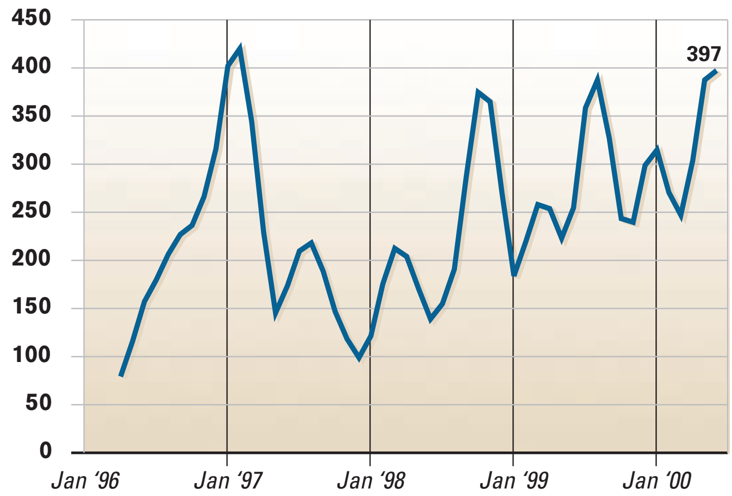
Single Family Housing Permits, MA

Number per month

Source: Census Bureau; seasonally adjusted by author

Multi Family Housing Permits, MA

Number per month



Source: Census Bureau; seasonally adjusted and smoothed by author

So Far, Few Signs of Slowing…

The only sector that shows a clear trend toward slowing that is consistent with monetary tightening is construction of single-family homes. The number of single-family housing permits in Massachusetts in the 12-month period ending in June was 8.8 percent below the number for the prior 12-month period. In a related manufacturing sector, employment in lumber and furniture was down 3.2 percent from June 1999. This manufacturing sector had been one of the better performers in the state over the current expansion, with an annual average employment growth of 1.3 percent.

Interestingly, multi-family permits are exhibiting a rising trend, which may reflect a longer product development and permitting cycle—and high rental rates.

… but Also, Few Signs of Continued Strong Growth

While there is limited evidence solidly supporting a slowdown in the Massachusetts economy, there is also little evidence that supports continued strong growth. Such growth seems to be limited to certain types of construction and some manufacturing sectors supplying investment demand.

The declines in single-family home construction are being more than offset by heavy construction (road projects, commercial office buildings) and public projects (school buildings, which reflect swollen K-12 school enrollments). Because of this, construction employment in the state continued near its expansion-average pace. In the second quarter, construction jobs grew at an annualized rate of 5.4 percent, and June's employment was 6.0 percent above that of June 1999. The effects of the baby boom echo are also apparent in the continued growth in child-care services, a component of social services. The number of social services jobs grew by 3.8 percent from June 1999 to June 2000.

Through the second quarter, investment spending, as measured by real equipment and software investment in the GDP accounts, continued to grow robustly. It expanded by over 20 percent at annual rates in the first half of the year. Growth was especially strong in IT-related sectors. As an example, consider the electronics and electrical equipment industry, which happens to be the largest manufacturing 2-digit sector in the state in terms of employment. At the national level in the second quarter (there are no timely state-level data available) shipments grew at an annual rate of 22.3 percent, new orders at 29.8 percent, and unfilled orders at 49.6 percent. (Inventories grew at an annual rate of 9.2 percent.) Nationally, employment in the industry grew at 3.0 percent in the first quarter, and in June was 1.9 percent higher than in June 1999.

Massachusetts is receiving its share of the national market. State employment in this industry grew by 3.8 percent in the first quarter, and in June was 2.5 percent higher than in the prior year. The strength of this industry is also apparent in exports. The nominal dollar value of Massachusetts merchandise exports in electrical equipment grew at an annualized rate of 98.5 percent in the first quarter (seasonally adjusted), and was 30.7 percent higher than the first quarter of the prior year.

Unfilled Orders, Electronic and Other Electrical Equipment, U.S.

Recent growth has been especially strong in this IT-related sector, reflecting technology investment.

Source: The Conference Board

While employment growth in other Massachusetts manufacturing sectors was mixed over the 12-month period ending in June (fabricated metals and machinery were growing, for example, while instruments, textiles, and plastics were declining), overall manufacturing employment essentially remained level. Given rapid productivity growth in manufacturing, this represents strong output expansion.

Business confidence, as measured by the Associated Industries of Massachusetts, is high. Both its overall index and its sub-index assess conditions in Massachusetts at record quarterly averages in the three months ending in June. The Federal Reserve Bank's *Beige Book* for Boston (June 14 edition)—an informal survey of the region's employers, focusing on retail trade, manufacturing and related services, software and IT services, temporary employment firms, and commercial real estate contracts—reports, on the whole, strong current and expected sales and activity.

Many Signs Are Difficult to Read

Other indicators are not giving a clear indication of either slowing or continued strong growth. Labor markets are still tight, as evidenced by historically low unemployment rates, low initial unemployment claims, low vacancy rates for commercial office space, and many anecdotes of labor shortages. The Fed's *Beige Book* for Boston concluded that economic activity was still at a high level, with tight labor markets.

With such low unemployment rates (2.6 percent in June), and slow population and labor force growth (0.4 percent in the 12 months ending in June), employment growth is constrained, and so is not a reliable gauge for growth in labor demand. Does a drop in employment growth represent tightening labor supply constraints, or a diminished expansion in demand? One way to answer this question is to look at vacancy rates and real-wage rate

growth. Higher vacancy rates and higher wage inflation would signal increasing demand, while lower vacancy rates and lower wage inflation would signal decreasing demand. Unfortunately, we do not have data on vacancy rates or good data on wage rates; the wage rate measures we do have are not in agreement with one another.

At first glance, this discussion appears to be irrelevant, because total nonagricultural employment growth accelerated to 2.3 percent in the second quarter and grew by 1.8 percent in the 12 months ending in June. However, without the effect of temporary Census workers, employment growth in the second quarter was only 1.5 percent. Employment growth in most sectors was below expansion-average rates. Wholesale and retail trade; electric and gas utilities; banking and non-banking services (the latter include money management firms like Fidelity and Putnam); and business, health, and engineering and management services all grew more slowly than in the past several years. In most cases, the slower pace appears to be due to labor shortages, but there has also been restructuring in utilities, commercial banking, and health services.

Employment Growth in Massachusetts, Selected Industries

The expansion began in June 1991, the trough of the Current Economic Index.

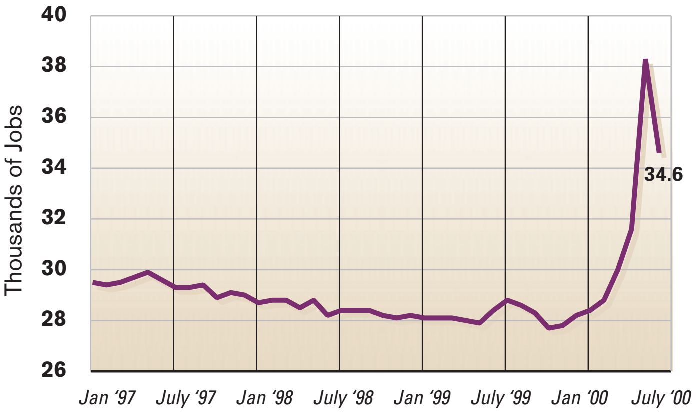
	Annualized Rates of Growth		
	Second Quarter 2000	June 1999 to June 2000	Expansion Average
Total Payroll Employment	2.3	1.8	2.1
Excluding Decennial Census	1.5	1.7	2.1
Construction	5.4	6.0	6.7
Manufacturing	0.4	0.0	-0.8
Lumber and Furniture	-5.1	-3.2	1.3
Industrial Machinery and Equipment	2.2	1.2	-0.7
Electronics and Electrical Equipment	3.8	2.5	0.5
Instruments	-2.6	-0.6	-2.2
Misc. Plastic Products	-0.1	-1.0	2.3
Transportation & Utilities	1.2	0.6	1.8
Electric, Gas, and Sanitary Services	-5.3	-5.5	-4.5
Wholesale Trade	-0.3	1.2	2.0
Retail Trade	0.3	0.9	2.0
Finance, Insurance, and Real Estate	-0.3	1.0	1.8
Depository Financial Institutions	-4.8	-1.1	0.9
Nondepository Financial Institutions	6.5	4.8	8.0
Services	2.4	2.7	3.6
Business Services	6.0	6.3	8.2
Health Services	-1.9	-0.5	0.8
Engineering and Management	0.5	2.5	4.5
Local Public Education	0.7	2.1	3.4

Sources: Massachusetts Division of Employment and Training, some series seasonally adjusted by author. Author's estimates of Census employment.

Indicators of consumption, which accounts for two-thirds of aggregate spending in the economy, are not giving a clear signal. Consumer confidence, as measured by the Conference Board's Index for New England, remains near record levels, but was at about the same level in June as a year earlier. The tax-based indicators of consumer spending for Massachusetts are mixed and are difficult to interpret because of volatility. Both general sales taxes and motor vehicle sales taxes indicated strong growth over the 12 months ending in June, but recently the two measures were at odds with each other. Sales taxes were very strong in the second quarter, while motor vehicle taxes declined. In contrast to Massachusetts sales taxes, national retail spending in the second quarter was weak, and actually declined in real terms.

Federal Government Employment in Massachusetts, Excluding U.S. Postal Service

The spike in employment reflects hiring of temporary Census workers.



Source: Massachusetts Division of Employment and Training; seasonally adjusted by author

Stock markets, important because of their effects on consumer spending through wealth, continue to be volatile. The Bloomberg Stock Index for Massachusetts gained 37.6 percent between its April 14 low and July 17, then fell by 10.3 percent (as of August 8).

Inflation in Danger of Becoming Entrenched

While inflation does not yet appear to be a problem nationally, there is a real danger it is beginning to take hold in Massachusetts.

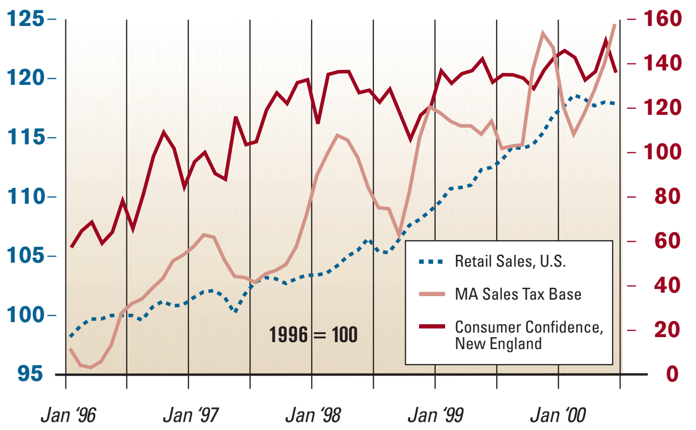
The Boston CPI for May is up 4.2 percent over a year earlier. Though this year-over-year increase is down from March's 4.5 percent, the drop represents a moderation of fuel price increases only. The core rate of inflation, as measured by all items less food and energy, is actually up from 3.5 percent in March to 3.6 percent in May. In comparison, the U.S. CPI was up 3.1 percent in May from a year earlier, with a core rate of 2.3 percent. In May versus a year earlier, housing costs in the Boston metro area were up 5.7

percent, rents were up 6.6 percent, services were up 4.4 percent, and medical care was up 5.5 percent. The medical care figure measures consumers' out-of-pocket expenses. The portion of medical costs borne by businesses is also rising, as reported in the *Beige Book.*

Information on wage rate inflation in Massachusetts from different sources continues to conflict. All sources agree that wage rate inflation is higher here than nationally but disagree widely by how much. Two measures for Massachusetts and one for the nation all are defined to be estimates of total wages and salaries divided by payroll employment. Wage rate growth is measured as the percentage change from the same quarter in the previous year. The U.S. estimate is 4.4 percent in the second quarter. One estimate for Massachusetts is based on wages and salaries from the U.S. BEA, and

Consumer Confidence and Spending

Retail sales indices are measured on the left axis; confidence is measured on the right.



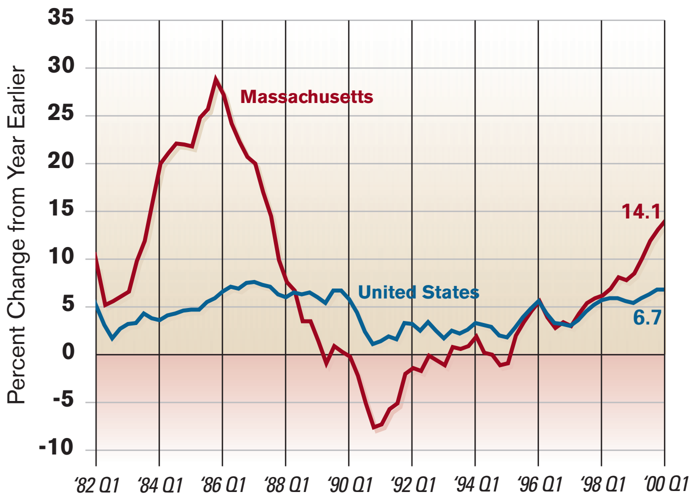
Sources: The Conference Board; U.S. Census Bureau; U.S. Department of Revenue; author's calculations. Retail sales indices are deflated by the U.S. CPI.

gives a wage rate inflation of 6.0 percent in the first quarter (data are not available yet for the second quarter). A second estimate for Massachusetts, based on withholding taxes, is 11.2 percent in the second quarter.

The *Beige Book* for Boston reported increases of 3 to 5 percent in retail, 20 to 30 percent in tourism (for seasonal workers), 2 to 10 percent in manufacturing, 6 to 10 percent in software, and 5 to 10 percent for contract workers. For the latter three, higher ends of the ranges were for workers with high-demand technical skills.

Housing price appreciation continues to accelerate, and the gap between average housing prices in Massachusetts and those in the nation continues to widen. In the year ending in March, the Fannie Mae index of repeat house sales for existing homes was up 14.1 percent for Massachusetts, versus 6.7 percent nationally. Real estate values are rising briskly throughout the state. Even Springfield is appreciating faster than the national average, while in Lawrence, the 14.8 percent appreciation nearly matches the Boston rate of 15.0 percent.

Change in Housing Prices, 1982–2000



Sources: Freddie Mac and Fannie Mae

Higher Inflation Means a Harder Landing – or a Longer One

If consumer prices, wage rates, and housing prices continue to rise in Massachusetts at a faster pace than in the nation, then the state's cost structure will get out of line with the rest of the country. Growth will ultimately slow, as it becomes more profitable for businesses to expand or locate elsewhere. Workers will follow these jobs by leaving the state, setting the stage for future labor and skill shortages in the next expansion.

If the expansion continues for another two or three years without some convergence in state and national costs, painful adjustments will occur. Restoring the state's cost structure will require either a reduction in wage rates, housing prices, and office rents, or a period of stagnation or slow growth while costs in the rest of the country catch up. In either case, the landing will be somewhat rocky.

For this reason, the leading index projection that growth is expected to slow in the second half of the year is welcome news. If all goes well, inflationary pressures will be reduced, as the expansion continues at a sustainable pace.

Submitted August 9, 2000

1. One measure confirming this is the declining interstate standard deviation of job growth over the last 25 years. See "The Regional Economy," *Regional Financial Review*, Regional Financial Associates, January 2000, pp. 15–21. Another recent study supporting the coincidence of economic growth among the New England states, New York, and the U.S. economies is by Carson Tsao, "Regional Coincident Economic Indexes: an Investigation of the New England States' 'State of the Economy'" (Ph.D. dissertation, University of Massachusetts Boston, 1999).

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