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Economic Currents: The State of the State Economy

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economic CURRENTS



Illustration by Naomi Shea

ALAN CLAYTON-MATTHEWS

Statewide numbers paint a picture of declining employment and output, continuing widespread layoffs, slow wage and income growth, rapidly declining consumer confidence, weak consumer spending, stagnant tax revenues, high vacancy rates in the commercial real estate market, and no clear sign of growth in demand for the state's technology products.

The Massachusetts economy seems to be trapped in recession. Nearly all of the indicators are headed downward. The state's economy is still weaker than the nation's, but the U.S. recovery is losing traction, and the risk of a national double-digit recession is rising.

The state appears to be in for more of the same in the near future. The Massachusetts Leading Economic Index, which forecasts six months ahead (to July), is projecting gross state product to continue contracting at a 1 percent annualized rate. The war in Iraq, the Commonwealth's budget crisis, impending state and municipal layoffs, and the prospect of a fourth year of the bear market in stocks are weighing the economy down.

Economic Indices for Massachusetts

The Massachusetts Current Economic Index for January was 125.9, down 1.6 percent from December (at annual rates), and down 0.5 percent from January of last year. The current index is normalized to 100 in July 1987 and is calibrated to grow at the same rate as Massachusetts real gross state product over the 1978–1997 period.

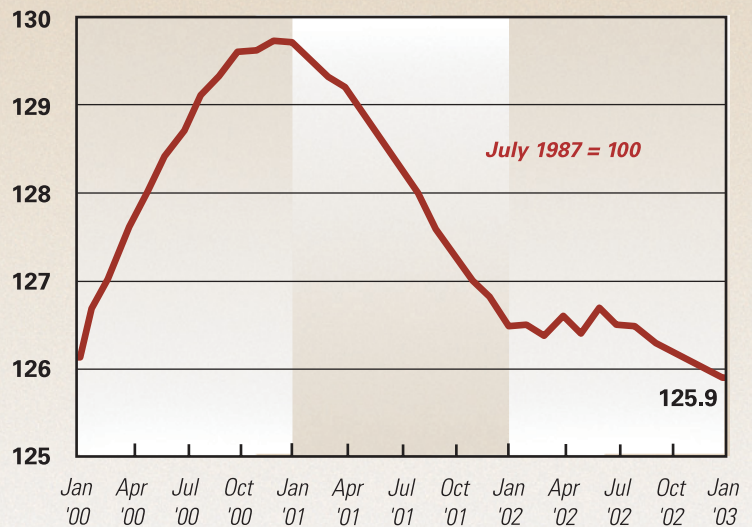
The Massachusetts Leading Economic Index for January was –1.0 percent (negative 1.0 percent), and the three-month average for November through January was –0.9 percent (negative 0.9 percent). The leading index is a forecast of the growth in the current index over the next six months, expressed at an annual rate. Thus, it indicates that the economy is expected to contract at an annualized rate of 1.0 percent over the next six months (through July). These indices incorporate the payroll employment revisions and switch to the new NAICS industrial coding system.

There were substantial employment revisions from July 2001 onward, resulting in a downward adjustment of the December 2002 job count by 38,600. The resultant revisions in the Current Economic Index show a steeper decline in the second half of 2001 than previously. They also show a brief respite in the state's recession in the second quarter of 2002, when the index grew at an annualized rate of 0.3 percent. Growth again turned negative, declining at a 1.0 percent rate in the fourth quarter.

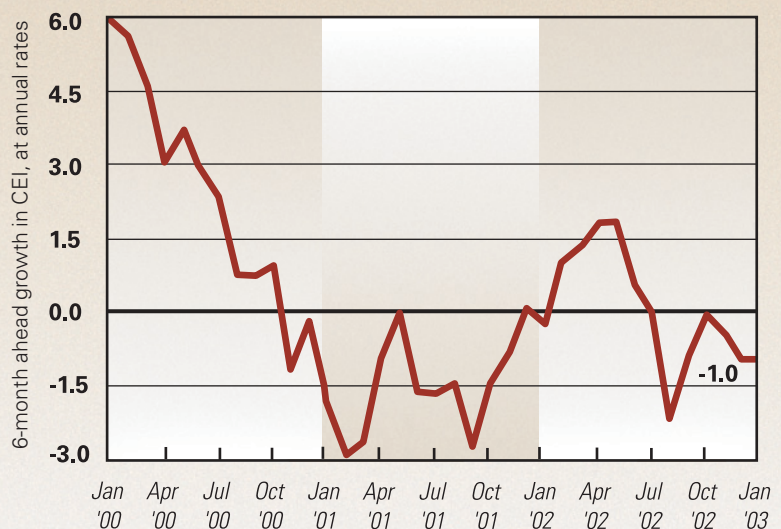
The state economy continues to contract, and the nation's economic growth appears to be slowing. Job losses and the veil of uncertainty from the Iraq war continue to delay the recovery in national business spending and to batter consumer confidence across the country. Wages and consumer spending in Massachusetts are stagnant or declining. Furthermore, there is no guarantee that a quick and successful outcome to the war in Iraq would bring an end to the nation's economic malaise. Whether or not demand will return after the war, and how much excess capacity, if any, still remains in the state's manufacturing sector, is unknown at this time.

SUBMITTED MARCH 25, 2003

Massachusetts Current Economic Index



Massachusetts Leading Economic Index



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

Job Losses Continue

The state's economy is continuing to shed jobs throughout most sectors. Adding jobs are sectors related to housing and mortgage refinancing, including finance, real estate, and retail sales of home building materials. Also expanding are hospitals and primary and secondary education, which are driven by demographics and therefore largely uninfluenced by the business cycle. The number of service jobs in buildings and dwellings has been rising, almost certainly because of increased security measures. Personal and laundry service employment continues to grow, perhaps because of increased home ownership and cheap immigrant labor. Scientific research and development service jobs are also more plentiful. In this list of expanding sectors, this is the only one (with perhaps some hospital employment in medical research) that is related to the export base of the economy. Most likely, the growth has been in life sciences jobs in biotechnology, pharmaceuticals, and medical research.

All other sectors of the economy continue to shed jobs, including manufacturing, business services, construction, retail and wholesale trade, transportation and communications services, finance, engineering and management services, and government. Since the peak payroll employment in January 2001, the state has lost 157,000 jobs, 4.7 percent of peak employment. This is quite substantial, though much less than the very severe recession that ended the 1980s. In the first 24 months of that recession, 242,000 jobs were lost, or 7.7 percent of peak employment.

The unemployment rate has continued to rise. Its brief drop in January is most likely a statistical artifact of the annual benchmarking process; otherwise it most likely resulted from a sharp drop in the labor force, indicating that many have given up looking for jobs. Initial unemployment claims persist at a monthly level above 40,000, which means that labor markets are continuing to weaken. Moreover, layoffs have been concentrated in jobs with higher-than-average pay. Those who become unemployed are finding it increasingly difficult to find jobs, indicated both by lengthening durations of unemployment and an increasing number of discouraged job seekers who have given up.

Still Waiting for the Technology Rebound to Begin

The turnaround in the technology sector has yet to gain traction. National production indicators throughout 2002 gave tantalizing yet inconsistent signs of the beginning of a rebound, only to retreat back to trough levels. This pattern has continued into the beginning of 2003 without any clear sign of an upward trend emerging.

On the positive side, industrial production of information processing equipment, released monthly by the Federal Reserve, was up in the first two months of this year. In the three months ending in February, industrial production

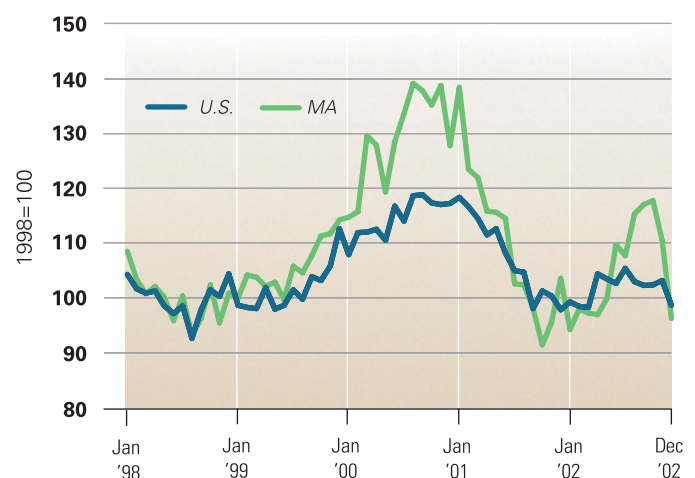
in this sector rose at a 6 percent annualized rate over the prior three-month period. Other indicators, however, do not corroborate this trend—at least not yet. According to the National Income and Product Accounts (NIPA), U.S. investment in information and processing equipment in the fourth quarter of last year (as measured in nominal dollars) declined at an annualized rate of 0.5 percent, after rising for the first three quarters of last year.

Shipments in the broad U.S. computers and electronic products industry have been flat, though they rose moderately in January after being down the previous three months. New orders are equal to current shipments, so there is no indication that the sector is about to expand.

The domestic semiconductor industry does not appear to have turned the corner yet. The Semiconductor Equipment and Materials International (SEMI) industry organization reports that both shipments and bookings of semiconductor equipment continued their downward trend into January, after a promising and sharp uptick in the spring and summer of 2002. The Semiconductor Industry Association (SIA) reports that semiconductor billings from North American companies continued to be essentially level through January, even as worldwide sales were growing. That growth has been captured largely by producers in the Asian Pacific region, who are supplying not only U.S. producers with parts and equipment but also the IT needs of the rapidly developing Asian Pacific countries, including China.

The only production-related data available at the state level are for merchandise exports, which are heavily weighted toward the state's technology products in computers, electronics, pharmaceuticals, and medical devices. Massachusetts merchandise exports surged in the first ten months of last year, only to lose almost all the year's momentum in November and December. The surge and subsequent decline were concentrated in electronic products, pharmaceuticals, and defense goods.

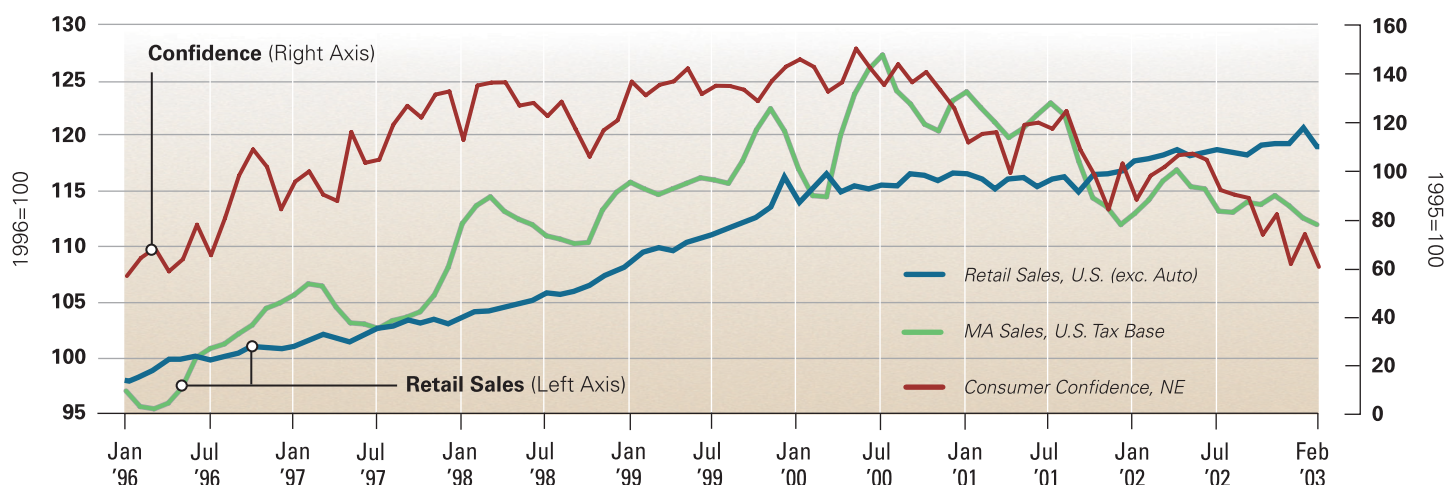
Merchandise Export Indices



Source: MISER

Consumer Confidence and Real Spending Indices

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



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

Weak Wage and Income Growth Restrain Consumer Spending

Wage-rate growth is weak in both Massachusetts and the United States. In terms of total wage and salaries per worker, using a tax-based measure derived from withholding taxes per payroll job, the average annual wage per worker in Massachusetts grew by only 0.4 percent from the fourth quarter of 2001 to the fourth quarter of 2002. A comparable measure for the United States shows a 3.6 percent growth for the same period. These measures include bonuses and other lump-sum payments. Another measure, from the monthly Current Population Survey, excludes these lump-sum payments and measures the hourly rate of pay per resident worker. Since the information for this calculation is asked of only one-fourth of the households surveyed, the sample size for Massachusetts is small and the calculations for the state fluctuate from month to month.

The CPS hourly pay measure exhibits a declining rate of growth both statewide and nationally. For Massachusetts, this measure shows stronger wage-rate growth than the measure that includes lump-sum payments. Hourly wages in the fourth quarter of 2002 were 2.9 percent greater than in the prior year for Massachusetts; nationally, hourly wages grew 2.1 percent over the same period.

Total personal income in the state is growing, but by little more than the rate of inflation. In the most recent quarter available, personal income in Massachusetts in the third quarter of 2002 was 2.7 percent higher than in the prior year. Real inflation-adjusted income grew by only 1.1 percent over this period.

The significance of weak wage and income growth is that consumer spending is vulnerable, especially given increases in the cost of energy for gasoline and home heating (both oil and natural gas prices have increased sharply).

Consumer spending in Massachusetts has been declining since last spring. The sales tax base, a measure derived from regular state sales taxes, declined by 1.3 percent in the year ending in February from the prior 12-month period. Adjusting for inflation, the drop was 3 percent in real dollars. Nationally, consumer-spending measures were stronger, but they also indicate a weakening in spending. U.S. retail spending, excluding automobiles, grew by 4 percent in nominal terms and 2.2 percent in real terms over the same period.

The combination of job losses, weak income growth, and uncertainty regarding Iraq have seriously undermined consumer confidence. Consumer confidence in Massachusetts, as reported by the MassInsight/Mass Development index, plummeted to 61 in January. As recently as April 2002, the index was at 109. According to similar indices released by the Conference Board, confidence in New England and the nation is plunging in tandem with the state. Confidence levels are now where they were in the early stages of the last recession. Furthermore, households' assessments about future conditions are declining.

Budget Battles Are Brewing

It is now clear that the Commonwealth is facing a large structural deficit. Given the existing tax structure and rates, plus the parameters of program spending on health, education, human services, and other state spending, the budget will not come into balance in the foreseeable future. The size of the structural deficit for the coming fiscal year, FY04, is \$2.8 billion, according to administration estimates, a figure about which all concerned parties are in rough agreement. There is little agreement yet, however, on how to address the shortfall, and it appears that the administration, the legislature, and several advocacy groups all have divergent viewpoints and differing stakes. Positions are becoming entrenched, and budget battles are brewing.

Tax revenues are not cooperating to cool the battles. Withholding taxes from bonuses are on track to fall by over \$200 million in FY03 from the prior year. The administration's estimate for tax receipts from capital gains is \$259 million this year, down three-fourths from the peak year of 2001, when over a billion dollars in capital gains taxes was collected. Since the fall (from September through February), tax receipts have been essentially flat. The prognosis for the rest of this fiscal year and into the next is for revenues to remain stagnant.

Finance Falls

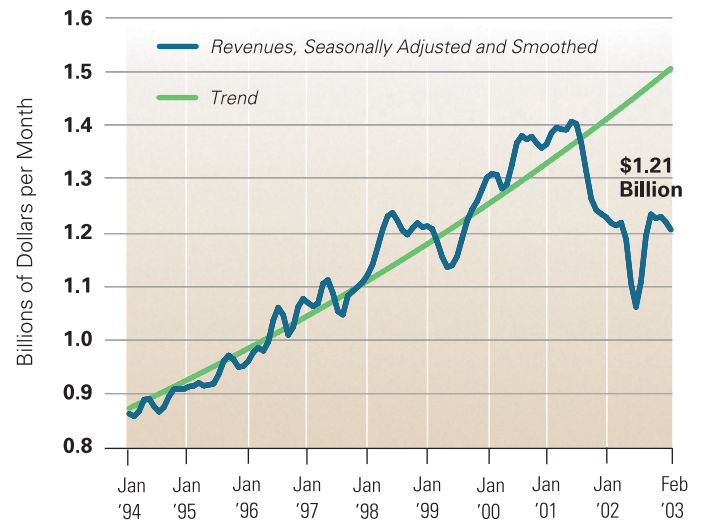
The bear stock market is entering its fourth year; the gloom on Wall Street has taken firm ground, forcing retrenchment in the money management sector. After reaching a peak of 55,400 in May 2001, Securities, Commodity & Investment Activities employment in Massachusetts has declined by 4,200 jobs, or 7.6 percent. Even when firms such as Fidelity are able to hold onto their clients, profits have fallen, as clients move funds from higher-fee equities to lower-fee bond and money markets. Moreover, fees from equity funds also fall along with stock prices. From their peaks in 2000, major stock indices have suffered massive declines. The Dow Jones has fallen 30 percent, Nasdaq 73 percent, and the Bloomberg Massachusetts index 57 percent. Banks tied to commercial lending are not faring well. Given the widespread excess capacity evident in the economy, and with reduced or delayed capital spending plans, demand for new loans from creditworthy firms is weak. Loans at risk—or outright losses from failed firms—have been rising. Fleet's foreign operations have also lost money.

Venture capital funding has receded as a source of financing. According to the PricewaterhouseCoopers MoneyTree Survey, such funds have declined steadily from a peak in the first quarter of 2000. In the fourth quarter of last year, venture capital spending was \$492 million in New England, only 17 percent of the average quarterly amount in 2000. This mirrors the national trend.

The state of financial markets and the banking industry reflect lack of demand by firms to expand, as well as reluctance among investors to support new ventures. Economies like the Commonwealth's thrive on developing and implementing new technologies. Economic growth depends on the demand for R&D and the supply of private financing. Neither is currently favorable for an economic rebound. Massachusetts also draws strength from its ability to pull in research monies from the federal government, particularly in medical, defense, and basic science research, but these are not enough to drive the economy.

Animal Spirits

Total Taxes for Budget



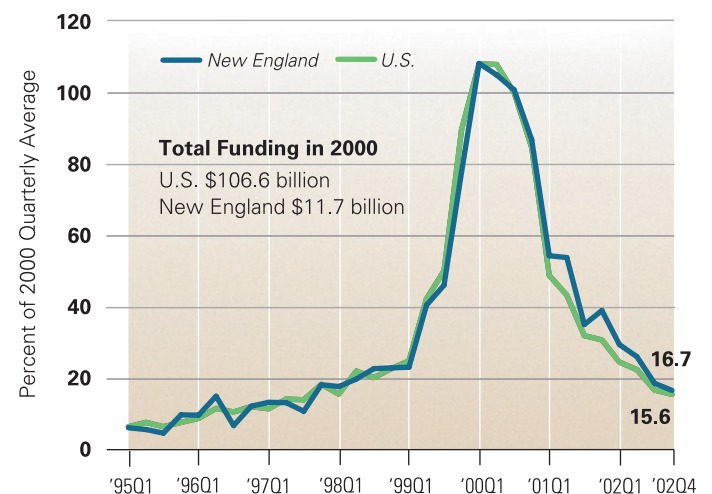
Source: MA Department of Revenue, author's calculations.

Securities Commodity & Investment Activities Employment



Source: Department of Employment and Training

Quarterly Venture Capital Funding



Source: PricewaterhouseCoopers MoneyTree Survey

Much of what drives business cycles is not manageable by monetary or fiscal policy. It is influenced by psychology—and not even rational in the normal sense of the word. John Maynard Keynes termed this “animal spirits.” In the 1990s, we saw the effects of animal spirits when abundant optimism led to growth in technology as the “new economy.” The Asian currency crisis of 1997, the collapse of the Russian ruble, the failure of a major hedge fund, and uncertainty over the potential “Y2K” catastrophe could not derail the expansion. The cry in the stock market was to “buy on the dips!” Now, perhaps, we are experiencing the dark side of animal spirits, when each piece of bad news or uncertainty leads to a postponement of spending plans by businesses. Investors are fleeing stock markets for safe havens like gold, lower interest rates are failing to spur investment spending, and consumer confidence is collapsing.

Three Plausible Paths

The important question is: When will these behaviors turn around? Economists simply don’t know. The international state of affairs has heightened the uncertainty that has prevailed since 9/11. The economy could follow one of three paths.

On the optimistic side, a quick war with a clear resolution to the problems in Iraq would boost both consumer and business confidence. The restoration of positive expectations would finally release the pent-up investment demand for technology products that has been building over the past two years, as computers and related equipment have become obsolete relative to the power, efficiency, and cost advantages offered by new products. Falling oil prices would lower producers’ energy costs and would effectively act as a tax decrease for households. Meanwhile, federal tax relief will further stimulate private spending, while public spending will increase to replace defense equipment and provide homeland security.

On the pessimistic side, the outcome in Iraq will do little or nothing to change expectations, because the cause of this recession was overinvestment and the subsequent bursting of the stock and technology bubble, not the events of 9/11. To the extent that the threat of terror has dampened economic activity, it is not clear that a victory in Iraq will have any effect on reducing those threats. The continued poor state of expectations—combined with falling commodity prices, income growth slowing close to zero, weak job markets, and lack of any pricing power for producers—is not only setting the stage for a double-dip recession nationally but also increasing the possibility of a Japan-like deflationary scenario that could result in a prolonged slump of subpar or no growth. This would become a serious concern if the housing market were to suffer a sharp and prolonged decline in prices.

This type of event presently seems unlikely. Unlike the housing bust at the beginning of the 1990s, there has not been a period of speculative overbuilding. Instead, the number of housing permits since the beginning of the 1990s has remained stable at roughly half the average level of the 1980s. And as long as homeowners are willing, they can simply hold on to their homes if prices dip. A precipitating circumstance, such as a significant percentage of households needing to sell, could occur if the recession continues into the summer months.

The third and most probable path is one of a weak national recovery following a successful war in Iraq. Consumer and business confidence and business spending rebound, as in the first scenario, but lift the state economy with less force. The recovery begins in the second half of the year, but its pace is restrained. Interest rates rise with the recovery for several reasons: Fed action, rising inflationary expectations, and federal budget deficits. Inflation is partly the result of rising import prices, as the large trade deficit continues to weaken the dollar. Higher interest rates slow both business investment spending and the residential real estate market. If housing prices fall, lower household wealth may restrain the growth in consumer spending. The recovery is sustained, but growth is slow for several years, until exuberant animal spirits rise again.

What we can project with some confidence is what will happen in the next few months: a delay of the recovery until the outcome of events in Iraq becomes more certain. This is consistent with the Massachusetts Leading Index reading for January, which projects that real gross state product will decline moderately, at least through July. ◀

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