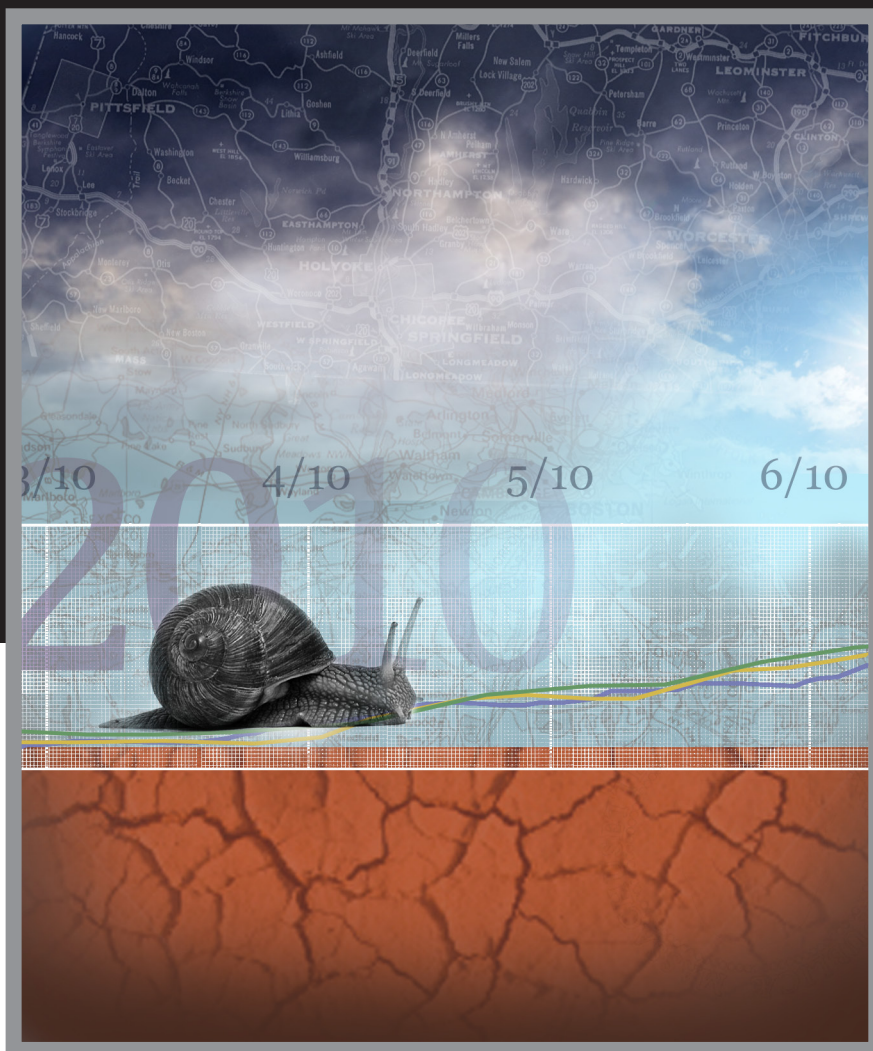


THE STATE OF THE STATE ECONOMY

ECONOMIC CURRENTS



The Outlook for 2010: A Long Hard Slog Ahead

WHILE THE OUTLOOK FOR THE MASSACHUSETTS ECONOMY REMAINS UNCERTAIN, CURRENT AND LEADING ECONOMIC INDEXES INDICATE THAT THE “GREAT RECESSION” HAS PROBABLY COME TO AN END IN THE STATE.

MICHAEL GOODMAN AND ROBERT NAKOSTEEN

The national economic downturn officially dated by the National Bureau of Economic Research (NBER) as having begun in December 2007 continues to date, although at this writing it appears to have bottomed out.

What had previously been a garden variety recession inspired by a significant correction in national and regional housing markets became a full-blown financial and economic crisis in the fourth quarter of 2008.

Unlike recent recessions, Massachusetts entered this recession somewhat later than the nation as a whole, as can be seen in Figure 1. The *MassBenchmarks* Current Economic Index (CEI), a proxy measure of the growth in gross state product, reveals that national GDP change turned negative during the first quarter of 2008, while in the state the downturn did not occur until a quarter later. And then, during quarters when the national economy declined, the state’s economy did so at a slower rate. This pattern has changed markedly in recent quarters, as the national economy is now outperforming the state.

The delayed onset of this recession in Massachusetts can be attributed in part to the Commonwealth’s industrial composition. More so than the U.S. as a whole, Massachusetts relies disproportionately on its innovation economy as a growth driver. This innovation economy comprises a variety of different industry sectors, including Education and Health Services, Information Technology, Life Sciences (biotech, pharmaceutical and medical devices companies) and Defense Technology. These sectors primarily sell their products and services to businesses and governments rather than to consumers. As a result, during business-led recessions — that is, recessions initi-

ated by reductions in business spending and investment — Massachusetts enters recession earlier and is harder hit than the nation as a whole.

The current recession has been decidedly consumer-led, fed and reinforced by the deflation of the housing bubble. As Figure 4 makes clear, consumer- and housing-sensitive sectors, including retail and wholesale trade and construction, have been most directly affected.

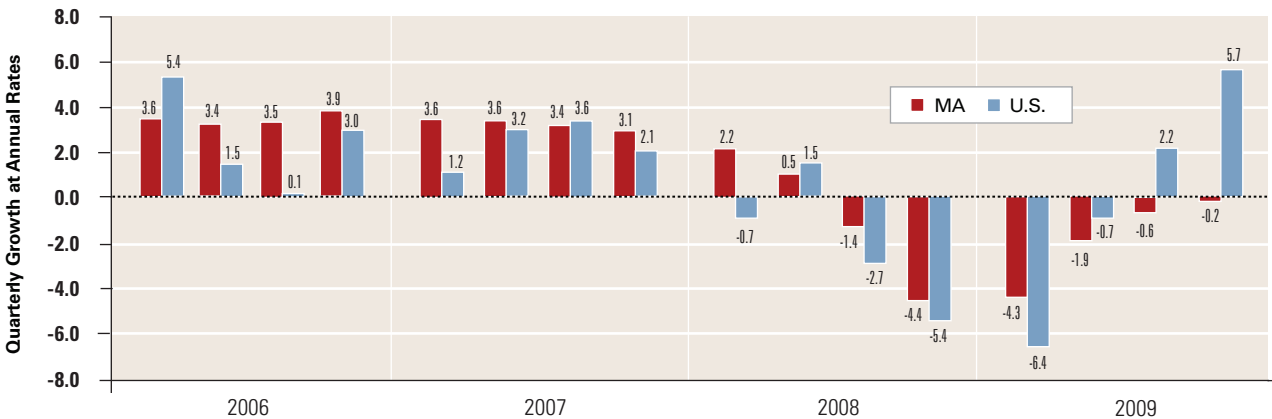
ON THE ONE HAND

The State Economy Is Showing Signs of Life

According to the *MassBenchmarks* Current Economic Index, the Massachusetts economy was essentially flat during the fourth quarter of 2009. There was a small decline in the index in the fourth quarter of 2009, at an annualized rate of 0.2 percent. For the quarter, the Current Index is 1.3 percent lower than it was in the same quarter last year. This is considerably below national performance during the fourth quarter. Because of technical issues involving its construction, the Current Index is probably understating the emerging strength of the state’s economy. Seasonal factors and the difficulty of incorporating growing labor productivity in the index contribute to this understatement.

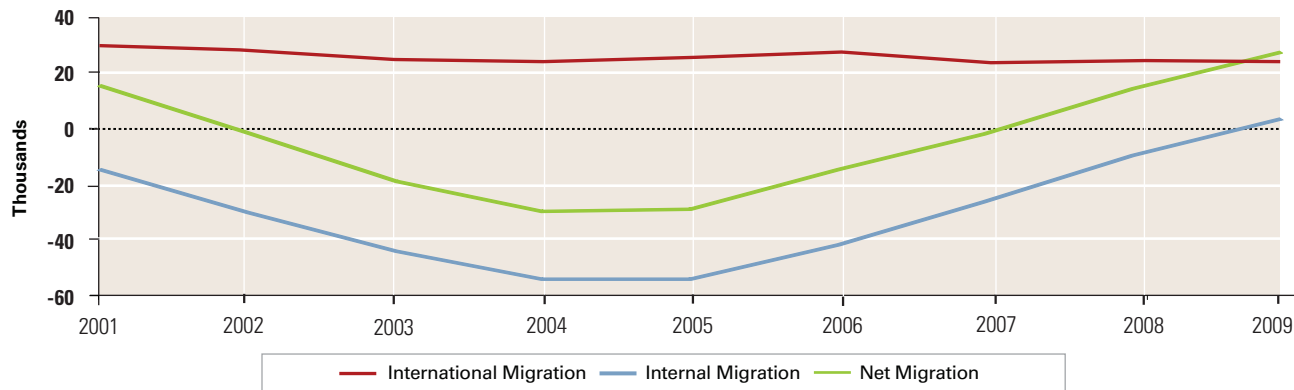
The *MassBenchmarks* Leading Economic Index forecasts that the economy will grow at an annualized rate of 1.1 percent over the next six months (through June). Given the behavior of both the Current and Leading Indexes, at least in a technical sense, the “Great Recession” has probably come to an end in Massachusetts.

Figure 1. Growth in Real Product, Massachusetts Current Economic Index vs. U.S. GDP



Source: U.S. Bureau of Economic Analysis; *MassBenchmarks* Indices

Figure 2. Massachusetts Components of Change: Internal Migration, International Migration, and Net Migration 2001–2009



Source: U.S. Census Bureau Population Division; Prepared by the UMass Donahue Institute

**People Are Voting with Their Feet;
In our Favor for a Change**

For the first time in over a decade, the Census Bureau recently reported that net domestic migration in Massachusetts turned positive between 2008 and 2009. In other words, the number of persons moving into the state from other states exceeded the number moving from the Commonwealth to other states.

This change in part reflects that economic conditions in Massachusetts have been relatively better (or more accurately, less worse) than those in many other states. In contrast to recent years, job opportunities have not been more plentiful in other regions of the country. Additionally, overall domestic migration across the U.S. has slowed considerably during the current recession as numerous households across the nation have been reluctant to leave their jobs and are having great difficulty selling their homes.¹

However, since 2005 the growth of the state’s population has improved notably, especially compared with other states across the nation. Where Massachusetts had the 49th slowest rate of annual population growth between 2004 and 2005, it ranked 25th between 2008 and 2009 — a significant reversal of fortune.²

ON THE OTHER HAND

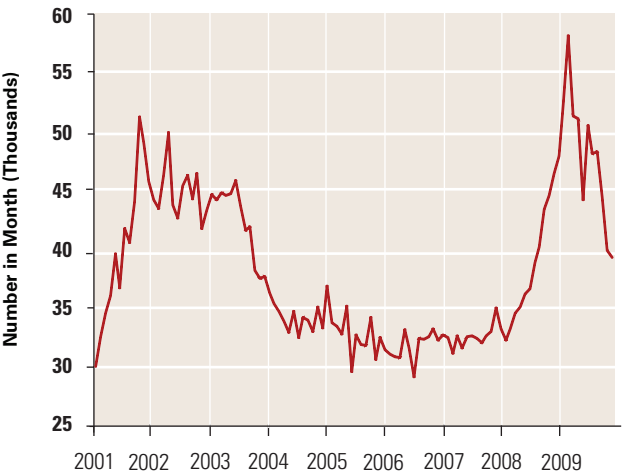
Labor Market Conditions Are Dismal

According to the New England Economic Partnership (NEEP), between the third quarter of 2008 and the end of 2009, Massachusetts lost an estimated 152,800, or approximately 2.2 percent of its jobs. While the pace of these losses has slowed significantly in recent months, NEEP fore-

casts that the Commonwealth will continue to shed jobs through the third quarter of 2010. From peak to trough, Massachusetts is expected to lose 184,800 jobs during this recession. This suggests that Massachusetts stands to lose an estimated additional 32,000 jobs in 2010.

The rate of job loss has been subdued, as the initial claims for unemployment data in Figure 3 illustrate, with the rate of initial unemployment claims falling for much of 2009. This is reflected in lower initial unemployment rates during much of 2009. However, there is little hiring going on, so unemployment remains high. Also, underemployment remains high. The U-6 unemployment rate for Massachusetts and the U.S. in December, which also accounts for people who have stopped looking for work or who cannot find full-time jobs, was 17.2 percent in Massachusetts and 17.3 percent in the U.S.

Figure 3. Initial Unemployment Claims, Massachusetts
(seasonally adjusted)

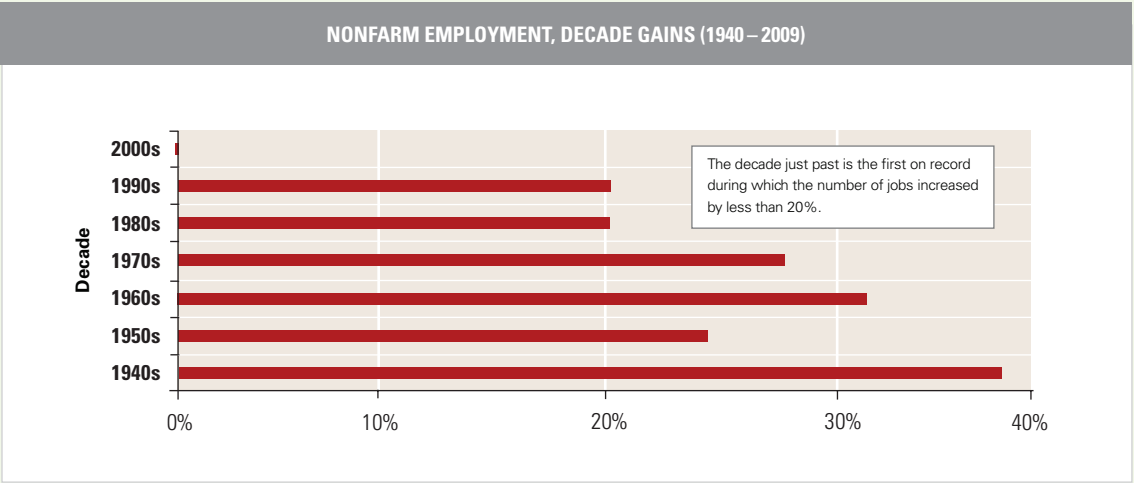


Source: Massachusetts Division of Unemployment Assistance (DUA)

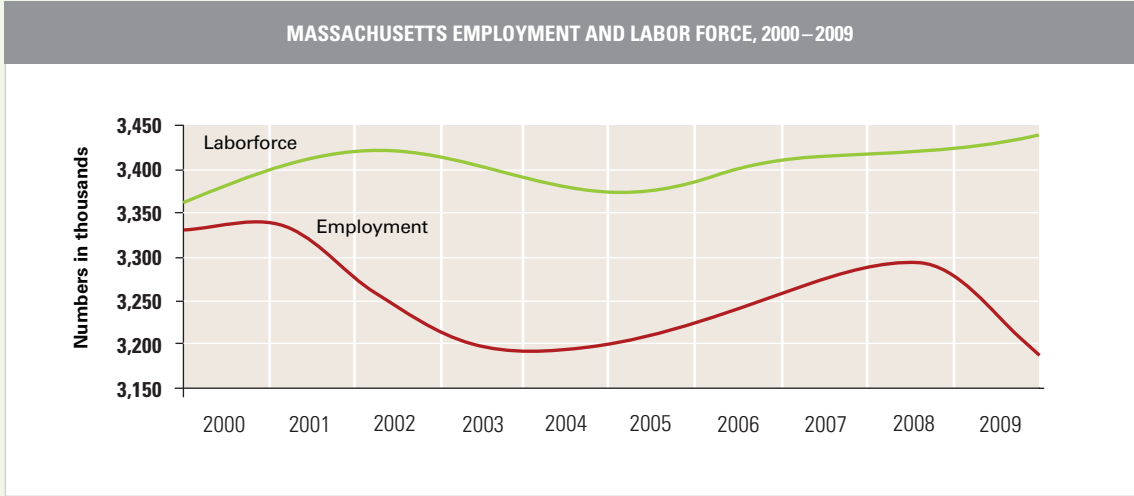
The Lost Decade

In every decade since the 1940s, the nation has experienced employment gains exceeding 20 percent, until the decade that just ended, when total employment at the end was virtually the same as at the beginning. The choice of starting and ending points at the beginning and end of decades is arbitrary, and can be misleading, but it is appealing. The misleading aspect of the endpoint choice is due to the beginning point of the just-concluded decade being at a business cycle peak and the end point being at a business cycle trough. A more realistic comparison would be from peak to peak. Still, no matter what start and end point one chooses, the American economy is not producing jobs at the same pace that it has historically.

The picture of employment change in Massachusetts is even more telling. Total employment is lower now than it was at the beginning of the decade. Again, the choice of endpoints is deceiving, as the comparison is from peak to trough. Still, a second peak in employment occurred on an annual average basis in 2008. Employment at this peak was lower than at the previous one. Also note that the current level of state employment is lower than the trough in employment in 2004. The state is in a jobs hole, from which it will be difficult to emerge. The decline in jobs in the state has been accompanied by the slow growth of the labor force.

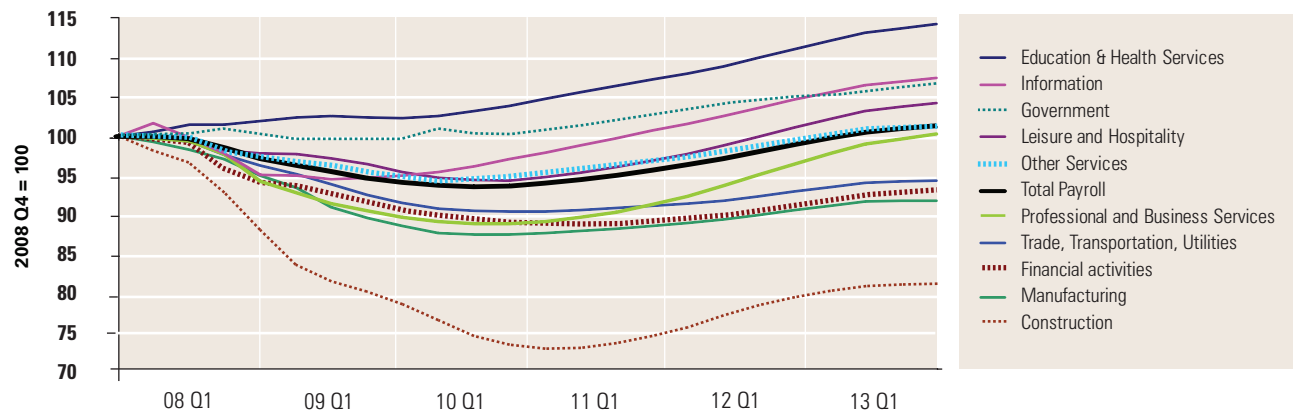


Source: Chart of the Day



Source: Bureau of Labor Statistics, Local Area Unemployment Statistics

Figure 4. Payroll Employment in Massachusetts



Source: New England Economic Partnership (NEEP)

Job growth is expected to resume in the fourth quarter of 2010, but the jobs lost in this recession will not likely be recovered by the middle of 2013. Continuing the trend of the past decade, the industries where jobs are expected to grow differ significantly from those where jobs have and are expected to be lost. Figure 4 illustrates expected job growth in Health Care and Education, Information Technology, and Professional and Business Services. The industry employment sectors hardest hit by this recession are Construction and Manufacturing. Neither sector is expected to regain its jobs lost during this recession in the foreseeable future.

The Residential Real Estate Market Continues to Struggle

Since 2005, the United States has been contending with the aftermath of a major bubble in housing prices. The scale of the decline has been dramatic. According to Karl Case,³ between 2000 and 2005, residential real estate val-

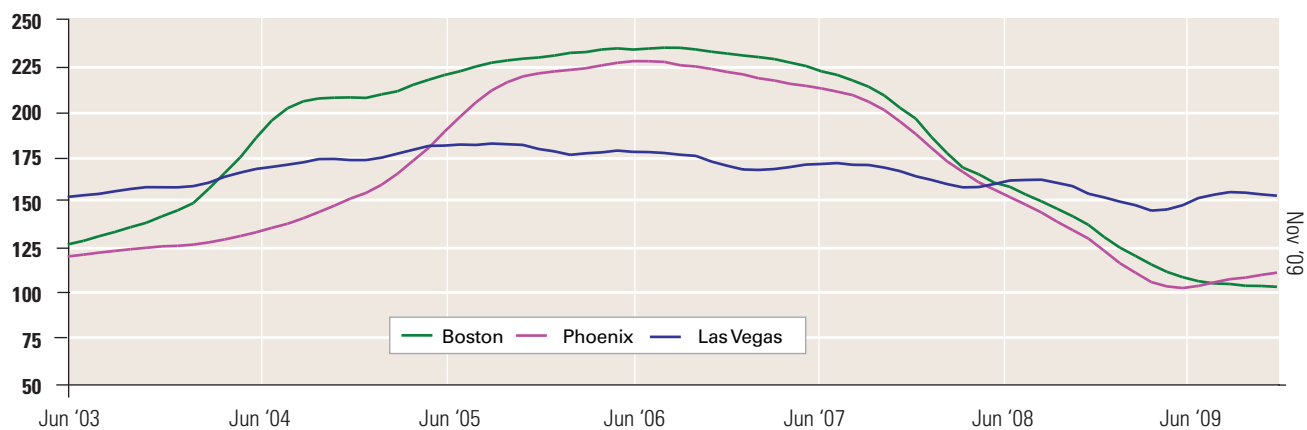
ues rose in value by \$10 trillion (from \$14 to \$24 trillion). Case estimates that between late 2006 and mid-2009, they had fallen by approximately 30 percent, a decline in value somewhere in the neighborhood of \$7 trillion.⁴

According to the October 2009 S&P/Case-Shiller Home Price Indices, home prices in Greater Boston are just below where they were in 2003, 15.5 percent below their peak levels. This is well below the declines seen in other major metro areas. Las Vegas and Phoenix have experienced price declines of over 50 percent while major metro areas in California, Florida, and Michigan have seen home prices decline by more than 30 percent.

The Housing Market is Caught in a Vicious Circle

The combination of job losses and declining prices has contributed to a vicious circle that, despite the efforts of state and federal policymakers, continues to date. As housing prices decrease and job losses continue, default

Figure 5. S&P/Case-Shiller Home Price Indices, 2003 to 2009



Source: FISERV Inc., S&P/Case-Shiller Home Price Indices

Figure 6. A Vicious and Self-Reinforcing Circle



Source: Authors

rates rise, making lenders more reluctant to grant loans. Greater difficulty in accessing credit reduces the number of prospective home buyers. This combined with rising defaults and a rising inventory of bank-owned properties puts greater downward pressure on home prices. And that pushes more homeowners underwater, completing the vicious circle.

The Outlook for the Residential Housing Market

According to the latest forecast from the New England Economic Partnership (November 2009), home prices and sales in Massachusetts reached their nadir in the spring of 2009 after experiencing over 3½ years of decline. The federal first-time homebuyer credit has clearly affected recent market activity. (The pending expiration of that credit led to a flurry activity in the fourth quarter of 2009.)

NEEP is forecasting moderate increases in housing prices (starting in late 2010) and a very slow recovery in housing production, which is not expected to reach pre-

bubble levels anytime soon. However, it appears at long last that the housing slump in Massachusetts may be at an end. In fact, year-end data show that home sales and home prices both inched up during 2009.

There continues to be a real risk that the housing downturn will last longer than expected, owing to the previously noted vicious circle and to weak labor market conditions. The future may bode a reversal of the recent upward trend, especially when federal government intervention in mortgage and house markets ends. While home prices have dropped notably, they currently stand just below where they did in 2003, well above their 2000 levels. As a result, prices have additional room to fall if the recovery stalls or if some unexpected shock hits the financial system.

While housing affordability measured on a median housing price-to-per-capita income basis is improving (as Koshgarian demonstrates later in this issue), housing affordability remains profoundly challenging for hundreds of thousands of Massachusetts households.⁵

*While the outlook for the Massachusetts economy remains uncertain,
it does appear that the worst of the “Great Recession” is behind us.*

The Commercial Real Estate Market: The Next Shoe to Drop?

The commercial real estate market in Massachusetts is dominated by the Greater Boston area, the center of the state's economy and the location of the bulk of real estate investments in the Commonwealth. The recession has taken and is expected to continue to take its toll on the Greater Boston commercial real estate market in 2010.

According to Grubb and Ellis, in 2009 Greater Boston's office space occupancy declined by over 3 million square feet and asking rents dropped by 17 percent. Additionally, by late 2009, over 1.5 million square feet of space was available in Boston for subleasing, over 60 percent more than just one year earlier.⁶ Industrial space did not fare any better as regional vacancy rates reached a twelve-year high of 14.8 percent by late 2009.⁷

Commercial real estate is a lagging indicator; accordingly, it is likely that conditions in this sector will remain difficult throughout 2010. While this may be good news for businesses seeking to expand or renegotiate their leases, it bodes poorly for investors and financial institutions that may find themselves more exposed to losses and defaults.

Whether recent developments, such as the auctioning of the Hanover Mall, will prove to be harbingers of things to come remains to be seen. However, the future condition of the commercial real estate market will bear significantly on the health and welfare of our regional banks. If conditions continue to deteriorate, the commercial real estate market may well prove to be a drag on the pace of the Commonwealth's recovery.

State and Local Finances Are a Mess

Even though state tax revenues exceeded estimates by nearly \$194 million in December 2009, the state's fiscal condition remains sobering. Some, though not all, of these unexpected revenues were due to tax settlements and other one-time payments. Even with these extra revenues, state tax revenues at the end of the calendar year (the end of the first half of state FY10) were nearly 4 percent (\$348 million) below where they were in December 2008.⁸ It *does* seem that revenues have turned the corner and are once again beginning to increase, although from a very deep hole.

The current recession has had a significant and negative impact on all major sources of state tax revenue, particularly income and capital gains tax receipts. Job losses and declining asset and equity prices have exerted downward pressure on earned and investment related income. The downturn has reduced sales tax receipts, but this has been partly offset by the recently approved increase in the sales tax rate.

The state budget's significant reliance on capital gains tax revenues is worsening the negative impact of this recession on state revenues. According to a December 2008 MassINC policy brief,⁹ in 2007 Massachusetts was the third most dependent state on capital gains tax revenues. The stakes are significant. According to Northeastern University Professor and *MassBenchmarks*' Senior Contributing Editor Alan Clayton-Matthews, the reduction of capital gains tax revenues during the 2001–2003 recession exceeded \$1 billion.

The outlook for the state's finances is similarly sobering. According to a recent analysis by the Massachusetts Taxpayer's Foundation,¹⁰ the Commonwealth faces a budget shortfall in the current fiscal year (FY10) and a looming \$3 billion deficit in FY11 as it spends the last of its federal stimulus funding. Even if the size of this deficit proves to be overstated, there can be no doubt that, in the absence of additional and substantial federal assistance, state and local governments will face a profound fiscal challenge over the next 18 months.

Concluding Thoughts

This article is being written during a particularly volatile period. A number of indicators suggest that the recession here in Massachusetts may be over. And historically reliable forecasts suggest that the path ahead for the state economy will be rocky and that growth will be slow.

At the same time, all macroeconomic forecasts are unavoidably dependent on historical trends and patterns and, if the experience of this recession has taught us anything, it is that the future behaves like the past until it doesn't. In other words, it is worth considering whether the recovery in Massachusetts may be different this time than it has been in recent years.

As recently as late in the summer of 2009, it appeared that the state was outperforming the nation (in relative

terms). That is, Massachusetts was doing “less worse” than the U.S. Analysts and the news media had begun speculating about the possibility that, perhaps, this time the Commonwealth would recover more rapidly than the nation as a whole.¹¹ By early fall, however, it appeared that these assessments had been premature. Payroll employment data had unexpectedly worsened and state tax revenues had dropped significantly.

But what if these unexpected declines reflected the volatility in data reports so common at the end of recessionary periods? Under what conditions could Massachusetts outperform the U.S. and exceed the rate of economic and employment growth predicted by the NEEP forecast and consistent with recent historical patterns?

What if businesses across the nation and the globe chose to make investments in technology products and services to enhance the productivity of their employees as an alternative to hiring new workers? Technology- and innovation-intensive Massachusetts would benefit disproportionately and might recover more rapidly than the rest of the nation. Of course, this alternative scenario — in the absence of a more sustained recovery leading to more consumer spending as well as business investment — would likely be short-lived. Any growth premium that Massachusetts might reap would be on the margins.

While the outlook for the Massachusetts economy remains uncertain, it does appear that the worst of the “Great Recession” is behind us. While this may not be much consolation for the Commonwealth’s tens of thousands of unemployed workers and households struggling to make ends meet, there is reason to believe that 2010 will be a better year for the state economy than 2009. 

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Endnotes

1.) William Frey, *The Great American Migration Slowdown: Regional and Metropolitan Dimensions* (Washington, DC: The Brookings Institution, December 2009).

2.) U.S. Census Bureau, Population Estimates Branch. The increase in the state’s population estimate is also the result of successful efforts to better enumerate the Commonwealth’s “group quarters” population during this period. These efforts have resulted in over 16 successful municipal challenges of U.S. Census population estimates. For more information see: <http://www.donahue.umassp.edu/press/news/umdi-chal-census>.

3.) Karl Case, “The Value of Land in the United States: 1975–2005,” in *Land Policies and their Outcomes*, ed. Gregory K. Ingram and Yu-Hung Hong, (Cambridge, Mass: Lincoln Institute of Land Policy, 2007), 127–147.

4.) Karl Case, Housing, Land, and the Economic Crisis, Land Lines, (Urban Land Institute, Jan. 2010).

5.) Lindsay Koshgarian, “Is Housing in Massachusetts More Affordable? (Only for the Lucky Few),” on page 13 of this issue.

6.) GVA Thompson Hennessy and Partners, *Office Market Review*, Second Half 2009. Accessed at <http://www.gvaboston.com/Research.htm>, January 18, 2010.

7.) Grubb and Ellis, *Market Trends Reports, Greater Boston*, 4th quarter 2009. (accessed at <http://www.grubb-ellis.com/research/Reports.aspx>, January 18, 2010).

8.) Massachusetts Department of Revenue Press Release, January 6, 2009.

9.) Cameron Huff, *Capital Gains: Avoiding Harm to the State Budget*, Fiscal Policy Brief 2 (2008). Massachusetts Institute for a New Commonwealth.

10.) *State Fiscal Crisis - No End in Sight* (December 2009), Massachusetts Taxpayer’s Foundation.

11.) For an example, see Robert Gavin (September 27, 2009), “State Set to Recover Sooner than U.S.,” *Boston Globe*.