

THE STATE OF THE STATE ECONOMY

ECONOMIC CURRENTS



Politics and Globalization: Uncertainty and its Economic Discontents

ALTHOUGH THE BAY STATE'S KNOWLEDGE-BASED ECONOMY IS POISED FOR CONTINUED MODERATE EXPANSION, IT FACES SERIOUS HEADWINDS BEYOND ITS CONTROL. THESE INCLUDE THE STUBBORNLY SLOW RECOVERIES IN THE NATIONAL AND GLOBAL ECONOMIES, THE PROSPECT OF SEQUESTERED BUDGET CUTS AND MAJOR TAX INCREASES AT THE YEAR'S END, AND THE CONTINUING SOVEREIGN DEBT CRISIS IN THE 17 EURO ZONE NATIONS.

MICHAEL GOODMAN AND ROBERT NAKOSTEEN

INTRODUCTION

As the Massachusetts economy concludes the third quarter of 2012, it faces a number of significant headwinds that have begun to have an impact on its current performance and can be expected to weigh heavily on its near-term economic outlook. For the most part these headwinds are beyond the control of the Commonwealth's elected

officials and business and labor leaders. This leaves the Bay State in the unenviable position of having to rely on decisions in coming months by national political leaders on both sides of the Atlantic.

Given the recent track record of national political institutions here in the U.S. and in Europe, it is difficult to predict exactly how major economic policy issues will be resolved. Consequently, there is considerable policy uncertainty weighing on the state and national economic outlook, and to date at least precious little evidence to

suggest that our political institutions are capable of doing what is needed to both relieve the uncertainty that is weighing on the decisions of some of the Commonwealth’s leading employers and financial institutions, and help to sustain and enhance the nation’s fragile economic recovery.

The competitiveness and growth of the Massachusetts economy is dependent in very important ways on its links to the national and global economies. Despite some recent positive signs, the national economic recovery has been slowing in recent quarters, providing yet another reminder that economic recoveries from balance sheet recessions brought upon by financial crises can be frustratingly slow.¹

As if the stubbornly slow pace of the national and global recovery was not enough, the U.S. government faces a fiscal cliff at the end the year which if unaddressed could push the nation into recession, according to the non-partisan Congressional Budget Office.² As things currently stand, the Bush-era tax cuts are scheduled to end on January 1, 2013, while draconian sequestered budget cuts agreed to when the Super Committee of the U.S. Senate failed to reach a budget agreement are scheduled to begin, both at the end of the calendar year. While there remains a clear need for action to put the nation’s fiscal house in order over the long term, there should be little doubt that should these cuts and tax increases take effect, the short-term impact on the U.S. economy will be strongly negative.

The fate of the U.S. and Bay State economies is also dependent on developments in Europe. The European Union and especially the 17 Euro Zone countries appear to be entering a new recessionary cycle even as they

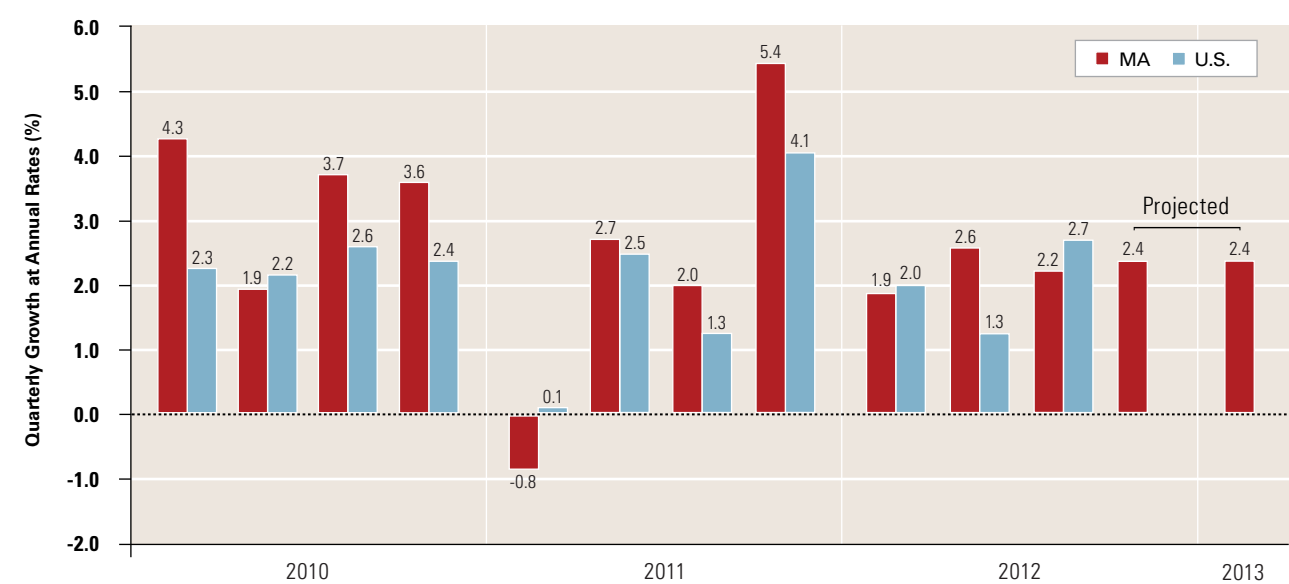
continue to struggle to resolve their sovereign debt crisis. If this were not enough, China, whose growth depends heavily on European consumer markets for its exports, is slowing. Deteriorating conditions in both Europe and Asia are beginning to slow the Massachusetts economy, which relies more heavily than the nation on both regions as major destinations for our exported high technology and medical products.

SLOWING GROWTH IN EMPLOYMENT AND OUTPUT

In the period since the formal end of what is now widely known as the Great Recession, the Massachusetts economy has consistently grown more rapidly than the national economy as measured by the *MassBenchmarks* Current Economic Index, a proxy for the growth in real state product. As can be seen in Figure 1, based on the latest revisions to the Current Index, it appears that state economic growth has been expanding more slowly throughout 2012 and is expected to continue to do so for the remainder of the year (according to the *MassBenchmarks* Leading Economic Index).

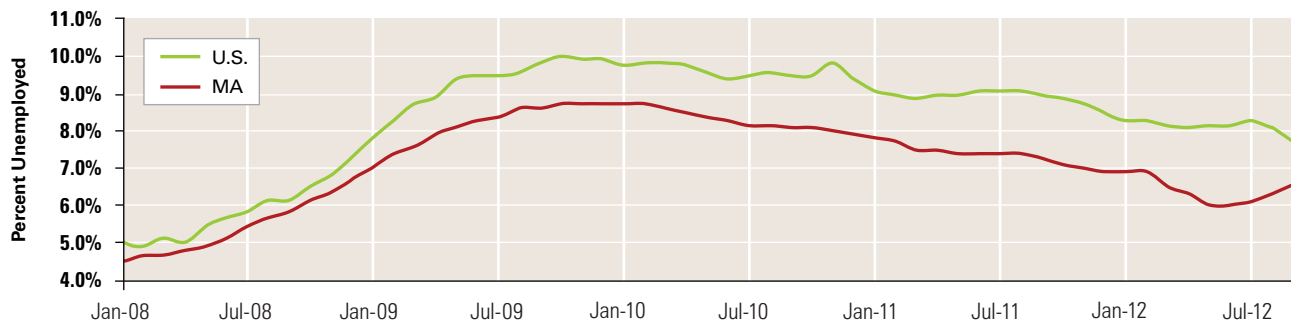
Recent revisions to the Current Economic Index significantly alter our understanding of the recent growth trajectory of the Massachusetts economy, particularly in 2012, and suggest strongly that the slowing that the national and global economies have experienced this year has had a demonstrable, if unsurprising, impact on the state economy.

Figure 1. Growth in Real Product, Massachusetts vs. U.S, 2010–2013



Source: U.S.: Bureau of Economic Analysis; Massachusetts: *MassBenchmarks*, MA real product estimated by the Current Index.

Figure 2. Monthly Unemployment Rate, Massachusetts and U.S.
January 2008–September 2012
 (seasonally adjusted)



Source: MA Department of Labor and Workforce Development

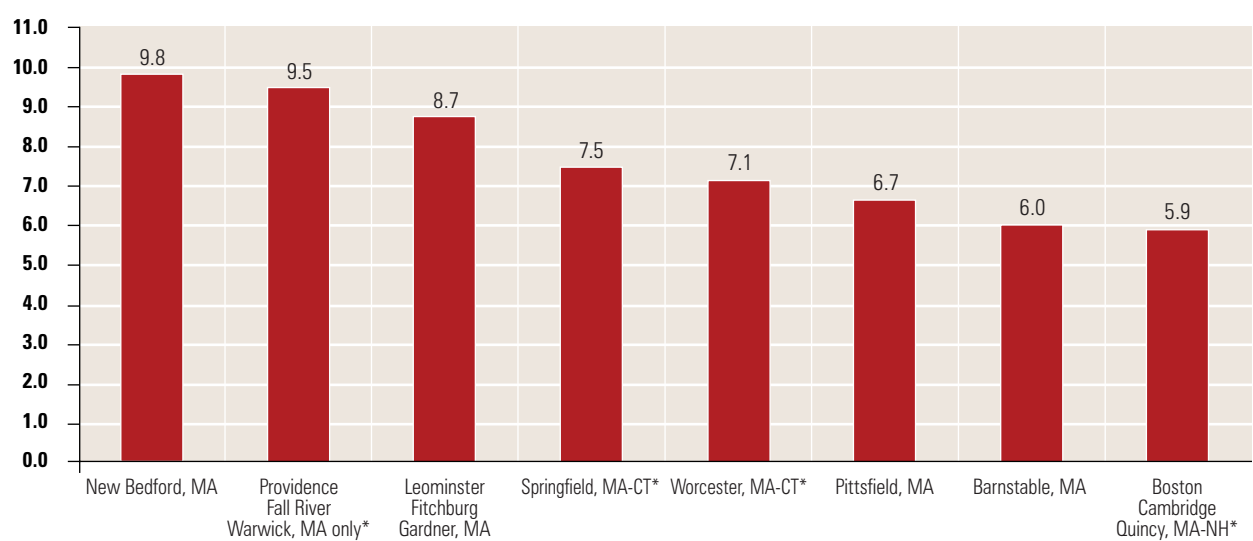
This pattern can also be seen in the unemployment rate, which has remained consistently lower in Massachusetts both during and since the Great Recession. As has been discussed at some length previously,³ the Commonwealth’s industrial composition and highly skilled workforce help to explain why Massachusetts has fared relatively better during one of the most difficult economic periods in over a generation. But evidence is accumulating that strongly suggests that the problems plaguing the national and global economies are finally beginning to have a visible impact on economic activity in the Bay State.

With clear evidence of slowing, both in the larger state economy and its labor market, Massachusetts continues to face significant challenges in creating enough jobs to provide economic opportunities for the Commonwealth’s working families.

But, as Andy Sum points out later in this issue,⁴ the aggregate unemployment rate does not tell the entire story. The state labor market remains sluggish and many people who want work cannot find it. Many others have left the labor force altogether, discouraged by their dim prospects for finding work. Far too frequently those with jobs are working part time and desire full-time work, or are working in jobs that do not take full advantage of their education and qualifications.

Another perspective on the Commonwealth’s labor market challenges emerges from looking at unemployment rates across metropolitan areas. While strictly speaking these local and regional unemployment rates are not directly comparable to the state’s unemployment rate, stark differences between economic conditions in the various regions of the state can be seen by comparing the

Figure 3. Metropolitan Area Unemployment Rates, September 2012
 (not seasonally adjusted)



Source: MA Department of Labor and Workforce Development

*Note: These metropolitan statistical areas contain Massachusetts locations only.

experiences of the state’s older industrial cities (Gateway Cities) to communities that have direct access to the economic opportunities presented by the state’s world-class innovation economy.

As can be seen in Figure 3, the state’s overall unemployment rate masks significant differences across the Commonwealth, continuing the previously documented pattern of a widening divergence of the economic destinies of the state’s regions and communities.

SLOWING EXPORT GROWTH

The state cannot maintain steady economic growth in the face of slowing national and international growth. As noted previously, a major reason that the state economy has been able to grow faster than the nation for some time has been its industrial composition. The state’s leading export sectors include medical equipment and technology products, information technology hardware and software, and a wide array of other innovative and technology-intensive products and services that, until recently, have been in high demand globally in spite of relatively slow overall national and international growth.

The impact of the evolving Euro Zone crisis on the Massachusetts economy can be seen in Figure 4. But this pattern appears to have changed in recent quarters. In addition to having the potential of sparking another global financial crisis, the continuing inability of European leaders

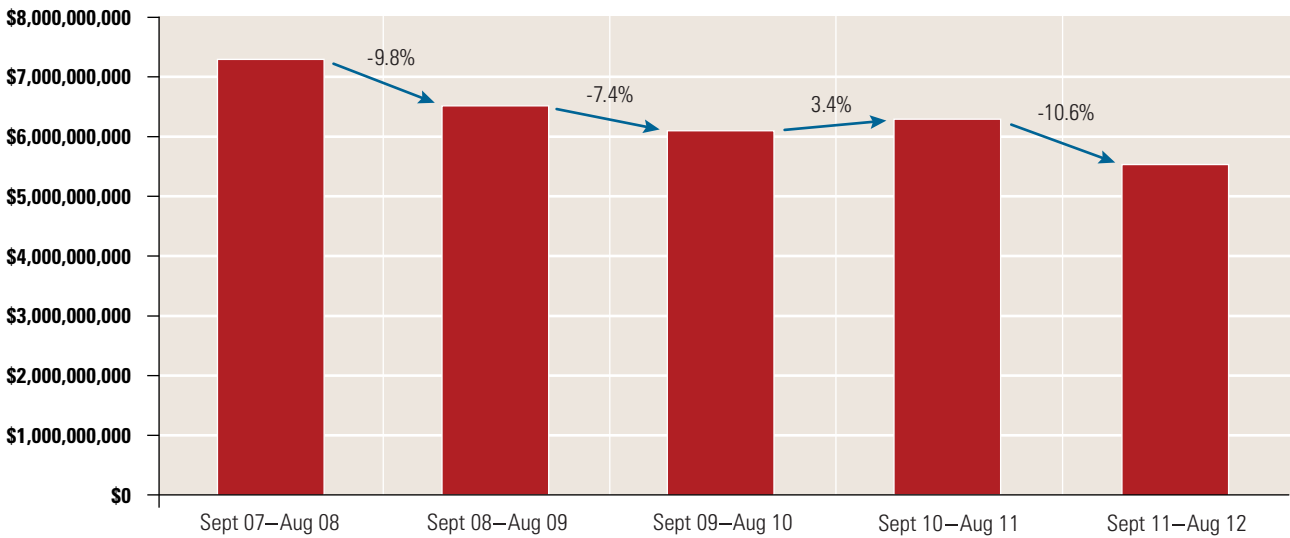
to resolve their sovereign debt and currency problems, along with fiscal austerity policies, have conspired to push many of the Euro Zone economies into outright recession and have weakened many of the nations that have been important destinations for Massachusetts exports.

The impact of conditions in Europe on the Massachusetts economy is currently most visible in the state’s export data. The Euro Zone receives nearly 40% of all Massachusetts exports. Exports, in turn, conservatively represent approximately 8 percent of all economic activities in Massachusetts.⁵

Our international comparative advantage in these sectors is crucial in our continued success as a technology leader. As can be seen in Figure 4, exports to the Euro Zone are cyclical — declining outright during recessions and gaining during recoveries. Based on the most recent export data available, it appears that our exports to our most important trading partner are currently declining significantly on a year-over-year basis. Apart from some resolution of the multitude of challenges facing Europe, this does not bode well for the near-term economic outlook for the Commonwealth’s export economy.

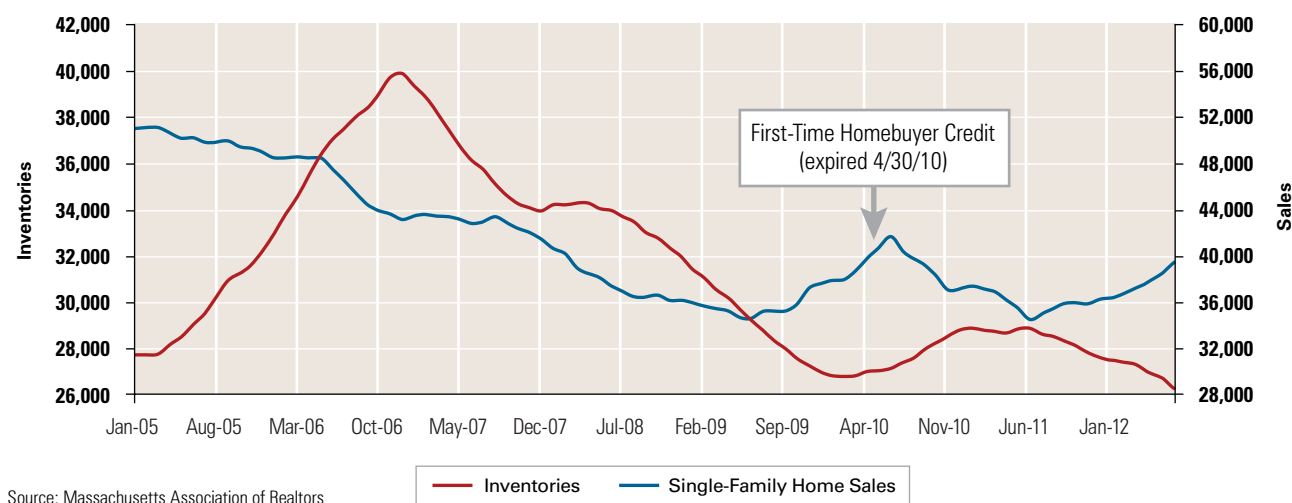
Growth also appears to be slowing in China, which also relies heavily on Europe as an export market and key trading partner. China and Asia have become increasingly important economic markets for the Bay State, further increasing the Commonwealth’s dependence on the global economy and heightening the risk that Massachusetts faces in a slowing and increasingly interdependent world.

Figure 4. Total Exports to the Euro Zone (12-month period)



Source: WISERTrade Foreign Trade Database

Figure 5. 12-Month Cumulative Single-Family Home Sales and Inventories (through June 2012)



Source: Massachusetts Association of Realtors

REAL ESTATE MARKET CONDITIONS⁶

Housing

After nearly seven years of consistent decline, the Massachusetts housing market is finally showing signs that it may have reached the bottom of what has been its most extended slump in generations. Outside of the luxury condominium market in the immediate Greater Boston area, clear evidence of price appreciation is lacking. However, as can be seen in Figure 5, single-family home sales have increased notably of late.

Unlike their national counterparts, the Massachusetts Association of Realtors does not report the share of single-family home sales that result from foreclosure-related short-sales. This makes it difficult to assess the extent to which recent trends are being affected by the disposition of distressed properties rather than positive market developments. In June, the National Association of Realtors (NAR) reported that 25 percent of single-family home sales in the U.S. were distressed properties. According to the NAR: “Foreclosures sold for an average discount of 18 percent below market value in June, while short sales were discounted 15 percent.”⁷

While Massachusetts has not had to contend with as difficult a housing downturn as many other states, the sheer scale of this potential impact suggests that any optimism about a housing market recovery in the Bay State should be guarded.⁸

While new foreclosures are continuing to enter the pipeline, conditions are clearly improving, particularly in communities that have been home to a disproportionate share of these distressed properties. According to the Massachusetts Housing Partnership’s Foreclosure Monitor, between April 2011 and April 2012 the share of distressed units per thousand declined by 8.6 percent statewide.

In Brockton and Worcester, the decline during the same period was 17.3 percent and 22.5 percent, respectively.

Rising sales and falling inventories (see Figure 5) are clearly helping to stabilize home prices — the average monthly change in median home price during the second quarter of 2012 in Massachusetts was flat (+0.17 percent) — and even if a significant portion of sales activity is being driven by distressed properties, their disposition is a necessary precondition for a more sustainable recovery in home prices. Ironically, falling inventories may be an expectations response to improving conditions. Homeowners who contemplate putting their house on the market may now delay in anticipation of future improving conditions, including selling prices.

Commercial Real Estate

The Greater Boston area remains the growth engine of the state’s economy and is home to the majority of the Commonwealth’s commercial and industrial real estate activity. While Grubb and Ellis’s most recent market analysis⁹ indicates that vacancy rates are continuing to fall in the Greater Boston region, putting some upward pressure on rents, they also document a flight to quality, with much of the activity being driven by rising demand for Class A office space in Boston’s central business district.

While aggregate statistics also suggest solid growth in rentable office space under construction, the recovery appears to be concentrated in Boston’s Seaport District, where Vertex Pharmaceuticals is currently building a new 1.1 million square foot corporate headquarters.

Although few data are available that describe conditions in commercial real estate markets outside of Greater Boston, the farther one travels from Boston the higher the vacancy rates get, consistently exceeding 20 percent in suburban Boston areas outside of Route 128.¹⁰ This suggests that CRE market challenges in the rest of the state are far from over.

CONCLUDING THOUGHTS

As 2012 comes to a close, the economic fate of both the nation and the state remain firmly in the hands of national political institutions that state leaders do not control and whose decisions will play a critical role in determining what the future holds for the Massachusetts economy and the people of the Commonwealth.

While in many respects Massachusetts is as well-positioned as any state in the nation to ride out whatever comes next, the precarious and uncertain status of the global economy is clearly having a negative effect on the Bay State's economic conditions, including our world-class innovation economy, which has been responsible for much of the state's growth premium in recent years.

Perhaps ironically, and in purely economic terms, Massachusetts and the nation appear to be through the worst of the financial crisis and the extended housing downturn. As the New England Economic Partnership (NEEP) noted in its most recent economic forecast for Massachusetts:

The Massachusetts economy is expected to continue to expand at a moderate pace. This assumes that the effects of the economic crisis in Europe and the slowing Chinese economy will be more than offset by growing demand within the U.S., and that the looming fiscal austerity scheduled to begin in 2013 will be softened by post-election compromises in Washington.

Should these assumptions hold and national political leaders here and abroad manage to find the will to address the significant challenges facing the global economy, we share NEEP's optimism that the Commonwealth can be expected to continue its moderate expansion.

If not, and national and international leaders once again shirk their responsibility to directly address both their long- and short-term fiscal and economic challenges, the outlook for the national, global, and Massachusetts economies is far murkier. 

MICHAEL D. GOODMAN is an associate professor of Public Policy at UMass Dartmouth and an Editor of this journal.

ROBERT NAKOSTEEN is a professor of Economics at the Isenberg School of Management at UMass Amherst and Executive Editor of this journal.

ENDNOTES

- 1.) Reinhart, Carmen M. and Kenneth S. Rogoff (2009). *This Time Is Different: Eight Centuries of Financial Folly* (Princeton, NJ: Princeton University Press).
- 2.) See <http://www.cbo.gov/publication/43262>, accessed on October 8, 2012.
- 3.) See Goodman, M. and Nakosteen, R. (2011). "Diverging Destinies: The Commonwealth's Relatively Robust but Imbalanced Economic Recovery," *MassBenchmarks*, Volume 13, issue 2
- 4.) See in this issue, Sum, A. and Khatiwada, I. (2012). "Going Beyond the Unemployment Statistics—The Case for Multiple Measures of Labor Utilization," *MassBenchmarks*, Volume 14, Issue 2.
- 5.) This figure excludes the exports of professional and business services, which are difficult to quantify, but, given the state's strength in legal, consulting, and R&D services, are likely very significant contributors to the Commonwealth's international trade.
- 6.) This section is adapted from Goodman, M. (2012) "The Massachusetts Credit Union in 2012: In the Eye of the Storm." A report prepared for the Massachusetts Credit Union Share Insurance Corporation (MSIC). Special thanks to the FDIC's Frederick Breimyer for his insights into the changes in the Massachusetts housing market.
- 7.) See <http://www.realtor.org/news-releases/2012/07/june-existing-home-prices-rise-again-sales-down-with-constrained-supply>, accessed on July 30, 2012.
- 8.) See http://www.mhp.net/vision/resources.php?page_function=detail&resource_id=483, accessed on July 30, 2012. On July 26th, Realty Trac identified Boston, Worcester, and Springfield as three of the top ten Metro Areas in which to purchase or invest in foreclosed properties. For more information, see <http://www.realtytrac.com/content/foreclosure-market-report/midyear-2012-metro-foreclosure-market-report-7305>, accessed on July 30, 2012.
- 9.) Grubb and Ellis, *Boston Area Office Trends Report—First Quarter 2012*.
- 10.) Op. cit.