THE STATE OF THE STATE ECONOMY

ECONOMIC CURRENTS

The Massachusetts Economy in a Time of Transition

THE MASSACHUSETTS ECONOMY CONTINUES TO GAIN STEAM IN A RECOVERY THAT IS ENTERING ITS SIXTH YEAR. DURING THE MOST RECENT QUARTER, THE STATE'S REAL PRODUCT GROWTH CONTINUED TO OUTPACE THE NATION'S. IN SPITE OF ITS STRONG PERFORMANCE, MASSACHUSETTS STILL FACES CONTINUING IMBALANCES BETWEEN ECONOMICALLY THRIVING AND STAGNANT COMMUNITIES.

MICHAEL GOODMAN AND ROBERT NAKOSTEEN

Data from the second quarter of 2014 make it evident that the state economy is bouncing back from a first-quarter temporary reversal of fortune. The Commonwealth's economy is now estimated to have grown at an annualized rate of 4.9 percent in the second quarter following a revised decline of 0.3 percent in the first quarter. In contrast, the nation is estimated to have contracted at a 2.1 percent annual rate in the first quarter, followed by an increase of 4.2 percent in the second quarter. There is good reason to believe that the nation's performance in the first quarter was an aberration that was partly the result of a very difficult winter season that limited economic activity in key weather-sensitive industrial sectors that the nation is more reliant upon than the state.

There is every indication that the Massachusetts economy is continuing its recovery that is now entering its sixth year. The Commonwealth continues to economically outperform the nation in a number of important respects even if the benefits of that growth premium remain concentrated in the dynamic Greater Boston regional economy. The *Mass*Benchmarks Current Economic Index estimates that the Massachusetts economy grew during 2013 by 4.1 percent, compared with the 2.3 percent experienced nationally. This pattern has continued this year.

Despite the surge in economic activity during the second quarter, a number of headwinds continue to slow the pace of economic activity both in the Bay State and across much of the nation. These include the continued negative impacts of federal budget austerity and a troubling slowdown in business investment and international trade.

Federal fiscal drag continues to weigh heavily on the prospects for Massachusetts institutions that are key players in the state's dynamic innovation industries. Significantly, these industries have been growth drivers for the state economy in recent years. Reduced levels of government spending and investment in research and development continue to negatively impact Massachusetts employers that rely on government contracts and our world-class universities and other research-intensive organizations. But these institutions appear to be adjusting to what appears to be a new federal budget reality. Anecdotal reports suggest that these adjustments include finding nongovernmental sources of revenue, expanding into international markets and streamlining business processes. Fortunately, to date it appears that the rate of growth of these institutions remains positive, even if it is slower than what would otherwise be expected in a less austere budgetary environment.

A similar pattern can be seen in national business investment, which remains stubbornly below pre Great Recession levels. The Wall Street Journal recently reported that business spending on capital equipment as a share of gross domestic product has averaged 5.2 percent over the past five years, after averaging 6.5 percent over the previous half century. This diminished level of investment has reduced annual national economic activity by an estimated $220 billion.[1] For a state like Massachusetts, which is a leading provider of industrial and technological business equipment, depressed levels of business investment are a definite cause for concern.

Another area of concern is the slowing pace of international trade. While state merchandise exports have been growing steadily in recent quarters, the state's important trading partners, especially the European Union, continue to struggle and face considerable economic and geopolitical uncertainty. Most notably, the economic fallout from the crisis in Ukraine remains unclear; economic and financial sanctions can be expected to have an impact on European economies at the very least. Among other things, Europe relies heavily on Russia as a source of energy.

While our outlook for the remainder of 2014 and first half of 2015 remains positive, in light of these continuing headwinds and significant risks to the state and national economic outlook, our optimism remains cautious.

STATE LABOR MARKET CONDITIONS

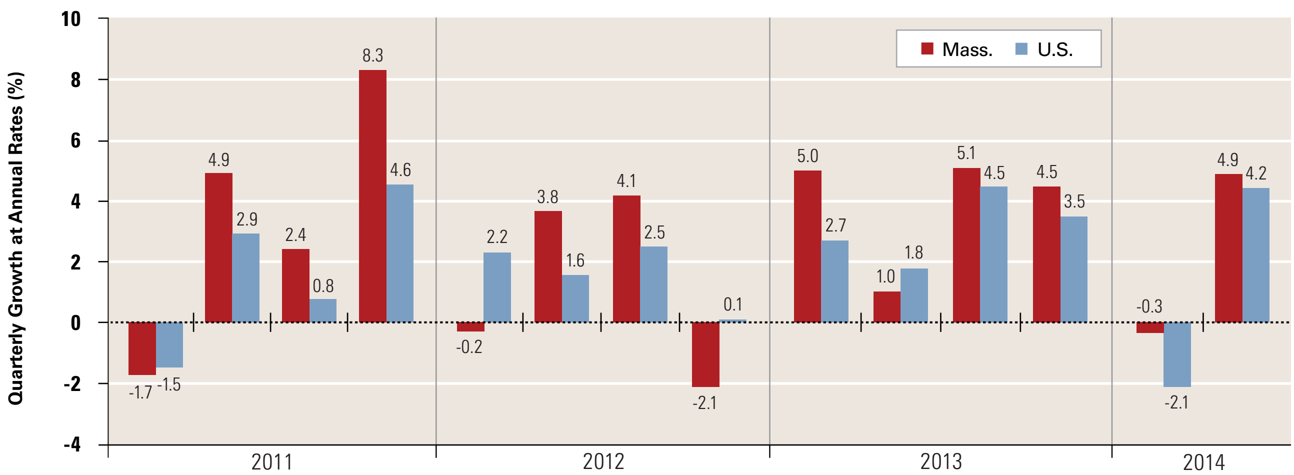
Employment in Massachusetts has been growing more or less steadily since it emerged from the recession five years ago. State employment is now at historically high levels and since October of 2009, when the state started adding employment following the recession, 240,800 jobs have been created, an increase of 7.6 percent. More recently, an estimated 42,200 jobs were created in Massachusetts between January and September of 2014.

The largest absolute employment gains beginning in October of 2009 have taken place in the Education and Health Services sector (just over 72,800 jobs added) and in the Professional and Business Services sector (70,300 jobs were added). Double digit gains were also registered in Leisure and Hospitality; Trade, Transportation, and Utilities; and Construction. Both Manufacturing and Financial Activities experienced employment declines over this period, though of a small magnitude.

The state's unemployment rate, which has consistently been below the national rate, has increased in recent months and is now slightly higher than the U.S. rate. In September 2014 state unemployment was estimated to be 6.2 percent. Nationally, the unemployment rate has fallen from a high of over 10 percent to an estimated 5.7 percent in September 2014.

As can be seen in Figure 2, a striking imbalance in the economic fortunes of regions outside of the Greater Boston area remains in evidence. While unemployment rates across the state have uniformly declined since September 2013, a sizeable gap persists in Southeastern Massachusetts, Northern Worcester County, and in the urban centers of Western Massachusetts. For example, the September 2014 unemployment rate in the New Bedford NECTA, which includes the City of New Bedford and several suburban communities, at 8.9 percent, is 44 percent higher than the state average and 59 percent higher than Greater Boston's rate.

Figure 1. Growth in Real Product, Massachusetts and U.S.



Source: U.S. Bureau of Economic Analysis Real GDP (U.S.); *Mass*Benchmarks Current Economic Index (Mass)

While this troubling imbalance is not new and merits renewed attention from state and regional policymakers and community leaders, there are some positive signs in recent local jobs reports. The labor force grew in each of the Commonwealth's NECTA areas between May and September 2014. This along with local anecdotal reports of improving conditions suggests that the return of discouraged workers to the labor force is partially responsible for stubbornly high unemployment rates in selected areas of the state. But notwithstanding these positive signs, the regions beyond Greater Boston continue to lag. Many have yet to experience their share of the benefits of the state's economic recovery.

EXPORT ACTIVITY

International exports are a key driver of economic growth and represent approximately 12 percent of the Massachusetts economy (combining goods and services exports), according to recent Brookings Institute research.[2] Exports bring new dollars to the economy and help support numerous other industries, so trade growth trends are critical to the Commonwealth's overall economic growth.

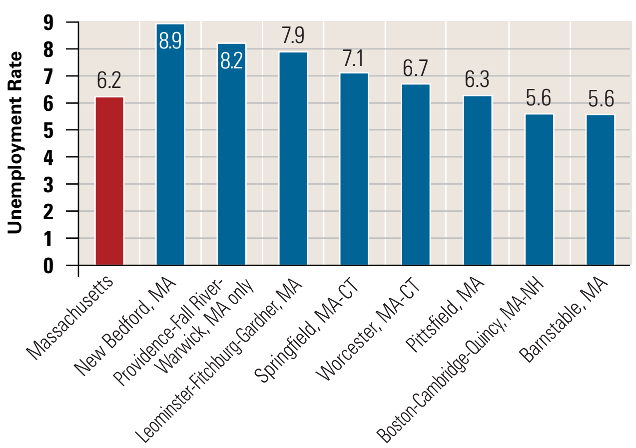
So it is undeniably good news that Massachusetts merchandise exports grew by 10 percent between July 2013 and June 2014 on a year-to-date basis. Despite the uncertainty surrounding the economic outlook for some of our key trading partners in Europe, our trade with both the

Table 1. Employment in Massachusetts by Industry, Beginning of the Economic Recovery through September 2014

Industry Super-Sectors	Employment at Beginning of Recovery (October 2009)	Employment in Most Recent Month (September 2014)	Employment Change	Employment Percentage Change
Natural Resources and Mining	1,300	1,000	-300	-23.1%
Construction	106,700	124,200	17,500	16.4%
Manufacturing	253,300	248,300	-5,000	-2.0%
Trade, Transportation & Utilities	539,300	569,500	30,200	5.6%
Information	86,100	92,700	6,600	7.7%
Financial Activities	210,300	209,100	-1,200	-0.6%
Professional and Business Services	452,100	522,400	70,300	15.5%
Education and Health Services	679,900	752,700	72,800	10.7%
Leisure and Hospitality	299,400	339,200	39,800	13.3%
Other Services, Excluding Public Administration	118,500	125,900	7,400	6.2%
Public Administration	437,300	440,000	2,700	0.6%
Total, All Industries	**3,184,200**	**3,425,000**	**240,800**	**7.6%**

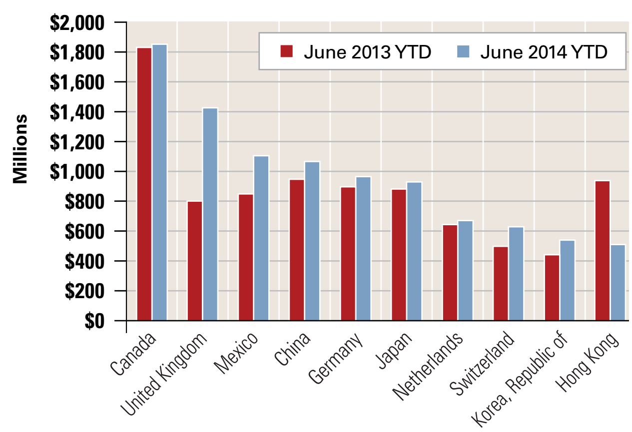
Source: Massachusetts Dept. of Labor and Workforce Development (MADLWD), Current Employment Statistics (CES-790) data; Calculations by authors

Figure 2. Unemployment by NECTA, September 2014
(Not seasonally adjusted)



Source: MADLWD, Local Area Unemployment Statistics, Metropolitan NECTAs

Figure 3. Top Ten Trading Partners June 2013 YTD vs. June 2014 YTD



Source: WISERTrade, U.S. State Exports

Eurozone and Asia increased over this same period. In fact, exports to all but one of the state's most important trading partners increased over the twelve-month period ending in June, compared with the previous twelve-month period.

As Figure 3 illustrates, Canada retains its long-held position as the state's most important trading partner, followed by the United Kingdom, China, Mexico, and Germany. Of the state's top-ten export destinations, two are border countries, four are in Europe, and four are in Asia. Exports to all but Hong Kong have grown over the past 12 months, compared with the previous twelve-month period.

The recent growth in state exports masks a potentially troubling longer-term pattern. Since 2010, state exports have grown at a considerably slower pace than national exports. As can be seen in Figure 4, the state's export performance has also been considerably more volatile than the nation's, where merchandise exports have grown steadily since early 2009. Part of the explanation for this pattern has been the recent domestic energy boom, which has helped to fuel national export growth in recent years.

Despite these recent improvements in national and state export activity, in recent years it has become evident that the link between global economic growth and global trade has weakened. According to the OECD, global trade in the decade prior to 2008 grew at nearly double the rate of global GDP growth. Since then, global trade has more closely tracked the rate of GDP growth, reflecting a substantially lower level of international trade growth. As the fortunes of the Massachusetts export economy cannot be decoupled from global economic conditions and trade patterns, this trend is worrisome. With European growth remaining modest, and continuing concern that Asian growth may be moderating, a further slowing of global trade could be on the horizon. If this scenario materializes, the Commonwealth's exporters will be in for a tough time, with predictable negative effects on state economic growth.[3]

THE STATE OF THE STATE HOUSING MARKET

The Commonwealth continues to experience a housing recovery which began in early 2012 and which has firmly taken hold in Greater Boston, where the number of available properties for sale remain below levels required to meet demand and ensure price stability. Rising rents and incomes in the immediate Boston area along with low interest rates continue to exert upward pressure on housing prices, which in some of the hottest markets in Eastern Massachusetts are substantially above their pre-housing downturn peaks.

In high-demand communities, there are widespread anecdotal reports and journalistic accounts of above-asking-price offers and other clear market signals that the demand for housing is outstripping the supply of available properties for sale in select communities. These communities offer potential buyers ready access to the dynamic Greater Boston job market and highly valued amenities, including quality public schools and convenient commuting options. But in these communities, this rising tide is pricing out all but the highest-income households.

A recent Boston Globe analysis of data compiled by the Warren Group[4] clearly illustrates this pattern. Between 2005 and 2013, it reported that the median single-family house price in Newton grew 17 percent from $760,000 to $889,000. In stark contrast, prices fell nearly 35 percent in Brockton during the same period.

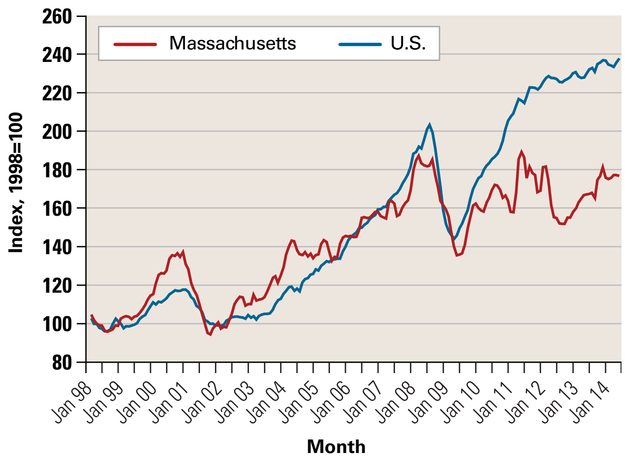
Thus, the solid overall recovery described in statewide housing price data continues to mask dramatic differences across local and regional housing markets across the Commonwealth. As can be seen in Figure 5, home prices in Greater Boston, as measured by the Case-Shiller Index, are approaching their late 2005 peak.[5] This is excellent news for home sellers in this region, especially those in high-demand communities. But if prices continue to rise more rapidly than incomes, recent modest improvements in housing affordability — a silver lining of sorts during the downturn — will quickly evaporate.

A Widening Development Gap

While the nature of the recovery in state housing prices highlights the troubling pattern of regional inequality that has characterized the state's recovery from the Great Recession,[6] prices alone do not offer us a complete picture of the state-of-the-state housing market.

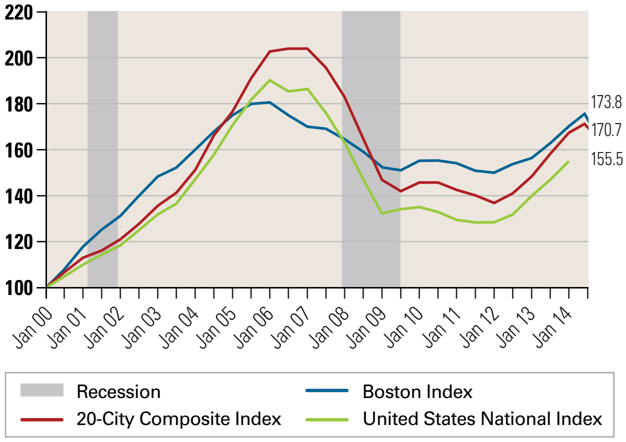
Housing production, as measured by both permits issued and housing starts, can provide us with some insight into how the housing recovery is impacting the larger state economy, including important housing-sensitive industrial sectors such as construction and build-

Figure 4. Massachusetts Merchandise Exports Three-Month Moving Average January 1998 – June 2014 (Seasonally adjusted)



Source: U.S. Department of Commerce; WISERTrade; Seasonal adjustments by author

Figure 5. S&P Case-Shiller Home Price Indices Boston, 20-City Composite and U.S. National January 2000 – June 2014
(Seasonally adjusted)



Source: S&P Dow Jones Indices LLC, S&P/Case-Shiller Home Price Indices; recession dates obtained from the National Bureau of Economic Research (NBER). Both data sets obtained through Federal Reserve Bank of St. Louis (FRED).

ing trades. These sectors suffered mightily following the bursting of the housing bubble and throughout the Great Recession that followed. While construction employment in Massachusetts has been recovering in recent years, it remains well below pre-recession levels. Construction employment in the state peaked at 145,000 in April 2006 and declined to 106,500 in February 2010. Construction employment has generally been recovering since but, as of September 2014, it stood at just over 124,000 — 20,800 jobs below the 2006 peak.

Notwithstanding the visible return of construction cranes to the Boston skyline, statewide housing permits remain below pre-recession levels (Figure 6). One notable feature of this recovery has been the growing share of permits granted to multifamily housing developments. Since 2012, multifamily units have represented just over half (51.2 percent) of all housing permits issued in Massachusetts. In contrast, between 2003 and 2006, multifamily permits represented just over one third of all housing permits (35.4 percent).

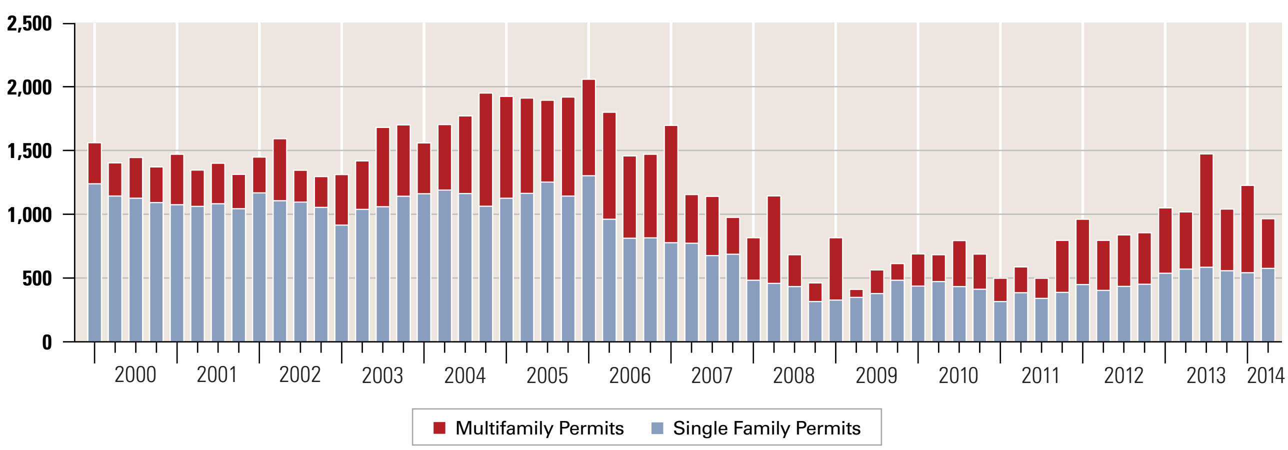
Another striking feature of the current housing recovery is the growing concentration of the state's housing development activity in the Greater Boston region. While this is not terribly surprising given the disproportionate demand for housing in the region as reflected by rising prices, it makes it clear that the impacts of the regional imbalance in the housing recovery are being felt by more than simply homeowners and municipal governments whose fiscal health is highly dependent on property values. As can be seen in Figure 7, over the past decade the share of state housing permits located in the Greater Boston region — defined here as the Boston-Cambridge-Quincy MSA[7] — has grown from 50 to between 80 and 90 percent. This widening gap in housing development activity is yet another illustration of how regionally imbalanced the state's economic recovery has been to date.

Foreclosure Activity and Distressed Properties

One of the legacies of the extended housing downturn has been a significant pipeline of homes that remain in distressed condition, defined by the Massachusetts Housing Partnership (MHP) as "properties where a foreclosure petition has been filed or an auction has been scheduled in the previous year, or is bank held."

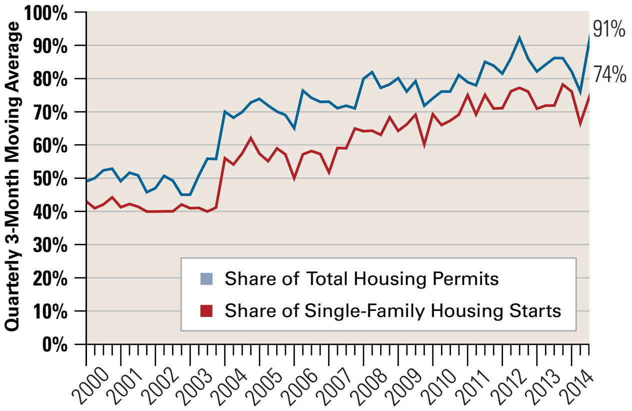
According to the May 2014 edition of MHP's invaluable *Foreclosure Monitor*,[8] between April 2013 and April 2014, distressed properties in Massachusetts declined from 8.8 units per 1000 to 3.8. This significant improvement was led by the City of Boston, which has seen its ratio decline by nearly two-thirds (a reduction of 64.4 percent) during the past year. While this clear improvement is undeniably good news, MHP's analysis also highlighted

Figure 6. Housing Permits in Massachusetts by Type, Three-Month Moving Averages January 2000 – June 2014



Source: Department of Commerce Census of Construction data, seasonally adjusted by the Federal Reserve Bank of Saint Louis (FRED); calculations by the authors

Figure 7. Boston-Cambridge-Quincy MSA's Share of Massachusetts Housing Permits and Starts January 2000 – July 2014



Source: Department of Commerce Census of Construction data seasonally adjusted by FRED; calculations by authors

the challenges in facing persisting issues, including those in the state's 26 so-called Gateway Cities. While MHP reports that every one of these communities experienced a decline in the number of distressed properties between April 2013 and April 2014, it noted that "these communities represent just 26.7 percent of the state's housing units, but account for 40 percent of the state's foreclosure distress."[9]

CONCLUSION

In the coming months, the Bay State will face a number of important decisions and transitions. In November, Massachusetts voters will elect a new governor and legislative class, and decide, among other things, whether the current plans to develop casinos and index the gas tax to inflation will be implemented. These are important decisions that will have a major impact on state policies and fiscal capacity.

Thus, in both political (note the small p) and economic terms, the Commonwealth finds itself at a crossroads. However the Massachusetts electorate decides to proceed, it is clear that the next generation of the Bay State's elected officials and its business and labor leaders will continue to face daunting challenges presented by the striking imbalances between those Massachusetts communities that are again thriving and those that have been largely left behind.

This transition is taking place alongside improving macroeconomic conditions, both in the state and the nation. Gross domestic product has bounced back nicely from the first quarter and employment continues to grow. Households continue to shed debt and the annual federal budget deficit has been declining rapidly. Improving economic and fiscal conditions should give policymakers greater flexibility to deal more directly with some of these troubling inequalities.

Extending the opportunity to fully participate in the economic recovery to every corner of the Commonwealth will not be easy and it will not happen overnight. But the patterns of social and economic development that have characterized the state's economic fortunes and failures in recent years make it clear that doing so will require sustained attention, wise strategic investments, and the development of the physical, technological, human capital, and civic infrastructure that is at the heart of the Commonwealth's true competitive advantage.

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The authors wish to thank Andrew Hall of the UMass Donahue Institute for his research assistance and contributions to this article.

We would also like to extend our gratitude to Rebecca Loveland not only for her critical role in this article, but also the work she does on the entire publication. She is truly irreplaceable.

Endnotes

1.) Neil Irwin. "Businesses Need to Spend More. The Future of the Economy Depends on It." The New York Times. July 21, 2014.

2.) The Brookings Institute supplies an interactive data page and reports to download. See *Export Nation 2013.* Brookings Institute. http://www.brookings.edu/research/interactives/export-nation

3.) The authors wish to thank Editorial Board members Professor Catherine Mann and Dr. Chris Probyn for drawing their attention to these issues.

4.) Jay Fitzgerald. "Home buyers face tight inventories, rising prices this spring." Boston Globe, April 6, 2014.

5.) Indices used with permisson. The S&P/Case-Shiller Boston Home Price Index, S&P/Case-Shiller 20-City Composite Home Price Index, and S&P/Case-Shiller U.S. National Home Price Index are proprietary to and are calculated, distributed and marketed by S&P Opco, LLC (a subsidiary of S&P Dow Jones Indices LLC), its affiliates and/or its licensors and has been licensed for use. S&P® is a registered trademark of Standard & Poor's Financial Services LLC; Dow Jones®, is a registered trademark of Dow Jones Trademark Holdings LLC and Case-Shiller® is a registered trademark of CoreLogic Case-Shiller, LLC. © 2014 S&P Dow Jones Indices LLC, its affiliates and/or its licensors. All rights reserved.

6.) We've discussed this at length in Michael Goodman and Robert A. Nakosteen. "Diverging Destinies: The Commonwealth's Relatively Robust but Imbalanced Economic Recovery" *Mass*Benchmarks 13.2 (2011): 4-13.

7.) This definition of the Greater Boston MSA includes two counties in New Hampshire (Rockingham and Strafford). County-level housing permit data for these two counties in the U.S. Department of Housing and Urban Development's State of the Cities Data Systems (SOCDS) indicate that the share of permits issued in the MSA that can be attributed to these two counties has been declining. Consequently, their inclusion cannot explain the trend reported here.

8.) *The Foreclosure Monitor* is published by the Massachusetts Housing Partnership and is prepared by Tim Davis, an independent research consultant.

9.) Op. cit.