The Economic Environment for Innovation Policy

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Innovation Policy Forum, Great Hall, State House, Boston, Massachusetts
December 8, 1998

I want to thank Joe Alviani and Pat Flynn for the opportunity to address this Innovation Policy Forum. I congratulate the Massachusetts Technology Collaborative--Joe and Pat in particular--for bringing together a diverse array of perspectives and disciplines in preparing the "Index of the Innovation Economy." As this state's economy becomes more complex, this is precisely the kind of regular comprehensive input that is needed to help determine how best to steer the state's future course.

The previous speakers at this forum assessed the competitive position of this state and its industries. What I would like to do is address a broader topic: the overall economic environment and its implications for the Massachusetts innovation policy.

Earlier this year, as work on the 1998 Index was starting, the economy was in remarkably good shape. Massachusetts' performance stood out, even in the context of a national economy that was arguably having its best year since the '60s. Total employment in the Commonwealth was increasing at an annual rate of about 3 percent--the best stretch of growth since the mid-1980s and nearly triple this state's long-run average. It was possible at the time to enumerate various risks to the state's economy. However, for many people these risks seemed quite hypothetical--and distant--against the steady backdrop of good news.

But as the year played out, the prospects for continued strong growth were challenged both nationally and locally. International currency and debt crises threatened U.S. export businesses. Surveys showed that business confidence, especially among manufacturers, was declining. After the simultaneous Russian devaluation and default this summer, investors ran from any risk to the haven of U.S. Treasury securities. Credit spreads widened, bringing the capital markets to a virtual halt in October, and raising the specter of harm to the real economy. The Federal Reserve reacted to these concerns by easing monetary policy three times since September. Markets have calmed considerably as a result, and there have been signs of continued domestic strength.

The state of the Massachusetts economy -- broadly speaking -- is similar to that of the national economy. Growth is continuing, but likely at a slower pace in 1999. Now we should remember that the U.S. and Massachusetts economies have been operating beyond most estimates of potential for some time. Locally, labor and real estate markets have gotten so tight that, for many employers, finding new workers or expansion space has been quite a struggle. International debt and currency crises have initiated a slowdown, and certainly have caused deep problems for the countries most directly involved, but some moderation to relieve pressure on capacity was not entirely unwelcome.

However, as is typically the case, the brunt of the difficulties has not been felt equally by all. Many services and construction firms are still humming along. But manufacturing industries that are dependent on international trade are being noticeably affected. After a very long decline, Massachusetts manufacturers added 12,000 net new jobs between early 1997 and early 1998. Since then, however, they have shed some 10,000 positions, including layoffs at some of our most prominent local employers.

There are reasons to believe we haven't yet fully escaped from the impact of the world's problems. On the one hand, the news from abroad actually has been somewhat more upbeat recently than it had been. In key foreign nations, from Japan to Brazil, concrete steps are being taken to shore up economies and financial systems. On the other hand, it will take some time for these countries to recover. Meanwhile, domestic corporate profits have slowed as margins are squeezed by rising wages and competitive pressures keep prices stable. As hiring slows, consumers may reevaluate spending habits that have taken the personal savings rate into negative territory for two months now and retrench a bit. This could result in lower revenues for businesses and affect spending and job growth as well. In short, I see a slower path for growth, but one that arguably has the benefit of the change in monetary policy already taken this fall.

What ramifications should this broad economic environment have on our thinking locally as we undertake to define and implement an innovation policy? I would urge you to avoid adopting either of two extreme assessments--the overly optimistic or the overly pessimistic--and to steer a reasonable middle course.

The overly optimistic view would be to believe that the innovation economy is tantamount to the invincible economy. This is simply illogical. As long as Massachusetts' businesses participate in worldwide trade and financial markets-and the MTC report correctly points out these growing links -- the state's growth will be affected, to at least some degree, by adverse developments outside our borders. And although it had become fashionable in some quarters to debate whether the business cycle was dead, we now have vivid proof from around the globe to the contrary.

The opposite trap is to be overly pessimistic. There is some tendency, perhaps understandable, to extrapolate any piece of bad news into a prediction of recession. And unfortunately, the term "downturn" here in Massachusetts brings back memories of the early nineties. Such an attitude ignores the very real progress Massachusetts has made in decreasing its exposure to potential calamities. As MTC points out, this state's economic base has become more diversified as new businesses and industries have emerged. In sharp contrast with the situation of a decade ago, construction activity has remained within the bounds appropriate for a state with modest population increases. And the state's fiscal policy has been on a prudent track, allowing the build-up of a sizeable rainy day fund.

On the whole, then, I see shared economic risks for the nation and this state, and I believe that it is appropriate for local decision makers to be watchful. I would argue, moreover, that the lack of either full-fledged exuberance or full-fledged alarm about the economy makes this a very appropriate time to structure an innovation policy for the longer-term.

In my view, the key challenge is to keep replenishing the economy's resources. The Massachusetts landscape is not dotted with steel mills or oil wells that keep turning out the same product year after year with only minor modifications in the production process. Instead, in every area, from manufacturing to services to construction, our businesses continually work to be smarter, more technically proficient, more efficient, and more effective at what they do. Regardless of where we are in the business cycle, this takes a skilled workforce, ample capital, new ideas, and the talent to manage these diverse inputs.

Massachusetts must struggle against the fact that in a well-established, densely-settled state, the number of people available to work inevitably grows quite slowly. Currently, our total working-age population is a mere 3 percent larger than a decade ago. Lacking large new resources in terms of numbers of people, Massachusetts must strive perennially to increase the skills of its population and to steer both new and displaced workers to the occupations in demand.

I was struck, then, as I read the MTC report by the human resources indicators-in particular, the sharp decline in engineering and computer science graduates and the wide gap between eighth-grade test scores for whites and Asian-Americans on the one hand and Hispanics and African-Americans on the other.

Some steps are being taken already in light of these concerns. For example, UMass recently announced plans to start an engineering program at its Boston campus. And as chairman of the Boston Private Industry Council, I have seen the city's School-to-Career effort produce motivated students who stay in school longer, get better grades and go on to two- and four-year post secondary education in much greater proportions than their peers. But clearly the MTC report will serve as a useful catalyst for all of us in discussing what more needs to be done, and the appropriate roles for the public and private sectors.

In sum, the need to foster the innovation economy and especially to improve the quality of the Massachusetts work force will, I think, remain and become more important regardless of where we might be in the business cycle. If anything, today's somewhat uncertain economic environment promotes meaningful discussion on these topics. After all, when you're on the roller coaster as it plunges downward, as we were in the early nineties, you're likely to be dealing only with emergencies. When the momentum is strongly upward, as it had been for the past couple of years, you want to relax and enjoy the ride. It is the current state of economic flux, by contrast, that can add just the right amount of impetus to our collective actions.

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