



WINTER 2019

# PERCSPECTIVES ON POLICY

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## GOODBYE 2018, HELLO 2019

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It's the beginning of a new year and the time when we make resolutions and predictions. We might make predictions about which team will win the Super Bowl, the Final Four, the NBA finals and the World Series. Here we'll consider predictions about whether the economy will grow or contract.

The recent stock market decline and the subsequent swings have many wondering about the near-term prospects for the economy. Individual stock prices are forecasts of a firm's anticipated performance. Stock market indexes aggregate across multiple firms' stock prices. A decline in stock market indexes can indicate that investors have revised downward their expectation of the economy's future performance. Increased volatility in stock prices can signal increased uncertainty regarding future economic performance. Reading the recent stock market tea leaves suggests an increased probability of a recession, and the variability bolsters that prediction. Of course, it is always useful to keep in mind the quote attributed to Paul Samuelson, "The stock market has forecast nine of the last five recessions."

The stock market is not the only bellwether of the economy's future, and The Conference Board's monthly Leading Economic Index is widely studied by those seeking guidance on the future path of the economy. This Leading Economic Index takes into account ten leading indicators, including the stock market index, but also weekly hours worked in manufacturing, new unemployment claims, several measures of new orders, building permits, consumer expectations, a credit index, and the interest rate spread between 10-year Treasuries and the Federal Funds rate. All provide information useful for previewing future economic activity. Collectively they were up for November, suggesting good news for future economic activity, but the Conference Board's press release suggested that they also indicate a slower rate of improvement.

Several of these individual leading indicators offer added insight into where the economy has been and where it is going. On the positive side, production employees in manufacturing worked 42 hours on average in December 2018, for the third month in a row. This is remarkable; since the end of WWII there have been only 30 months when average hours worked have been 42 or higher, and all but one of those months have occurred during the current expansion. Even as workers' hours have been rising, manufacturing employment and wages have risen throughout the current expansion. Also on the positive side, single family housing permits held steady in November, and total housing permits, including multi-family permits, were up.

Two leading indicators are trending in the wrong direction – unemployment claims and the yield curve. New unemployment claims were up slightly during the last week of December; the number of insured unemployed workers rose before Christmas and the unemployment rate for December rose to 3.9% percent from November's 3.7%. The uptick in the unemployment rate occurred even as total nonfarm employment rose by 312,000 in December. During the expansion we've seen a sustained general trend of declining unemployment rates. We'll return to the employment picture below.

The yield curve is the relationship between interest rates and the maturity of bonds. Typically, bonds with longer time to maturity have higher interest rates, or yields. The Conference Board looks at the spread (the difference) between the interest rate on 10-year Treasuries and the Federal Funds rate as their measure of the slope of the yield curve. The Federal Funds rate is an important indicator of monetary policy and is an overnight loan rate, so the Conference Board's measure is the difference between interest rates on a 10-year bond and a 1-day bond. The yield curve is rapidly flattening - the spread de-

clined from 1.10 percentage points (110 basis points) in December 2017 to 56 basis points in December 2018, and as of January 17 of this year the spread had dropped to 35 basis points.

Why is this important? The yield curve inverted, or turned negative, one or two years prior to each of the last three business-cycle peaks. There are several ideas for why an inverted yield curve precedes a recession. The yield curve can flatten when long-term inflation expectations are low or negative, an indicator that monetary policy has significantly tightened. The yield curve also flattens with a decline in market expectations of long-term investment returns.

The leading indicators are thus sending mixed signals. Hoover Institution economist John Cochrane has suggested that the current economic expansion has transitioned from what he calls the demand phase to the supply phase. The demand phase has rising employment of previously idle labor and capital, and growth is rapid. It is relatively easy to put existing, previously idle resources back into production. The supply phase occurs when previously idle resources are already employed, and the economy must find ways to increase the resource base of capital or labor. For labor, the main potential source are those who are not currently in the labor force. To incentivize their participation wages must rise.

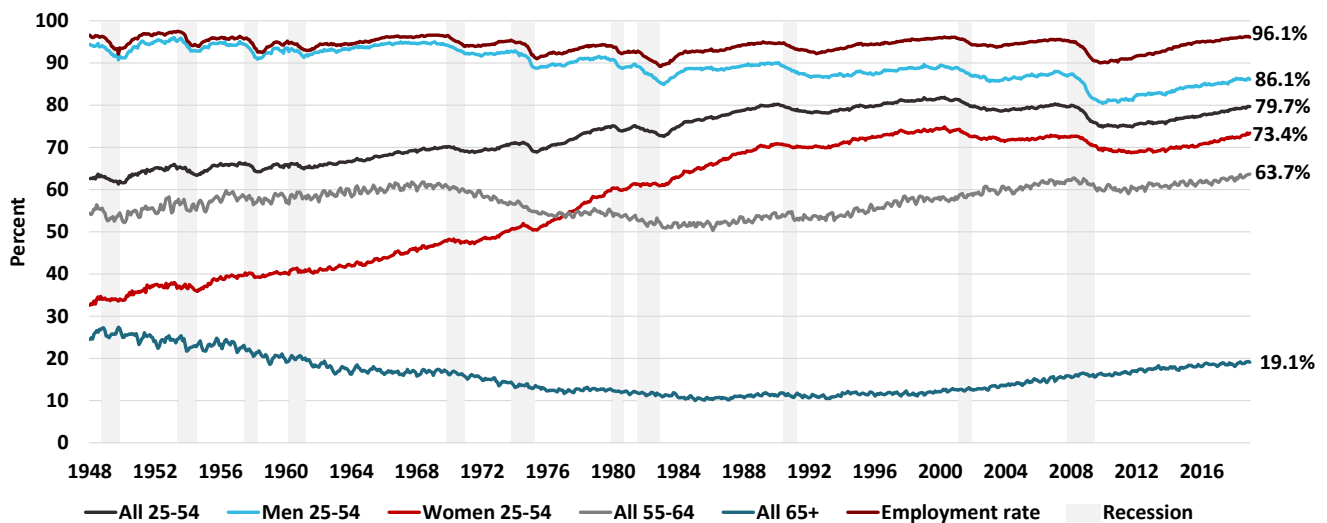
Figure 1 depicts the employment rate, several employment ratios and recessions over the post war years. The employment rate, the upper-most line in

the figure, measures the percent of workers in the labor force who are employed. It is calculated as 100 minus the official unemployment rate. The employment rate typically rises in the months leading up to the peak of a business cycle and then declines during recessions. This series illustrates that the December 2018 employment rate of 96.1% was at one of the highest levels over the last fifty years. Since 1970, only for five months during 2000 and for eight months of this year has the employment rate been as high as the December rate. The question remains, does the current high employment rate mean that employment cannot grow further?

One solution is an increase in the labor force participation rate, the percentage of the population choosing to work or look for work. The civilian labor force participation rate was 66% at the outset of the Great Recession and it dropped precipitously in the aftermath of the recession. It has since increased somewhat, but in December it was still 63.1%. This low participation rate may indicate that there is still room to grow the labor force by incentivizing additional people to join the workforce. This faces headwinds, however, as there are a growing number of retirees due to the Baby Boomers' exiting the workforce. This strong demographic force will put pressure on the labor force participation rate to drop.

It's helpful to look at employment ratios depicted in Figure 1 by age groups and by gender to gain a better understanding of participation dynamics over

**FIGURE 1. EMPLOYMENT RATE AND EMPLOYMENT RATIOS**



Sources: Employment Ratios and Rate from Bureau of Labor Statistics. Recessions from National Bureau of Economic Research.

the business cycles and to determine how much employment could continue to grow. Employment ratios measure the percentage of the relevant population that is employed in a given month. The ratios for the population 25-54 years of age illustrate the percent of prime-age men, women, as well as for men and women combined who are employed.

As with the employment rate, the employment ratio grows during economic expansions and declines during recessions. The series for men 25-54 shows the gradual decline in their employment over the past 70 years. In contrast, the series for prime-age women 25-54 shows steady growth in the employment ratio until its peak in 2000. It should be noted that in 2000, the Baby Boomers were all 25-54, were all in their highest earnings years, and consequently in the years of their highest potential employment rates. Given the sheer size of this generation, and where they were in their careers, the employment ratio would have been expected to rise in 2000. Overall, the employment rates of men and women aged 25-54 combined reached its highest rate of 81.9% in March 2000. The rate for men in that month was 89.2% and for women it was 74.9%.

The remaining two employment ratios for all people 55-64 years of age and for those 65 and above follow different, less cyclical, time trends. The employment ratio for individuals 55-64 increased slightly over the first 20 years shown in the graph, declined for the next 20 years, grew again for almost 20 years, fell during the Great Recession and has rebounded to its highest rate of 63.7% as of December 2018. The final series for all individuals 65 and above declined until the mid-1980s and is now at its highest level since the early 1960s. The recent increases in both series are related to the Baby Boomers moving through these age categories, coupled with the increases in Social Security's full retirement age. Altogether, the employment-to-population ratios have grown throughout the current expansion.

The December 2018 employment rate of 96.1% was higher than the peak rates of the last six business-cycles, but as we have seen, the high employment rate does not necessarily mean participation is high. The employment ratios for prime-age men fell between the peak months of each successive post-war business cycle, except the increases between 1948 and 1953 and between 1960 and 1969. The men's employment ratio in December 2018 was 86.1% or 1.1 percentage points lower than the 87.2%

in December 2007, the month of the previous business-cycle peak.

The prime-age women's employment ratio grew between the peak months of each successive business cycle besides the decrease between 2001 and 2007. The rate in December 2018 of 73.4% was already one percentage point higher than in December 2007 and is now just one percentage point lower than the rate in the month of the 2001 business-cycle peak. The December 2018 employment ratio for men and women together is the same as the rate in the month of the pre-Great Recession peak. For further employment growth among prime-age workers to occur, men's employment ratios will need to continue to grow and possibly reverse the 50-year trend.

Where does this leave us? Are we approaching the peak of the current expansion? Certainly, some of these indicators are pointing toward such a conclusion. While there is nothing definitive at this point, the economy is likely to have slower growth in the coming year and there is some possibility that this slowing growth may actually turn into negative growth. Still, nothing prohibits a continuation of slow but positive growth rates into the coming years, and absent a major shock, this might be the most likely scenario. There are plenty of possible flash-points including our ongoing trade disputes, especially with China, and the possibility of military action in a number of regions.

Perhaps the biggest long-term concern is that this economic expansion has not been accompanied by political action to address growing fiscal concerns. Washington has failed to get federal finances in order, and our long expansion has not led to declining federal deficits or a reduced debt burden. While the deficit as a share of GDP did decline until 2015, it has grown since, and the federal debt held by the public is now at 76.4% of GDP and growing. The future fiscal imbalance continues to grow as the Baby Boomers retire and draw both Social Security and Medicare benefits. It is impossible to avoid this reality, although Washington has taken a head-in-the-sand approach to these very real and obvious problems.

Bottom line, we can definitely predict that a recession is coming, but maybe not this year, and we can add a resolution to prepare for either higher future taxes or reduced retirement benefits. The growing employment ratios of older Americans may signal that some of us are already preparing for this future.



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