Washington Economy Watch

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The Stephen S. Fuller Institute
for Research on the Washington Region's Economic Future
Schar School of Policy and Government
George Mason University

The Washington Economy Watch is a monthly report issued by The Stephen S. Fuller Institute that is intended to inform its readers regarding the current and near-term performance of the Washington region's economy. The Leading and Coincident Indices were first reported in February 1991 and have been calculated each month since that first release and reflect an underlying data base that dates from 1978 covering five complete business cycles in addition to the current cycle that began in mid-2009.

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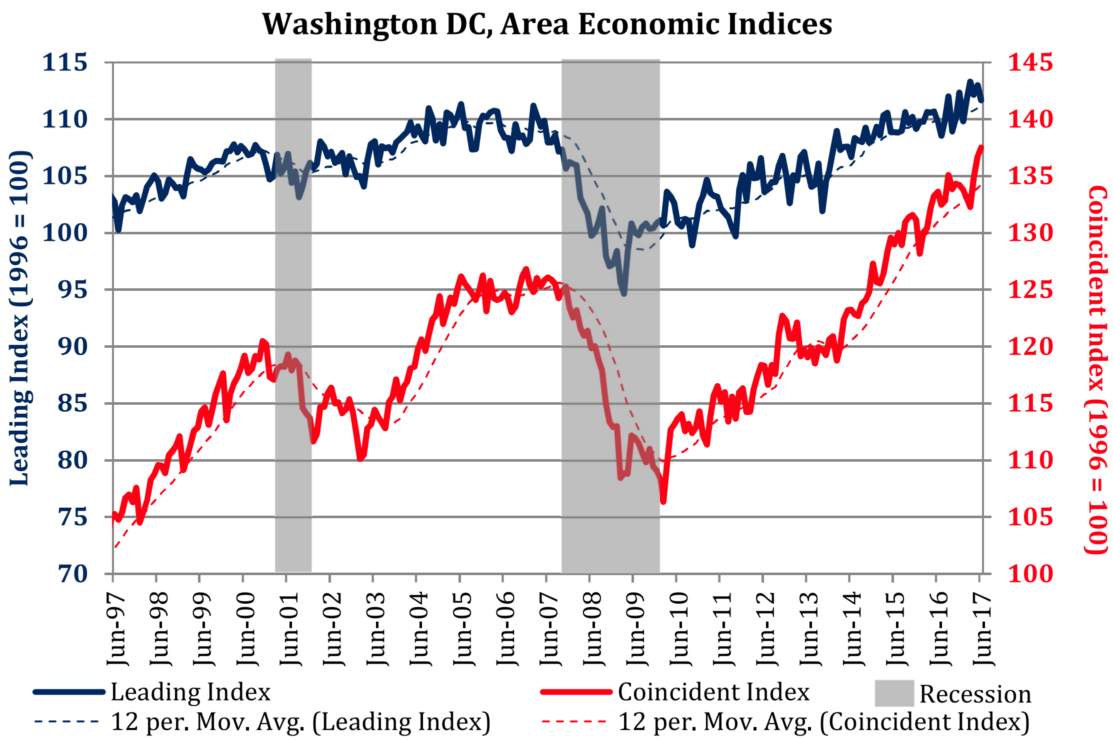
The Washington Region's Economic Performance Continues to Strengthen

The Washington Leading and Coincident Indices were stronger in June than in May and continue pointing to a stronger performance in 2017 than in 2016. Overall, the region's economy has recovered from the unevenness experienced during the first quarter. At mid-year, the Coincident Index confirms that the economy has regained its momentum since March and the Leading Index is pointing to the region's positive performance continuing into the first quarter of 2018 in the absence of a major disruption in federal spending with the beginning of FY 2018 on October 1st. With the federal debt ceiling limit requiring Congressional action by September 28th and the federal government facing a shutdown in the absence of its budget approval by October 1st, the Washington economy's smooth path forward is not guaranteed.



Source: The Stephen S. Fuller Institute at the Schar School, GMU

The **Washington Coincident Index**, which represents the current state of the metropolitan area economy, increased for a third consecutive month in June registering a 0.6 percent gain from May 2017 with three of the Index's four components increasing on a month-to-month basis. Prior to April, the Index had declined in five of the previous six months on a month-to-month basis.

The Index's third month-to-month gain in June reflected its positive long-term trend (as measured on a monthly over-the-year basis) extending back to April 2014 (totaling 39 months). June's gain of 2.91 percent from June 2016 represents its strongest monthly over-the-year gain since January (4.4%) and its second strongest performance since September 2016 (3.2%). The Coincident Index has now registered consecutively stronger performances three months in a row following March's weak performance (the weakest in 39 months).

In June, all four of the Coincident Index's four components were greater than in June 2016.

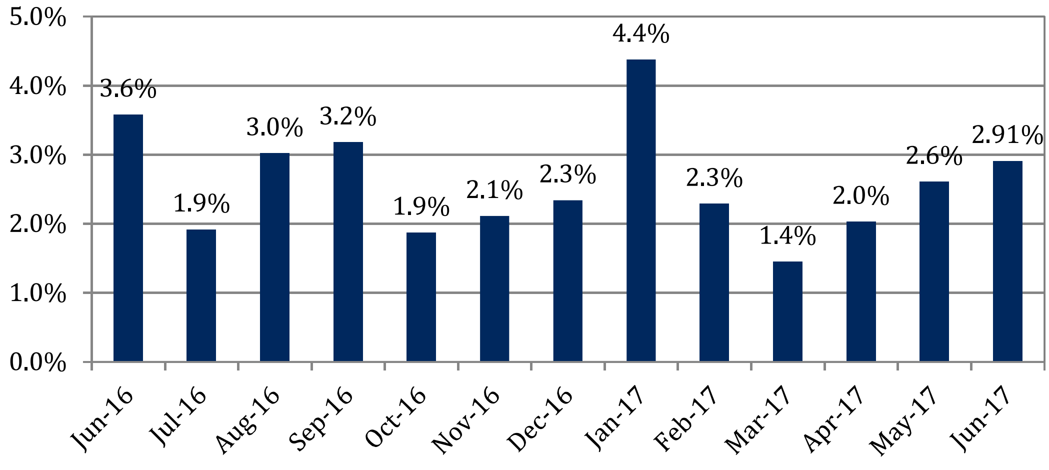
- *Wage and salary employment* growth in the Washington region increased 1.8% between June 2016 and June 2017;

- *Consumer confidence (in the present)* continued its positive trend, increasing 21.6% from June 2016;

- *Non-durable goods retail sales* increased 2.4% from June 2016, growing for the fourth consecutive month after declining in February; and,

- *Domestic passenger volume at Reagan National and Dulles Airports* increased 2.2% in June compared to June 2016 and has now increased in five of this year's first six months on a monthly over-the-year basis.

Washington Coincident Index, Monthly Over-the-Year Changes



Source: The Stephen S. Fuller Institute at the Schar School, GMU

The **Washington Leading Index**, which is designed to forecast the performance of the metropolitan area economy six to eight months in advance, increased in June, gaining 1.77 percent from June 2016. The Leading Index has now increased in five consecutive months in 2017 after registering no gain (0.05%) in January. This upward trend represents the strongest sustained performance for the Leading Index since 2014.

This year's accelerating performance points to stronger economic growth during this year's second half extending into early 2018. This growth path contrasts with the Index's pattern of gains and losses during 2016. For the January-June period in 2016, the Leading Index registered a slight decline (- 0.02%) while for the same period in 2017, the Leading Index has increased 1.7 percent.

In June, three of the Leading Index's four components contributed to its gain from June 2016.

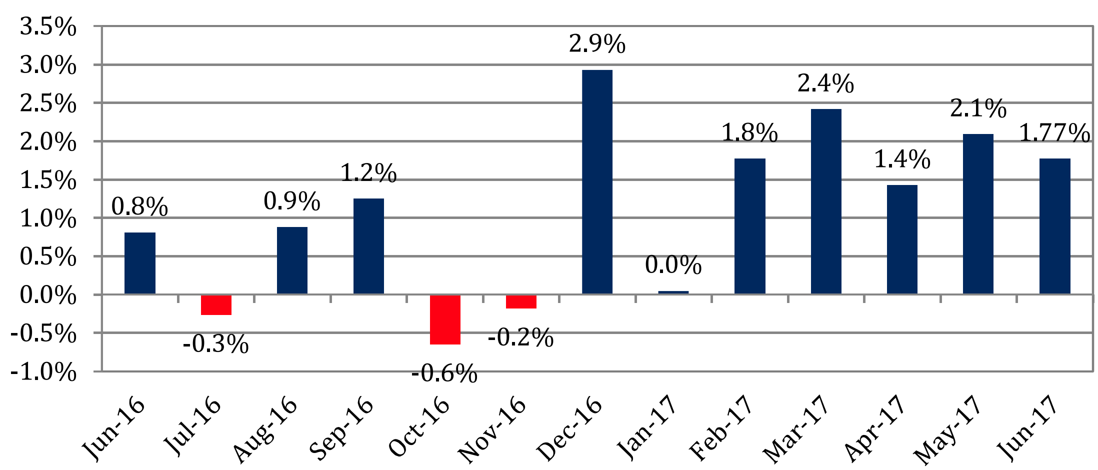
- *Durable goods retail sales* increased 6.8% in June from June 2016 continuing its positive trend from 2016 when it increased every month;

- *Consumer expectations (consumer confidence six months hence)* extended its upward trend for a ninth month gaining 14.9% and registering double-digit gains for a seventh consecutive month; and,

- *Initial claims for unemployment insurance* decreased (improved) for a first time in eight months pointing to a tightening the DC labor market; while,

- *Total residential building permits* declined for a second consecutive month, falling 5.7% below its June 2016 mirroring a temporary nationwide weakness in residential investment.

Washington Leading Index, Monthly Over-the-Year Changes



Source: The Stephen S. Fuller Institute at the Schar School, GMU

The Washington region's economic performance in June extended its growth trajectory to a 39th month and ends the year's first half with a strong gain. While the first half of 2017 showed some unevenness, especially with March's relative small gain, the region's economy appears to have weathered the change in Administration's and the initial federal budget uncertainty without permanent damage. Each of the four components of the Coincident Index were stronger in June than when the year began confirming the direction and breadth of the region's current economic performance.

The performance of the region's forward-looking indicators continues to suggest stronger growth six to eight months ahead. Five strong monthly gains since January present a clear signal that the economy is poised for stronger future growth. However, residential construction has shown signs of weakness in both May and June contrary to local and national projections. This downward trend is not expected to continue more than a few months as market conditions remain favorable: consumer confidence continues to increase with double-digit gains, mortgage interest rates remain low, and consumer spending has continued to grow along with jobs and personal earnings.

As has been noted previously in *Washington Economy Watch*, the Leading Index cannot project the impacts of external disruptions to the region's economy that could dampen or even possibly accelerate its future performance. While the near-term economy looks well positioned to grow at an accelerating rate in 2017 and 2018, its actual performance over this period will depend on the favorable resolution of the federal debt ceiling debate on or before September 28th and approval of the FY 2018 federal budget by October 1st. With timely action on these two key federal policy actions, the Washington region's economy appears well positioned to continue on its current growth path well into next year.

Current Performance

At mid-year, the Washington region's economy was performing much like it was at mid-year 2016. However, over the intervening period it had to overcome some turbulence during the last months of the Presidential Campaign, a one-month bounce generated by the Inauguration, and a hiccup in business and consumer confidence suffered with the release of the Trump Budget Blueprint in March. This performance pattern proves the economy's continuing sensitivity to changes in its core industry—the federal government.

The economy's resilience was also tested during this period and it has shown its ability to weather these short-term disruptions, some real and others imaginary, and to continue on its upward growth path. The region's economic expansion, which started in March 2010, was substantially disrupted during 2013 with a budget impasse that shut the federal government down between October 1st and October 16th and the Sequester that reduced federal spending nationally and had a disproportional negative impact of the region's economy. For calendar year 2013, the region's economy contracted slightly (-0.5) while the U.S. economy grew (1.7%).

The recovery from this economic disruption in 2013 is illustrated by the continuous, uninterrupted, monthly over-the-year increases in the Coincident Index that has increased for 39 consecutive months through June 2017. This recovery's most reported metric has been the region's remarkable job growth. In 2014, the Washington region added only 18,600 net new jobs. Job growth jumped to 57,700 new net jobs in 2015, a remarkable tripling of job growth in one year. And, yet, the region's economy, which grew at the 1.0 percent in 2014, only ticked up to 1.3 percent growth rate in 2015. Job growth was strong again in 2016, with the region adding 55,600 net new jobs. In spite of a second year of strong job growth, the region's economy is estimated to have grown only 1.1 percent.

It should be noted that the U.S. economic growth rate exceeded the Washington region's economic growth rate in each year since 2010. During the 2010-2016 period, the Washington region has achieved an annual average economic growth rate of 0.95 percent, well off of its annual average economic growth between 2000 and 2006 of 3.8 percent.

Job growth through seven months in 2017 is averaging 57,600 net new jobs. This is an unexpected performance compared to a beginning-of-the-year forecast for 45,700 new jobs job growth in 2017. Through seven months, job growth in the Washington region is running 25 percent ahead of forecast. Does this strong rate of job growth for the third consecutive year portend a breakout year for economic growth?

The answer is both yes and no. The economic forecast for 2017 for the Washington region is for growth to accelerate to an annual rate of 2.1 percent. Currently, this is the same rate projected for the U.S. economy. So, if these forecasts hold true for the full year, the Washington economy's performance will have improved from 1.1 percent annual gain to a 2.1 percent annual gain. This is a significant increase. Still, 2.1 percent annual growth is well below the region's historic growth path and still would not exceed the national growth rate. During the 1980-2010, the Washington region's growth rate regularly exceeded the national rate by a full percentage point.

The primary reason that the region's strong job growth cannot be equated to equally strong economic growth is that the types and mix of jobs being generated currently do not generate the same output value per job as the types and mix of jobs that the Washington region's economy generated prior to 2010. This shift in job mix has been the result of changes in federal spending as this has affected the Washington region. This change is most clearly seen in the decline of federal employment from its all-time peak level in 2010 and the decline in the value of federal procurement spending in the Washington region from its all-time peak, also in 2010. The loss of these federal and contractor jobs, jobs characterized by their high-value added and export-base (they were not funded by local consumer spending) and the absence of annual increases in federal spending, as had occurred each year between 1980 and 2010, have changed the complexion of the region's economy and its recent job growth has not achieve the re-balancing necessary to effectively diversify away from its historic federal dependence.

Job data for July, released August 18th reflect this unfavorable shift in the region's job mix. Compared to July 2016, preliminary estimated by the Bureau of Labor Statistics report that the region's job base increased by an impressive 83,100 jobs in July 2017. If this number stands revision, it would be the strongest monthly over-the-year gains since 2004. While this is a large number of new jobs, the mix of these new jobs favors lower-value added sectors and sectors that tend to be dependent on local consumer spending and not on markets external to the region thereby attracting new money into the region for subsequent re-spending in support of local jobs. Economic growth is all about the multiplier effect. Jobs supported by national and global markets tend to have a larger multiplier effect than jobs supported by local markets.

So what was the job mix in the most recently release July jobs data? Three private sectors—professional and business services, education and health services, and leisure and hospitality services—accounted for two-thirds of the net new job added. The federal government added 500 net new jobs or 0.6 percent of the 12-month gains in July and lost jobs between June and July 2017. In contrast, state and local government reported an increase of 17,000 jobs accounting for 20.5 percent of all new jobs. Retail trade and construction jobs accounted for 6.9 percent and 5.7 percent respectively of the new jobs added during this period. All other sectors either lost jobs or added only small numbers of new jobs.

What is most worrisome about this jobs report is that professional and business services, the region's largest sector with 761,900 jobs, accounting for 22.9 percent of the region's total jobs, added only 16,000 net new jobs between July 2016 and July 2017. This increase accounted for just 19.2 percent of the region's total job gain. This key sector, characterized by high-value added jobs and sales to external markets, was significantly overshadowed by sectors with much lower value-added per worker and sectors dependent on local consumer spending. This may generate a positive short-term economic outcome but is not the recipe for accelerating long-term economic growth.

Near-Term Outlook

The 39 consecutive monthly over-the-year gains in the Coincident Index and the positive performance of the Washington region's forward-looking indicators comprising the Leading Index are pointing to continuing economic gains extending into 2018. These gains are being actualized in much stronger job growth through six months of 2017 than had been initially projected at the beginning of the year with the result that the region's economy may exceed its current growth forecast of

2.1 percent. But, even achieving a 2.1 percent gain for 2017 would be a major improvement over 2016.

As noted above, the region's ability to accelerate its growth to levels exceeding the national growth rate, as was common before 2010 when federal spending was increasing annually, will require more than only generating large numbers of jobs. Rather, it will require that more of the new jobs being generated be in higher-value added occupations selling services to non-local consumers. The Washington region's economy will need to increase its penetration of the national and global market places thereby reducing its dependence on federal spending.

Still, the Washington region has clearly demonstrated its economic resilience in overcoming the negative impacts of the Sequester and lower levels of federal spending since 2010. The economy not only continues to generate large numbers of new jobs but it has slowly increased its economic growth rate to near-national average levels. In the short term, this achievement can be celebrated but it is only a holding action.

Further reductions or interruptions in federal spending within the region's economy will undermine its slow recovery since 2013. The first test will come soon with the end of the current fiscal year. How the region's economy responds to this disruption, should it occur, will be a function of how long the shutdown lasts; in 2013, this disruption did not have a significant impact on the overall economy but did impose hardships on particular segments of the local economy especially in the District of Columbia in sub-markets dependent on the daily spending of federal workers.

However, restructuring of federal agency budgets and shifting budget authority from domestic agencies to defense and national security agencies would likely have a substantial intra-regional economic impact. Changes in the amount of annual federal funding captured within the region's economy as well as which agencies are affected will be key along with the timing of these spending changes. As the last quarter of 2017 is the first quarter of FY 2018, any disruption to federal spending flows at the beginning of FY 2018 will likely undermine this year's currently favorable performance.

Should major changes occur in the federal budgetary policy, how these would impact the region's economic performance in 2018, a year that is currently expected to achieve the decade's strongest gains, is uncertain. What happens on or about October 1st will be telling and any impactful changes to federal spending policy that is reflected in Congressional and Administration actions at that time will be quickly analyzed and reported out by the Stephen S. Fuller Institute. Stay tuned.

Washington Area Economic Indicators
Current and Previous Months

Economic Indicator	Estimates			Percent Change	
	Jun-17 Prelim.	May-17 Final	Jun-16 Final	May-17 to Jun-17	Jun-16 to Jun-17
Washington Area Business Cycle Indicators					
Coincident Index (1996 = 100)	137.5	136.7	133.6	0.56%	2.91%
Leading Index (1996 = 100)	111.7	113.0	109.7	-1.15%	1.77%
Washington Area Coincident Index Components					
Total Wage & Salary Employment ('000)[a]	3,306.3	3,285.0	3,246.9	0.65%	1.83%
Consumer Confidence (South Atlantic)[a]	152.2	147.2	125.2	3.40%	21.57%
Domestic Airport Passengers ('000)[b]	2,239.1	2,255.5	2,191.0	-0.73%	2.19%
Nondurable Goods Retail Sales ($000,000)[c]	3,181.3	3,171.2	3,105.4	0.32%	2.45%
Washington Area Leading Index Components					
Total Residential Building Permits[a]	2,432.0	2,406.0	2,578.0	1.08%	-5.66%
Consumer Expectations (South Atlantic)[a]	106.6	113.8	92.8	-6.33%	14.87%
Initial Unemployment Claims[b]	1,765.8	1,606.4	1,875.2	9.92%	-5.84%
Durable Goods Retail Sales ($000,000)[c]	3,555.5	3,585.3	3,328.6	-0.83%	6.82%
Wahington Area Labor Force[a]					
Total Labor Force (000)	3,424.7	3,384.3	3,320.2	1.19%	3.15%
Employed Labor Force (000)	3,291.9	3,261.4	3,189.8	0.94%	3.20%
Unemployed Labor Force (000)	132.8	123.0	130.4	7.99%	1.86%
Unemployment Rate	3.9%	3.6%	3.9%	--	--
Washington Area Wage and Salary Employment[a]					
Total (000)	3,306.3	3,285.0	3,246.9	0.65%	1.83%
Construction (000)	159.8	158.5	159.8	0.82%	0.00%
Manufacturing (000)	54.4	53.6	54.2	1.49%	0.37%
Transportation & Public Utilities (000)	67.9	66.4	64.5	2.26%	5.27%
Wholesale & Retail Trade (000)	345.1	342.9	340.9	0.64%	1.23%
Services (000)	1,974.4	1,956.7	1,927.4	0.90%	2.44%
Total Government (000)	704.7	706.9	700.1	-0.31%	0.66%
Federal Government (000)	368.5	367.9	369.8	0.16%	-0.35%

[a]Unadjusted data

[b]Seasonally adjusted data

[c]Seasonally adjusted constant (1996) dollars