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Reading the Markets USD

The many faces of declining US participation

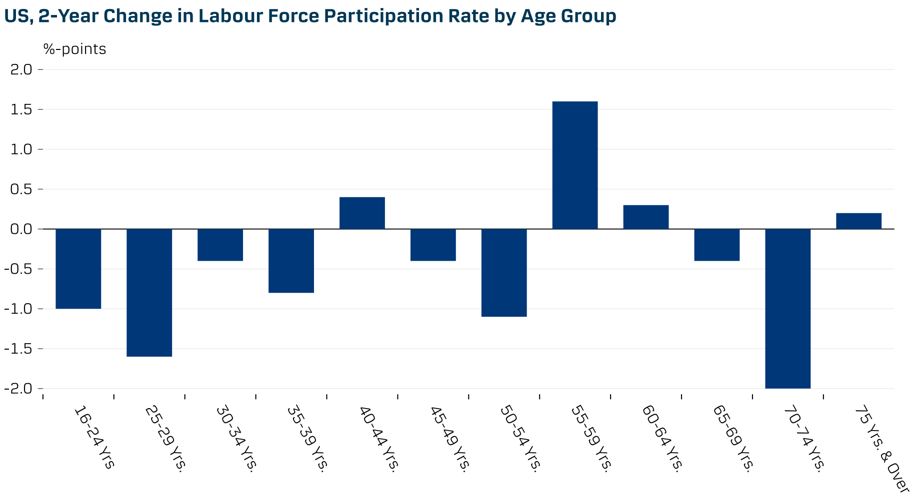
The recent decline in the US participation rate cannot be explained by a single driver alone. Rather, BLS's data suggests that several factors are at play simultaneously. We focus on three possible explanations: 1) a decline in net immigration, 2) a loss of entry-level job opportunities and 3) early retirements.

In absolute terms, the sharp decline in net immigration has been the single most important driver behind slowing breakeven employment growth. The number of illegal border crossings reported by the US Customs & Border Protection is down by more than 86% from three years ago. Foreign-born labour supply shrunk by more than 1.3 million over the three months leading up to July. **But while changes in net immigration inflow and deportations affect the size of the foreign-born population, its participation rate has not declined any more than that of native-born Americans**.

When looking at participation rates across different age groups, the decline seems to concentrate among younger workers below the age of 40 and elderly workers over the age of 70 (Chart 1).

Within the former group, the most pronounced decline in the participation rate has been seen among 25–29-year-olds. The BLS does not differentiate between foreign- and native-born participation within the more granular age groups, but when looking at ethnicities, the decline appears fairly even across Hispanic, Asian, African American and white workers. There are no material differences between changes in male and female participation rates either.

Chart 1. Decline in the participation rate appears concentrated on those aged below 40, and those aged above 70



Source: Macrobond, U. S. Bureau of Labor Statistics, Danske Bank

Key views

- **Macro:** Cyclical outlook remains healthy, even if stagnant labour supply growth weighs on real growth. GDP +2.0% in 2026, close to consensus of +2.2%.
- **The Fed:** 25bp hikes in December and March. Rates held at 4.00-4.25% for the rest of 2027 (above market pricing).
- **EUR/USD:** Relative macro and monetary policy outlook push EUR/USD lower towards 1.12 on a 12M horizon. Below consensus (1.18) and forward (1.17).
- **10Y UST:** 5.00% in 12M (above forward at 4.91%).

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Instead of ethnicity or immigration status, the decline could be linked to a perceived weakening of entry-level employment opportunities. In consumer confidence surveys conducted by the Conference Board, NY Fed and University of Michigan, younger respondents are consistently less optimistic about future employment prospects than others.

And while overall the unemployment rate has decreased this year, both average and median durations of unemployment have increased (Chart 2). This suggests that even if the overall labour market balance is tighter than before, there could still be certain demographic groups that are facing growing difficulties in finding new jobs. Supporting this, BLS's labour force flow data shows that **a rising number of unemployed job seekers are leaving the labour force instead of finding employment.**

It is still difficult to say to what extent AI is behind the current labour market trends, but it could be contributing to mismatches between labour demand and supply. In the latest Challenger Report, 33% of all reported layoffs were explained by AI.

Within the older (+70-year) age groups, the participation rate has declined the most among ethnic white workers. Until the pandemic begun, old-age participation rates generally trended higher, but since then, the direction has reversed (Chart 3). One possible explanation is that perceived weakness in labour market conditions combined with past years' strong capital gains on retirement savings have pushed a growing number of Americans to retire earlier than they otherwise would have.

Implications: monetary headaches & fiscal headwinds

A sudden loss of labour supply that goes beyond the expected extent of the immigration slowdown is both a downside risk to real growth and an upside risk to inflation. On the one hand, stagnant employment growth mechanically slows wage sum growth, which weighs on private consumption unless compensated for by a lower household savings rate. On the other hand, rising supply constraints can also lift workers' bargaining power leading to faster growth in wages, and ultimately inflation.

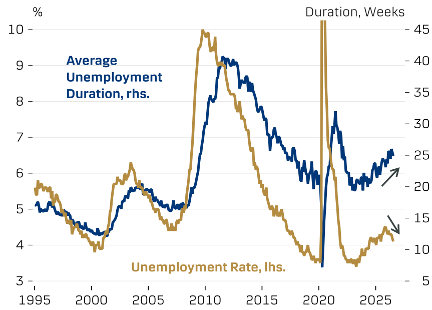
Importantly, the former effect can be seen faster than the latter and could already help explain the weak July retail sales figures from last week. We expect the Fed to remain on hold during the autumn meetings but still hike rates later on in December and March.

The lower participation rate could also become a headwind for US public finances and debt sustainability. During the 2010s, economists lauded the big positive gap between real GDP growth and real interest rates and the resulting fiscal space it created for policymakers. But the windfall gain has disappeared in recent years, as GDP growth now matches the real interest rate derived from the TIPS market (Chart 4).

The main reason for this change is the rise in the real interest rate, which used to be close to zero and now hovers above 2%. If growth starts to slow because the US has reached its limit on how much it can grow employment, and productivity does not offset this effect, then the sign on this equation might turn negative. This would accelerate the rise in the US debt-to-GDP ratio, which is already growing rapidly because of the large deficits. Ultimately, this would create upward pressure on inflation expectations, actual inflation and downward pressure on the USD.

Chart 2: Fewer unemployed job seekers, but longer periods of unemployment

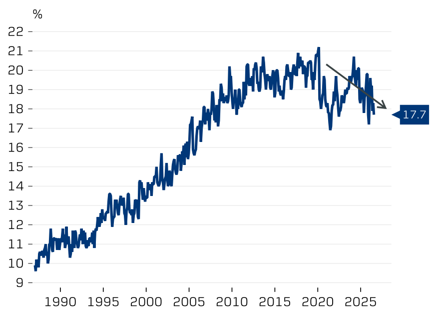
US, Unemployment Rate vs. Average Duration



Sources: Macrobond, U. S. BLS, Danske Bank

Chart 3: Trend in old-age participation rate has turned lower

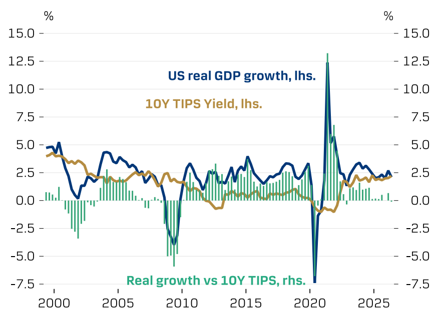
US, Participation Rate, 70-74y Ethnic White Workers



Sources: Macrobond, U. S. BLS, Danske Bank

Chart 4: Real interest rate on US public debt now matches the real growth rate of the economy

US, Real GDP Growth vs. Real Interest Costs



Sources: Macrobond, The Fed, U.S. BEA, Danske Bank

Note: Past performance is not a reliable indicator of current or future results.

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