

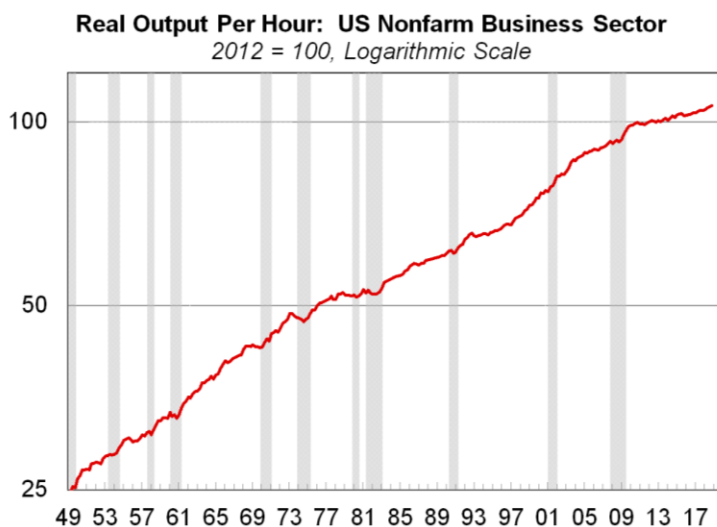
Current Economic Conditions

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PRODUCTIVITY IS PARAMOUNT

In the fourth quarter of 2018, output per hour worked in the nonfarm business sector, the most commonly used measure of U.S. labor productivity, rose at a 1.9% annual rate. Year-over-year growth rose to 1.8%, the highest since 2015. Since the first quarter of 2017, productivity has grown at a 1.5% annual rate, significantly faster than the 0.6% growth rate that prevailed from the fourth quarter of 2010 to the first quarter of 2017. Only once before, during the 1979-1983 period, had productivity growth been so weak for so long, and that period included two oil price shocks, two recessions, and the highest inflation rates since World War II. Productivity growth has clearly accelerated. Whether that acceleration is a temporary blip, a permanent upshift, or an intermediate step towards even faster productivity growth will determine how fast the U.S. economy can grow and whether tight labor markets and rising wages will lead to higher living standards for most Americans or higher inflation, higher interest rates, and the end of the current economic expansion. No measure of economic performance is more important than productivity growth.

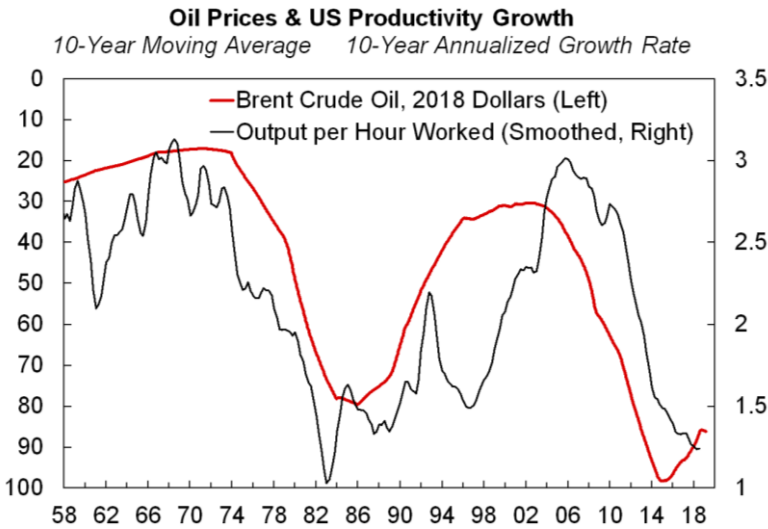


Economic growth can be decomposed into growth in labor input and growth in productivity. Growth in labor input is affected by the average workweek, the unemployment rate, and the labor force participation rate, but is ultimately limited by growth in the adult population. In the 1970s, the U.S. adult population grew by more than 2% per year. Currently, the adult population is growing about 1% per year, but this measure is misleading because it includes many people who have reached retirement age. The “prime-age” population, ages 25-54, is growing at less than 0.5% per year. Americans already work longer hours than workers in other developed countries, so it’s unlikely that we can increase labor input much by increasing the average workweek. The unemployment rate is already well below the level commonly regarded as full employment, so it’s unlikely that we can increase labor input much through further declines in the unemployment rate. The labor force participation rate could continue to edge up as formerly discouraged workers reenter the labor force, but with baby boomers continuing to retire, it’s unlikely that we can increase labor input very much by increasing the labor force participation rate. With all options for increasing labor input (other than increased immigration) so limited, economic growth will depend overwhelmingly on productivity growth. Without a significant further acceleration in productivity growth, the U.S. economy will have a hard time sustaining growth in real Gross Domestic Product above 2%.

My forecast for long-term growth is significantly higher than the Congressional Budget Office’s 1.9% estimate for potential GDP growth from 2017 to 2029. That’s because I view the slow productivity growth of the 2010-2017 period as the great aberration, not the new normal. Productivity growth was suppressed over that period by a combination of lingering damage from the financial crisis (Democrat story), bad regulatory and tax policies (Republican story), and oil prices that exceeded \$100/barrel almost

continuously from February 2011 through August 2014 (my story, and I'm sticking to it). With the financial crisis now a decade behind us, taxes cut and regulations eliminated, and oil prices down by about \$50/barrel, you should expect productivity growth to rebound towards historical norms, regardless of your political leanings and the relative weights you place on these three factors.

CBO, apparently influenced by the slow growth of the 2010-2017 period, expects productivity to grow at a 1.8% annual rate from 2017 to 2029. They expect hours worked to grow at a 0.5% rate (with much of that growth in 2018 and 2019), yielding growth in nonfarm business output of 2.3%. Because the farm and government sectors tend to grow more slowly than the nonfarm business sector, this is consistent with potential real GDP growth of about 1.9%. But from the first quarter of 1951 to the fourth quarter of



2010, productivity grew at a 2.2% annual rate. Boosting productivity growth from the CBO's forecast to this historical trend would boost GDP growth to about 2.3%. But productivity could grow faster than its long-term trend for an extended period, especially after a period of slow growth. Productivity grew at a 2.7% rate from 1951 to 1973, and lest you think such growth rates are a relic of the ancient past, productivity grew at a 2.8% rate from the first quarter of 1997 to the fourth quarter of 2010. Boosting productivity growth to 2.8% could get GDP growth close to the Trump Administration's 3% forecast. Getting all the way to 3% would require either more immigration or near-record productivity growth.

The other reason productivity growth is so important is that it will determine whether accelerating wage growth, the likely result of today's tight labor markets, will translate into higher living standards or into higher inflation and the eventual end of the expansion. If labor costs accelerate but productivity growth doesn't, growth in unit labor costs (labor costs per unit of output) will rise. The result will be some combination of higher inflation, which hurts consumers, and lower profit margins, which reduce business income and investment. The gains to workers come at the expense of consumers and business owners; rising wages just change how the economic pie is divided. But if the acceleration in labor costs is matched by an acceleration in productivity growth, gains to workers do not come at the expense of consumers and business owners; productivity growth increases the size of the economic pie. Strong increases in average hourly earnings, part of the monthly employment report from the Bureau of Labor Statistics, often prompt an increase in interest rates and a decline in stock prices because market participants believe that higher wages mean higher inflation. Accelerating wage growth without accelerating productivity is indeed a bad thing because it boosts inflation, which will force the Federal Reserve to raise interest rates and ultimately end the expansion. But since most people get most of their income from wages and salaries, accelerating wage growth supported by accelerating productivity is the single best thing that can happen to an economy.

While productivity can be improved by better education and training and better management, the greatest source of productivity growth is a growing capital stock and the technological change embedded in new equipment and software. If businesses don't respond to fading fears of a financial crisis, better tax and regulatory policies, and lower oil prices by boosting investment in plant, equipment, and software, productivity growth will continue to languish. It's too early to know whether tax reform will permanently boost investment spending. It's also too early to determine whether the recent acceleration in productivity will fade, continue, or strengthen. You usually don't get the investment needed to boost productivity growth until businesses begin to run out of capacity and labor becomes scarce. Consequently, you usually don't get an acceleration in productivity growth until you need one. We're at that point now.