The Unsettling Mystery of Productivity

Since 2010 U.S. productivity has grown at a miserable rate. And no one, not even the Fed, seems to understand why.

By ALAN S. BLINDER
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A cottage industry on Wall Street tries to forecast the Federal Reserve’s policy decisions. The Fed, in turn, bases its policy on how it thinks the economy will perform. The cottage industry, of course, knows that; so it is constantly engaged in forecasting the economy.

Attention nowadays is focused on the degree of slack in the U.S. labor market. The financial news is full of stories about payroll employment, the unemployment rate, labor-force participation rates, quits, initial claims for unemployment insurance, and the like. Fed staffers devote thousands of hours to combing the data for hints about how tight or loose the labor market is or might become. Investors devote millions of hours to divining what Fed Chair Janet Yellen and her colleagues think about these matters.

Meanwhile, another variable that is just as important to the forecast is being almost completely ignored. I refer to labor productivity.

Just as important? Yes, because the Fed wants to forecast the so-called GDP gap—that is, the difference between actual and potential gross domestic product. Potential GDP, in turn, depends on the number of hours of work the economy would have at full employment, which is what all the fuss is about. But it also
depends on the future track of output per hour of work (labor productivity). The Fed and the markets could err in forecasting potential GDP either by getting the availability of labor wrong or by getting productivity wrong.

Yet oddly, while enormous amounts of research, energy and chatter are poured into analyzing and forecasting the labor market, hardly anyone is talking about productivity—though that may be the greater source of uncertainty.

The nearby chart displays average annual growth rates of output per hour in the U.S. over five historical periods. The left-most bar summarizes the entire available history: Over 143 years, the U.S. has averaged about 2.3% annual gains in productivity. (If you’re counting, that raised living standards more than 25-fold.) Moving rightward, we encounter the Golden Age of productivity growth, the quarter-century following demobilization from World War II, during which the U.S. averaged 2.8% per annum—probably our best performance ever for a sustained period.

Then, quite surprisingly and still somewhat mysteriously, productivity growth plummeted in the years 1973-95. The 1.4% annual average shown in the middle bar was the worst in recent history. Fortunately, we were surprised again—this time, pleasantly—when, in the 15 years starting in 1995, productivity growth leapt back up to a rate almost as high as during the Golden Age.

You have probably noticed the puny bar at the far right, which covers only three years. That is far too short a time period to draw any conclusions. (Adding 2014, which is not over yet, will not change the picture.) But so far in this decade, productivity has grown at only half its rate during the productivity slowdown period—our previous standard of poor performance.

No one should mechanically extrapolate the recent miserable performance into the future. There is no statistical basis for doing so. My point is that, as we look out one to three years into the future—the time frame most relevant for the Fed—no one has the slightest idea how fast productivity will grow.

Over the next decade or so, we can be reasonably confident that, within a small margin of error, potential GDP will advance roughly 0.2 points faster than nonfarm labor productivity (the variable shown in the chart). So if the U.S. reverts to its 2.3% historical average, potential GDP will grow about 2.5% per annum. That could happen. But if productivity crawls along at just 0.7% a year instead, potential GDP will grow less than 1% a year. Now that’s a large potential forecasting error!
By comparison, the current debate between hawks and doves features arguments over small beer. For example, the “central tendencies” in the Federal Open Market Committee’s latest published forecasts range from 5.2% to 5.5% for the “full-employment” unemployment rate, and from 2% to 2.3% for the potential GDP trend.

In sum, here’s what we know—and do not know—about productivity growth. First, it’s been dismal for the past four years. Second, economists cannot predict swings in productivity growth. Each sharp swing shown in the chart took us by surprise. Third, while the Fed is now forecasting something near 2% productivity growth over the next several years, it really has little basis for choosing that number. That’s not a criticism; no one else has a better basis for a different number. We are all in the dark.

So maybe some of the copious attention now being devoted to assessing labor-market slack should be redeployed to studying productivity growth. It might be more productive.

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