Not Dead Yet: Productivity is Looking Mid-Cycle

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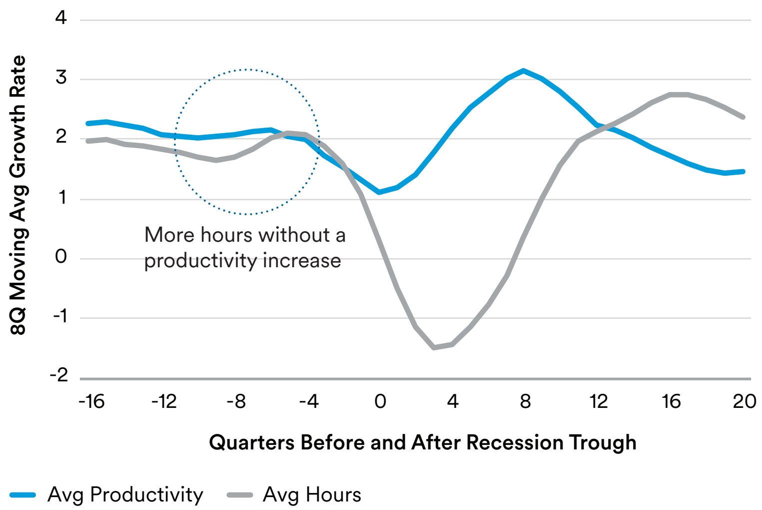
U.S. labor productivity growth has been increasing over the last several quarters. This is strange late cycle behavior; improvements in productivity usually happen during the recovery phase of a business cycle. We see this as a sign that the business cycle has some life left to it, and a recession may not begin until after 2020.

In a normal cycle, productivity plateaus at the end of a cycle when unemployment is low. Why?

First, declining unemployment rates mean that the less productive workers are entering the workforce. Generally, the most productive unemployed workers get snapped up first; at very low unemployment rates, employers are simply scrambling for bodies to keep business expansion going.

Second, if the economy is running close to or above potential output, those last workers tend to get added to capital investment that is already overcrowded. Think of a coffee shop that adds a worker but doesn't add cash registers or espresso makers. The additional worker, once a location is at or close to capacity, will be less productive than workers hired before her.

Figure 1 | More Labor Hours, Flat Productivity in Late Cycle



Source: BLS, NBER, Haver Cycle averages from 1961

At the tail end of a business cycle, we usually see productivity plateauing as the above dynamics start to take effect, and then begin to drop.

By contrast, right now we are in a situation where the medium-run productivity indicator (a two year moving average) has been accelerating over the past five quarters. Q4 productivity growth came in at 1.8%, which is the second highest reading since the post-crisis recovery period of 2009-2010.

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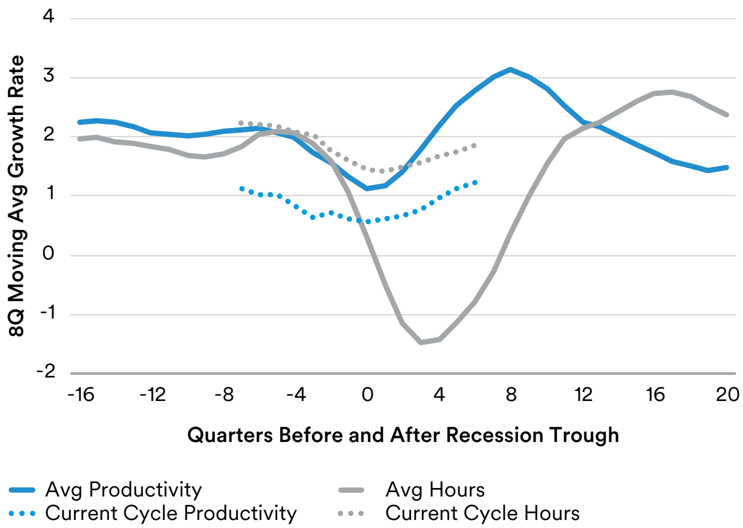
But why is productivity growth increasing now? The accounting answer is that output is increasing at a faster rate than hours worked. Even though workers are being added at a rapid clip, output is growing even faster.

A more nuanced reason could be that we may not be at the bottom of the labor barrel the way we usually are at these low rates of unemployment. The marginal worker—that most recent hire—may be more productive than the usual worker being hired at the end of a business cycle because there appears to be more labor market slack hiding in the low labor force participation rate. A related reason could be that the so-called corporate recession in 2015— and potentially the 2018 tax cuts—led to a subsequent upswing in investment. Marginal workers are now still adding productivity since they are paired up with more capital investment.

Figure 2 | Current Cycle Appears to be in Recovery



Source: BLS, NBER, Haver Cycle averages from 1961. Current cycle data from Q3 2015 to Q4 2018.

In short, the current productivity story looks closer to the type of story we might see during a recovery, not a story we would see heading into a recession. We see the business cycle continuing for some time yet as it rides this positive dynamic.

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