US Macroeconomics

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The Productivity / Real Rate Paradox

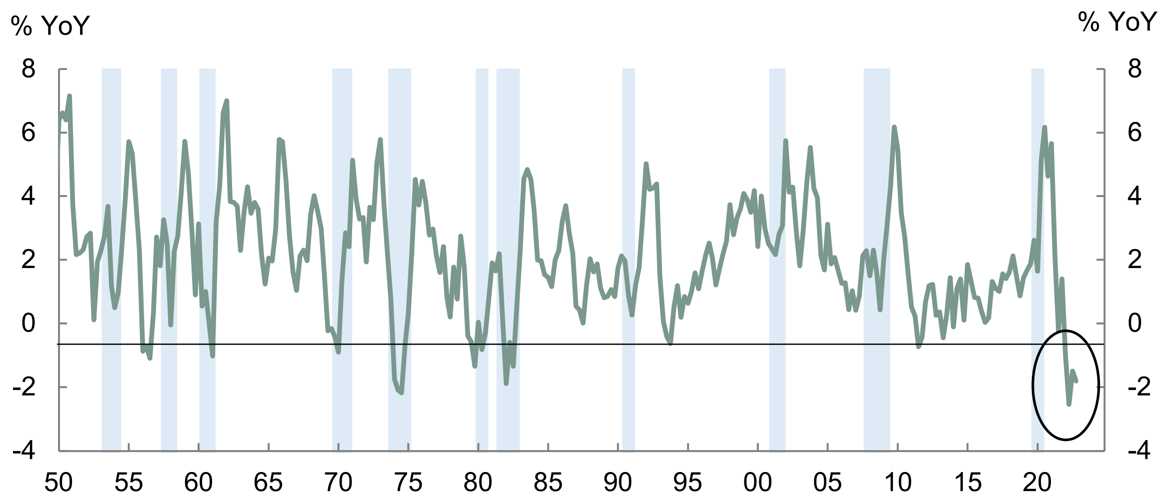
From 2017 to 2019 quarterly real GDP grew at a 2.6% annualized rate. During the same time, nonfarm productivity expanded at a 1.6% annualized rate. The government-imposed lockdown led to an historically deep but short recession. The V-shaped recovery which began in May 2020 continued into 2021 when the government provided an unnecessary $2 trillion splurge of fiscal stimulus. The economy grew 5.7% in 2021 on Q4 over Q4 basis. But growth since then has sputtered.

Over the last five quarters, real GDP grew at a meager 0.9% annualized pace. While we do not yet have data on Q1 productivity — those figures are released this Thursday — the past four quarters have been atrocious. Over the last year, nonfarm productivity is down 1.8% which is one of its worst four quarter performances on record as illustrated in the chart below. The only other business cycles which experienced worse readings were the four quarters ending Q1 1974, Q2 1974, Q3 1974, and Q1 1982. Why does this matter?

It matters for many reasons, the most important of which is that **productivity gains are the ultimate determinant of improved living standards**. While we expect productivity to eventually start expanding again, if its underlying trend is weak then so too will be household real incomes. Hopefully, a cyclical upswing in productivity is in the offing. But in the short- to intermediate-term, weak trend productivity growth also implies a lower real equilibrium interest rate all else being equal. Today, the relationship between productivity and rates is askew.

Either productivity growth is too low, or today's level of real interest rates is too high. This paradox is essentially captured in the current inversion of the treasury yield curve. At least one of two developments need to occur to rectify this unstable situation. One, the economy enters and exits a recession which then leads to a surge in productivity, as the chart clearly demonstrates. Two, the Fed needs to lower interest rates. If the economy goes into recession, then the Fed no doubt will lower interest rates and probably by a lot. But even until this happens, it is still difficult for us to see how the yield on the 10-year treasury note can go meaningfully higher from today's levels.

Nonfarm Productivity



Sources: BLS, NBER, Haver, SMBC Nikko

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