

## Is Productivity Growth Picking Up?

This week the Fed has its first meeting under new Chair Kevin Warsh. For only the third time in US history, the former Chair, Jerome Powell, will still participate as a regular member of the Board of Governors.

While many will frame this meeting as a battle between two people, the data are not clear enough to argue for either a rate hike or a rate cut, no matter who is in charge. The economy and jobs continue to grow, and while many think they see evidence of rising productivity, inflation has been higher than expected. We think this is because of the Iran conflict, but only time will tell. And with a peace agreement in place, we will find out soon.

One change that Warsh is likely to push for is an end to “forward guidance.” He has spoken out against this practice, where the Fed tries to guide markets about the future path of short-term rates. Most members would not find this particularly controversial and would likely support it.

Other possible changes could be to the “dot plots” and economic forecasts – updated versions of which the Fed is supposed to deliver on Wednesday – or the schedule of how frequently the Fed holds post-meeting press conferences. Changes to the regional bank structure and a move to reduce abundant reserves will take much more time.

But, lurking in the background of all this – and what could determine the eventual path of monetary policy – is a debate about productivity. Warsh has said we could be on the verge of an AI-led acceleration in productivity growth. If so, inflation might be tamed more easily than expected in the next couple of years.

Typically, the Fed would view faster “real” (inflation-adjusted) economic growth as a signal that monetary policy is easy and rate hikes might be warranted. But if the economy is being lifted by faster productivity growth, then the Fed can let the economy run, and may even want to cut rates because productivity would hold inflation down.

We present data here with the full understanding that productivity (output per hours worked) is very hard to measure. This is especially

true when net immigration has come to a virtual standstill and government employment has fallen at historically fast rates. In other words, the economy has continued to grow while the labor force and employment have slowed.

The result is a rise in measured productivity growth. In the past three years, official productivity has climbed at a 2.7% annual rate in the nonfarm business sector, compared to an average of 1.8% since the mid-1970s.

Three years is not a very long period of time, but since the pre-COVID peak in the business cycle in 2019, productivity is up at a 2.1% annual rate versus a slower 1.5% pace in the twelve-year business cycle that ended right before COVID (from the last quarter of 2007 through the last quarter of 2019).

Overall real GDP is up 2.6% in the past year. And this happened with an increase in the unemployment rate. The way the Fed looks at the economy, “potential” growth is the rate at which the economy can expand without causing it to overheat. So, if the unemployment rate is rising, it signals that monetary policy might be too tight. In other words, using typical Fed models, it would have taken an even faster economic growth rate to keep the unemployment rate stable. In turn, this suggests the “growth potential” of the economy has improved.

However, there are also reasons to be skeptical about the theory that productivity growth has accelerated. For one thing, the size of the federal government relative to GDP has grown substantially since 2008.

Another is that while AI has been incorporated in various technologies for years its wide use is relatively new. Most importantly, excluding the massive investment in data centers, GDP growth has been very slow. This is reminiscent of the late 1990s boom in dot.com technology.

In other words, there is some evidence of higher productivity, but it is way too early to declare this a real fact. For now, the Fed is on hold, new Chairman or not.

| Date/Time (CST) | U.S. Economic Data            | Consensus | First Trust      | Actual       | Previous  |
|-----------------|-------------------------------|-----------|------------------|--------------|-----------|
| 6-15 / 7:30 am  | Empire State Mfg Survey – Jun | 13.7      | <b>6.9</b>       | <b>5.7</b>   | 19.6      |
| 8:15 am         | Industrial Production – May   | +0.3%     | <b>+0.3%</b>     | <b>+0.7%</b> | +0.9%     |
| 8:15 am         | Capacity Utilization – May    | 76.2%     | <b>76.3%</b>     | <b>76.2%</b> | 76.1%     |
| 6-16 / 7:30 am  | Housing Starts – May          | 1.430 Mil | <b>1.417 Mil</b> |              | 1.465 Mil |
| 7:30 am         | Import Prices – May           | +1.0%     | <b>+0.1%</b>     |              | +1.9%     |
| 7:30 am         | Export Prices – May           | +0.6%     | <b>+0.1%</b>     |              | +3.3%     |
| 6-17 / 7:30 am  | Retail Sales – May            | +0.5%     | <b>+0.6%</b>     |              | +0.5%     |
| 7:30 am         | Retail Sales Ex-Auto – May    | +0.6%     | <b>+0.7%</b>     |              | +0.7%     |
| 9:00 am         | Business Inventories – Apr    | +0.5%     | <b>+0.5%</b>     |              | +0.9%     |
| 6-18 / 7:30 am  | Initial Claims – Jun 13       | 225K      | <b>224K</b>      |              | 229K      |
| 7:30 am         | Philly Fed Survey – Jun       | 10.0      | <b>10.8</b>      |              | -0.4      |