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Productivity: Fact and Fancy

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We take a back seat to no one as believers in the productivity miracle of the late 1990s. The empirical record is overwhelming that a technological revolution fueled by the ready availability of low-cost risk capital – itself the consequence of major changes in the tax and monetary setting – bore fruit in a remarkable jump in the trend rate of productivity growth. The leap in reported non-farm output per hour, from an average of about 1.5% in the 20+ years through 1995 to nearly 2.5% in the last half of the decade, also left in tatters the dour consensus estimates of growth "potential." Even Fed Gov. Larry Meyer, the quintessential Phillips Curver whose long-standing growth "ceiling" was no higher than 2.25%, could no longer deny that non-inflationary expansion was consistent with a growth rate above 3%.

That was then. Sure, a revival of those robust conditions would certainly be plausible in an environment of restored risk preference after removal of current lingering impediments to capital formation. But it would seem a clear-cut case of denial to suggest that present circumstances, which lack only for the official imprint of "recession," bear any fundamental resemblance to those boom years, especially in a downturn being led by an outright collapse in high-tech capital goods investment. Yet, yesterday's release of the third quarter productivity report, which purported to show a 2.7% annualized gain in non-farm output per hour, became the occasion for just such a widespread misreading of reality. Representative of such opinion, former Clinton Administration economic adviser Martin Baily is quoted in today's *Wall Street Journal* enthusing, "It was pretty astounding…. If you look over the last five quarters, they suggest the underlying trend of productivity growth is still pretty good." Elsewhere, we had the likes of Ian Shepherdson of High Frequency Economics suggesting that the "productivity cycle may now be turning up."

One can only assume that the reasoning behind such assertions was unburdened by a review of relevant data. Such a review, in fact, strongly suggests that yesterday's reported 2.7% gain was a statistical quirk. As a measure of output per hour worked, reported productivity gains can result from output rising faster than hours worked, which is what we would expect to see in a healthy expansionary phase. As a matter of simple mathematics, however, growth in the productivity measure can also be a byproduct of both hours worked and output falling, as long as hours are declining faster. That is the situation depicted by yesterday's report, which obviously offers little cause for celebration. In fact, the 3.6% decline in hours during the third quarter was the sharpest since first quarter 1991, during the last recession. The 1% decline in output, meanwhile, was the largest since first quarter '93.

It's possible that so-called expert opinion was thrown off because the normal pattern is for employers to attempt to hold on to workers in the early stages of recession, forcing productivity lower. The third quarter reading would have been significantly different, for example, had the labor force conformed to the experience of the 1990-91 recession, when hours worked fell by only 1.2% in the first quarter of the downturn. Why the departure from past patterns? It appears the explanation is rooted in large measure in the sharp labor market tightening of the late 1990s and 2000. That's when a growing scarcity of labor relative to capital drew an increasing share of the pool of "marginal" labor into the active workforce for the first time. As a proxy for that phenomenon, the black unemployment rate fell from nearly11% in early 1997 to 7.2% -- a

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record low – in the third quarter of last year. Now, it seems clear, we're seeing a rapid unwinding of that labor-market tightening, with the marginal, most-recently-hired-worker taking the brunt as payrolls are pared back. Black unemployment has risen from 7.5% to 9.7% just since February. It should be obvious in any case that if the underlying condition supporting a statistical productivity improvement is a forced decline in the workforce, it means little in terms of progress in overall prosperity.

No doubt, the high-tech, high-productivity, information economy still has its best days in store. Adoption and refinement of such fundamental technological advances tend to be long-run phenomena that recovery quickly from cyclical setbacks once a risk-friendly environment favoring the quest for the extra margin of innovation and wealth creation potential is restored. Make no mistake, though, that is not the setting in which we currently find ourselves, no matter the rampant misinterpretation of misleading government data.