Productivity growth (the increase in nonfarm business output per hour of work) has been a key factor in the strength and duration of the current economic expansion. Without last year's productivity growth, output would have expanded only 1.4%. One surprising feature of this expansion is that productivity growth has accelerated as the expansion has extended. More typically, after an initial growth spurt associated with recovery from a recession, productivity gains vary around a steady trend.

Long-run economic projections rely on an assumed average rate of productivity growth, plus an estimate of growth in the working-age population. From the post-World War II period until the oil shock and ensuing recession of 1974, average U.S. productivity growth exceeded 2¾%, yielding GDP growth of about 4% per year. After 1974, productivity growth was much slower (just over 1%), although it took several years to recognize the decline. Some commentators have suggested that the productivity growth increase of the last four years is the beginning of what will eventually be recognized as another, much higher, long-run average.

While it is risky to declare a new long-run average rate of productivity growth based on four years of data, this has certainly been an unusual (continued on next page)
Productivity Growth (cont.)

A series of gains. Since 1995, the average annual productivity gain has been 2.9%; moreover, the rate of growth has unexpectedly accelerated, as noted earlier. What has supported this unusual pattern of productivity growth? Output growth in the nonfarm business sector has been fairly steady throughout this expansion, although some of the largest gains occurred in the last four years. Arithmetically speaking, a more significant factor in the recent spurt of productivity growth has been a slower increase in hours of work (up only 1.7% last year).

The pattern of vigorous productivity growth appears in manufacturing too during this expansion, but earlier and more strongly. Manufacturing productivity reveals not a slowdown but an increase following the 1974 oil shock—as long as the 1990s are included in the period. From 1974 to the present, gains have averaged 3%, compared to 2.6% before 1974. If we had made this comparison in 1989, however, we would have concluded that productivity growth slowed slightly, averaging just 2.4% from 1974 to 1989. The current acceleration in productivity growth was certainly underway among manufacturers in 1995. As in the economy as a whole, these gains primarily reflect fewer hours of work generating more stable gains in output. Manufacturing work hours have declined about (continued on next page)
½ percentage point annually over the last five years. Outsourcing and the use of temporary employment agencies, both of which depress measured employment growth, have been important factors but probably explain less than 1 percentage point of manufacturers’ healthy productivity gains. To the extent that tangible products are easier to count than services, manufacturing gains may be a better indicator of the real rate of overall progress.

Productivity growth also offers the possibility of compensation gains. Indeed, compensation per hour in nonfarm businesses has risen strongly in the last four years, averaging more than 4.2% annually. This is all the more remarkable given the decline in inflation throughout most of this period. Net of inflation, the years since 1995 have yielded employees 8.6% more real compensation. The same pattern of compensation gains holds for manufacturers as well. Despite compensation increases, productivity growth is holding down employers’ costs of producing output. Unit labor costs among nonfarm businesses are up an average of only 1.4% annually over the recent productivity boom. Manufacturing unit costs are down 1.4% on average over the last five years. Once again, these figures must be compared to the inflation rate. The slight overall increase in unit labor costs and the declines in the manufacturing sector reveal no signs of any wage-push inflation.