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If Productivity Rebound is Done, Fed is Done

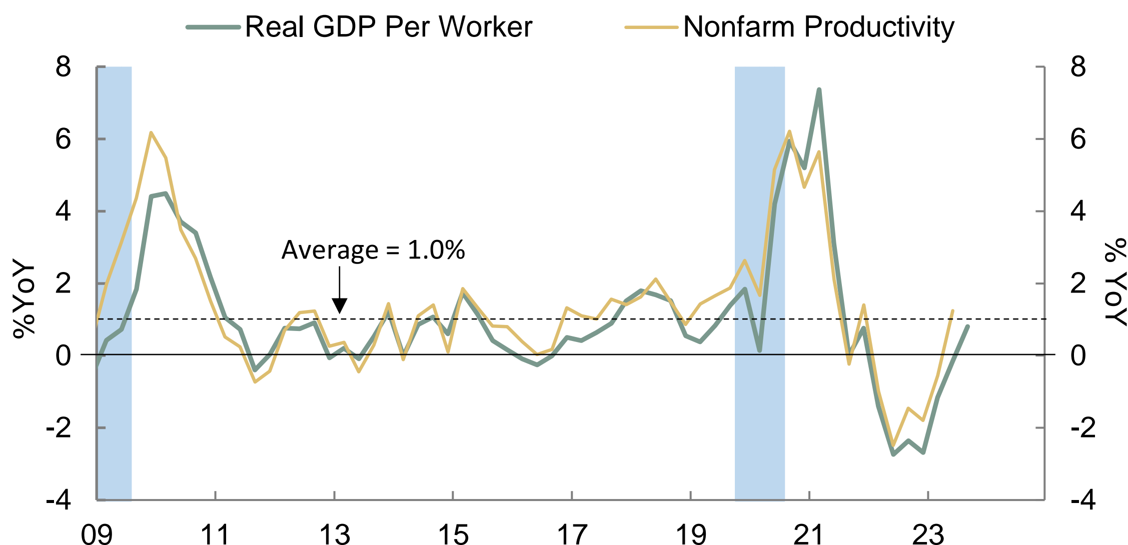
The Q3 productivity data is not yet available, but we can make a good guess on what output per hour did last quarter based on the data we already have. This is important because underlying productivity is the key input into underlying trend GDP growth which is necessary for properly estimating R-star, or the natural rate of interest.

While R-star is highly uncertain and not directly observable, it is an important factor in determining the broad stance of monetary policy. Fed policymakers use it as a guidepost for action, and Chair Powell will likely be asked about R-star in tomorrow's post-meeting press conference. If the fed funds rate is below R-star, monetary policy is accommodative. But if the funds rate is above R-star, and we believe it is well above R-star, monetary policy is restrictive.

Nevertheless, with real GDP rebounding, some investors are wondering whether the Fed needs to hike again or push out the timing of interest rate cuts. We believe this would be a mistake because underlying productivity growth is still weak. This means that trend growth is still weak, which means the natural rate of interest is still low, or at least on the lower range of economists' estimates. We project that R-star is between 2% and 2.5%.

As we can see in the chart below, **the growth in the ratio of real GDP to nonfarm payrolls is nearly identical to the growth in productivity**. Our productivity-proxy grew 3.1% last quarter after declining 1.8% at an annualized rate over the previous six quarters. But it is up less than 1% over the past year. Essentially, productivity has rebounded near its post-financial crisis average of 1%, after unusually large declines associated with pandemic-related distortions. But the productivity rebound may have run its course.

Current quarter real GDP growth is projected to slow markedly while job gains persist. This means that productivity should weaken noticeably, thus capping further year-over-year gains. Going forward, if trend economic growth remains in line with its 2010 to 2019 rate, then today's 5.5% fed funds rate is plenty restrictive. We hope monetary policymakers take note.



Sources: BEA, BLS, Haver, SMBC Nikko

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