ECONOMIC VIEWPOINT

A New US Economy?

By Francis Généreux, Principal Economist

The US economy has been surprisingly resilient in the face of high interest rates and numerous other headwinds. At the same time, fresh projections from the Congressional Budget Office suggest potential GDP growth could be higher than previously forecast. And those numbers don't take into account the recent increase in worker productivity. If the US continues to make solid productivity gains, it could mean faster potential GDP growth and slower inflation.

One of the major themes so far in 2024 has been the surprising resilience of the US economy. Solid real GDP growth in the second half of 2023, improving consumer confidence in recent months, an uptick in some business activity indicators, and a robust job market south of the border in January all argue against an imminent recession. So is the US economy completely immune to a downturn? Not by any stretch. Interest rates remain elevated, excess savings are dwindling and disruptions in the Red Sea are jeopardizing the disinflation process. Retail sales, manufacturing output and housing starts were all weak in January. While the weather was likely to blame, these numbers are a reminder we still need to be cautious—especially as the latest inflation data came in stronger than expected. Yet until we get evidence to the contrary, we still expect healthy US economic growth in Q1 2024.

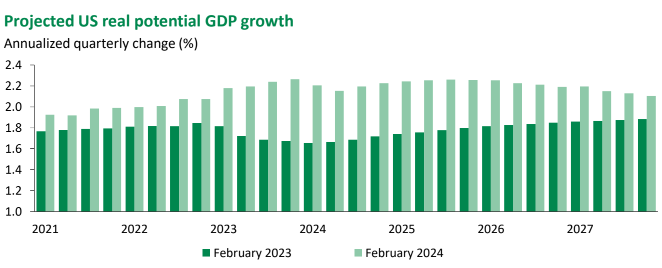
But the good news about US economic resilience doesn't end there. Not only is the economy strong, estimates of US real potential GDP growth have improved. When the Congressional Budget Office[1] (CBO) released its latest Budget and Economic Outlook in early February, it raised its projection for potential GDP growth. Potential GDP is defined as the level of GDP the US economy can achieve without generating too much inflation. When actual GDP is higher than potential GDP, we have what's called a positive output gap. Economic activity exceeds production capacity, resulting in additional price pressures. Conversely, when potential GDP is higher than actual GDP, we have a negative output gap. In this case, production capacity is being underutilized, which tends to reduce inflationary pressures.

That said, since the pandemic, the output gap hasn't reflected actual inflationary pressures. Supply and demand disruptions have been too sudden and deep to be captured by an indicator like potential GDP, which relies more on long-term movements. But the potential GDP growth rate is still a useful measure of economic activity.

The fact that potential GDP growth was revised upward is striking, and it's a good sign for the US economy. The projected annual growth rate of real potential GDP for 2024 was raised from 1.7% in February 2023 to 2.2% in February 2024 (graph 1). This 0.5 percentage point increase is significant. It suggests we can expect the US economy to grow faster without fuelling inflation.

What's behind this upward revision? Potential GDP projections are based on two factors: labour force growth and productivity growth. The CBO's latest revision was due entirely to higher

Graph 1
Potential GDP Growth Was Revised Sharply Higher



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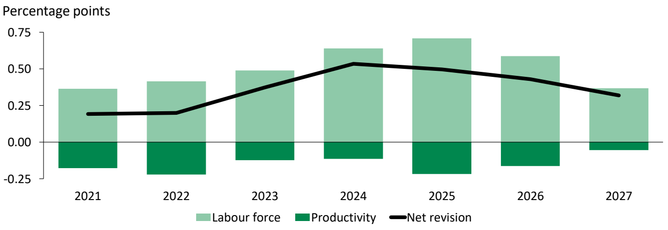
[1] The CBO is a nonpartisan agency of the US Congress that produces analysis of budgetary and economic issues to support the Congressional budget process.

labour force growth estimates (graph 2). The CBO is now expecting the labour force to grow 1.0% in 2024, much faster than its previous forecast of 0.4%. This upward revision was driven by the surge in net immigration that began in 2021 and, according to CBO estimates, peaked in 2023 and 2024 and will start to slow thereafter (graph 3). Increased immigration should offset the expected drop in the labour force participation rate (graph 4). Productivity was actually a slight negative contributor to the revised projection of real potential GDP growth. This is quite surprising given the changes that appear to be at work in the US economy.

Graph 2
Potential GDP Growth Was Revised Upward Exclusively on the Strength of Updated Labour Force Estimates
Contributions to revised US annual real potential GDP growth



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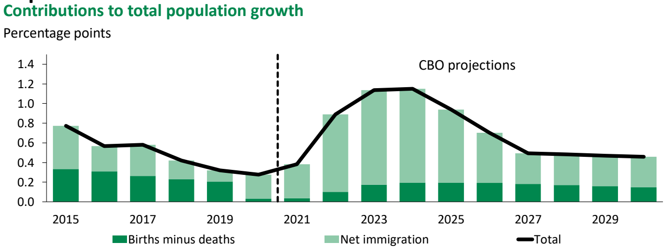
Graph 3
Increased Immigration Is a Major Driver behind Higher US Population Growth Estimates
Contributions to total population growth



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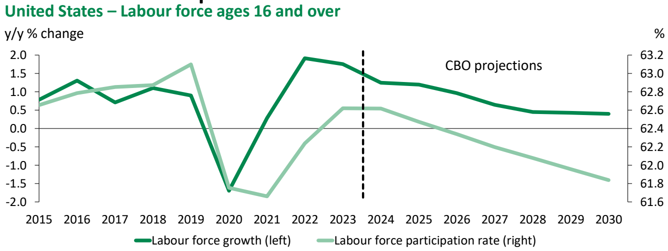
Graph 4
Labour Force Growth Should Hold Steady despite a Drop in the Labour Force Participation Rate
United States – Labour force ages 16 and over



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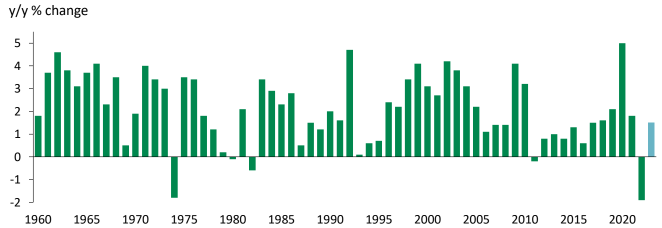
US Productivity Is Surging Again

The CBO is forecasting modest gains in US workers' potential productivity in 2024 and the ensuing two years. Between 2024 and 2026, the average gain is expected to be just 1.1%. That compares to a projected potential productivity gain of 1.4% for 2023. But could productivity surprise to the upside and prove the CBO wrong? It seems increasingly likely.

Productivity—defined as output per hour worked—surged in 2023 (graph 5), and recent productivity growth has hit levels not seen in nearly 20 years if we exclude the pandemic and recessions (graph 6). Productivity is already growing faster than the CBO projected (graph 7 on page 3). But can these gains continue? On the one hand, it's possible that 2023's gains were simply a rebound following 2022's declines. The pandemic created a lot of distortions in both total US output and the labour market. These distortions artificially inflated the productivity numbers early on in the pandemic, as output held up better than hours worked. But that didn't last. The slowdown and subsequent drop in productivity in 2021–2022 were exacerbated both by global supply chain disruptions, which slowed production, and by the labour shortage, which prompted businesses to hold on to their workers. The current uptick in productivity may just be the result of these movements. During his press conference following the January FOMC meeting, Fed Chair Jerome Powell seemed to suggest as much.

Graph 5
Worker Productivity Is Growing Again
United States – Business sector worker productivity



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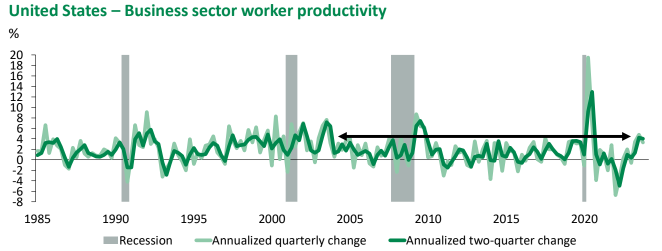
Graph 6
Productivity Growth Was Especially Strong in the Second Half of 2023
United States – Business sector worker productivity



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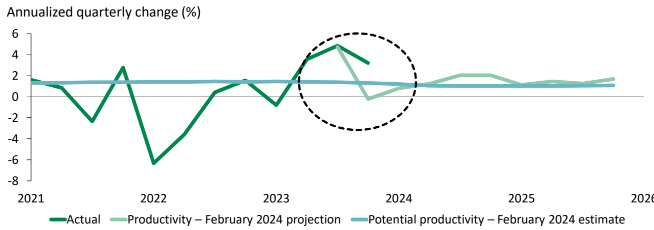
Graph 7
Productivity Is Growing Faster than the CBO Previously Projected

United States – Nonfarm business sector worker productivity



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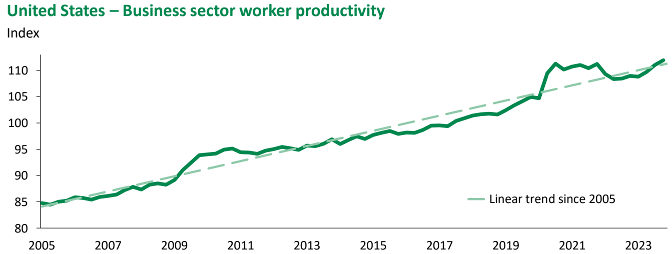
On the other hand, recent productivity growth seems like more than just a rebound, with levels surpassing early-pandemic highs in 2023 (graph 8). And there are signs this surge in productivity may have staying power. While US productivity data isn't very sector-specific, we know recent productivity growth hasn't come from durable goods manufacturing (graph 9). But that could soon change. Heavy investment in manufacturing thanks to various federal programs could boost worker productivity in the target industries (graph 10). Right now, it's mostly plant construction that's showing up in the data, but eventually output and productivity should pick up as well. The recent interest in artificial intelligence and cloud computing, along with the

Graph 8
US Workers Have Never Been More Productive

United States – Business sector worker productivity



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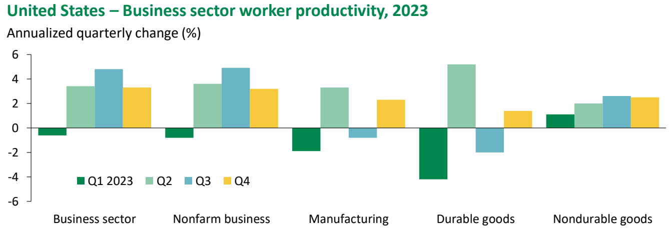
Graph 9
Productivity Hasn't Grown as Steadily in the Manufacturing Sector

United States – Business sector worker productivity, 2023



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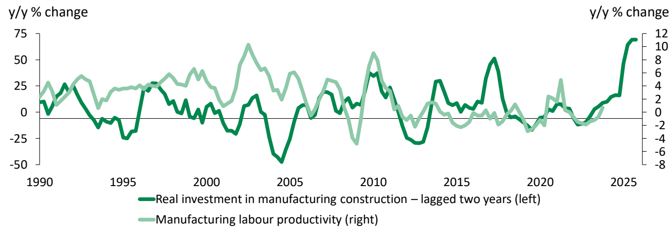
Graph 10
The Jump in Manufacturing Construction Could Boost Manufacturing Productivity

United States



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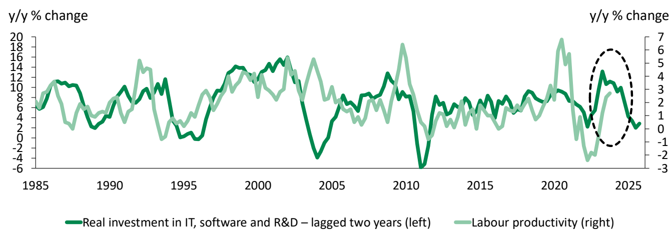
growing use of robots, online solutions and other information technology, could also bolster productivity. Increased investment in these areas in recent years already seems to be reflected in the relatively high productivity growth rate, though a pullback in investment in 2023 due to higher interest rates and uncertainty surrounding global growth could mean slower productivity gains later on (graph 11).

Graph 11
Increased Investment in IT, Software and R&D Seems to Have Helped US Productivity

United States



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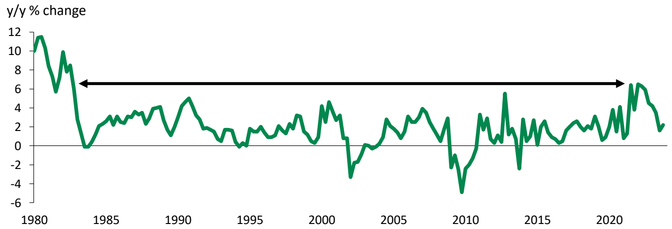
So there's reason to be cautiously optimistic about future productivity gains. If current productivity growth proves sustainable, it could mean higher potential productivity and real potential GDP growth. Solidifying recent gains would be valuable. It would mean the US economy could grow at a faster pace without generating additional inflationary pressures. It would also give the Fed more leeway in delivering on its dual mandate of maximum employment and stable inflation at a rate of 2%. With a strong economy and a tight labour market, higher productivity should theoretically mean slower inflation despite stronger wage pressures. That's because when productivity is high, businesses are better able to absorb wage increases without raising their prices or shrinking their profit margins. But when productivity is low as it was in 2021–2022, businesses don't have that cushion, so they tend to pass on those wage increases to customers. In 2021–2022, unit labour costs grew at their fastest rate since 1982 (graph 12 on page 4).

Graph 12
Unit Labour Costs Rose Sharply in 2021 and 2022, But Are Now Growing Slower
United States – Business sector unit labour costs



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There's a good chance the US will be able to build on its recent productivity gains. Increased investment—especially in the manufacturing sector—is cause for cautious optimism. Higher potential GDP driven by both solid labour force growth and improved worker productivity suggests the US economy can continue to expand briskly. It's already proven surprisingly resilient. But could the next few years be just as good, if not better? Other factors could cloud the economic picture, meaning the US economy isn't completely immune to a slowdown. The outcome of November's presidential election is just one unknown that will have major implications.