



FORMAT FOR
PRINTING
sponsored by



November 3, 2006

PAGE ONE

Pause Stirs Concern That Growth In Productivity May Be Flattening

By **MARK WHITEHOUSE** and **TIM AEPPEL**
November 3, 2006; Page A1

Productivity growth, a key driver of the nation's prosperity, stalled in the third quarter, raising questions about businesses' ability to continue squeezing more output from the same workers, a crucial factor in controlling inflation, boosting profits and improving living standards.

Nonfarm-labor productivity, a measure of the average worker's output per hour, was flat in the third quarter compared with the previous quarter, the Labor Department reported yesterday. That was down from a revised 1.2% annualized growth rate in the second quarter.

Compared with a year earlier, productivity was up 1.3%, less than half the blazing 2.8% average rate of the past decade -- a phenomenal surge that has helped economic growth in the U.S. outpace other developed nations.

WALL STREET JOURNAL VIDEO



1

The Journal's Jon Hilsenrath explains² how the construction and manufacturing data indicate the U.S. economy is slowing down.

Productivity matters for everyone, because it provides the essential ingredient that makes nations rich. When companies produce more for each hour their employees work, they can pay higher wages or reap bigger profits without having to raise prices. Annual productivity growth of 2% would more than double inflation-adjusted wages over 40 years, all else being equal. Add another percentage point in productivity growth,

and wages would more than triple.

Over the past five years, U.S. productivity has risen at 3.1% a year -- a boom that most economists attribute to the Internet and other technological advances achieved in the 1990s, and to businesses' increasing ability to make use of those advances. Recent data, however, suggest that the benefits of those breakthroughs may have begun to wane.

Economists are quick to point out that quarterly productivity numbers are volatile and subject to revision, and that much of the current slowdown in productivity is a natural consequence of the third-quarter downturn in economic growth. They expect growth to pick up in the current quarter.


Still, the latest productivity numbers extend a trend that has led many on Wall Street and in academia to wonder whether the U.S. can keep boosting its productivity as much as it has in the recent past.

"The Street is paying more attention," says Michael Feroli, senior economist at J.P. Morgan Chase & Co. in New York. "People recognize that we might be at an inflection point here."

Over the long haul, however, most economists agree that productivity growth, though it won't match the boom of recent years, will remain healthy.

Even as the economy slows, companies are redoubling their efforts to squeeze more out of their workers. To save gasoline, drivers at **United Parcel Service Inc.** are making fewer left turns. Bissell Homecare Inc. is bottling more rug shampoo per shift. In Ohio, Seaman Corp., a small fabric maker, is also doing its part, using machines that make wider fabric to boost efficiency.

DOW JONES REPRINTS

 This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: www.djreprints.com.

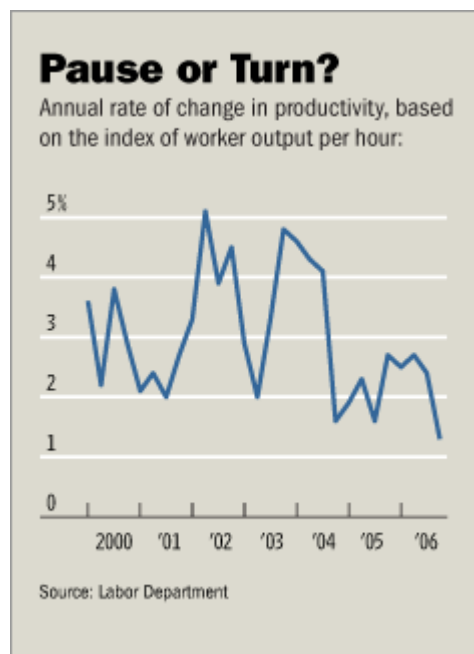
- [See a sample reprint in PDF format.](#)
- [Order a reprint of this article now.](#)

MORE ON THE NUMBERS

- Productivity -- [Labor Department](#)⁴, [Briefing.com](#)⁵
- Jobless claims -- [Labor Department](#)⁶, [Briefing.com](#)⁷
- Factory Orders -- [Census Department](#)⁸, [Briefing.com](#)⁹



For many, though, those efforts haven't been paying off quite as richly as they did in the past. "We've been at this for quite a while and have done a lot to improve our operations," says Bissell President and Chief Executive Mark Bissell. "I really think we're getting to the point where there aren't going to be more of those big advances."



"Productivity is really important not for the short run, but for the long run," says Ed Leamer, an economics professor at the University of California at Los Angeles. Increased productivity could help the U.S. grow its way out of its debts and demographic problems, such as the vast projected costs of paying for pensions and medical care as the baby-boom generation retires. "The question is: Are we going to be able to afford all these retirement benefits? And productivity is crucial for that," Prof. Leamer says.

Productivity also matters to policy makers at the Federal Reserve. If it slows, the economy's growth potential -- the "speed limit" at which it can grow without stoking inflation -- also declines. Recently, Fed staffers have been nudging down their estimate of the economy's future growth potential, a move that reflects lower estimates of productivity growth. In the current environment, that means the Fed might have to keep interest rates higher for longer to keep inflation under control.

"It's a big deal for the Fed," says Jan Hatzius, chief U.S. economist at Goldman Sachs in New York. "If the secular trend for productivity decelerates, then the economy becomes more inflation-prone."

A persistent rise in companies' labor costs presents another concern for inflation watchers. The Labor Department reported that average hourly compensation in the nonfarm sector rose at an annual rate of 3.7% in the third quarter from the second. As a result, unit labor costs -- the cost of producing each bicycle, refrigerator or box of gumdrops -- were up an annualized 3.8% from the second quarter and 5.3% from a year earlier.

Even so, the latest productivity data are unlikely to shift the Fed from its current stance of keeping interest rates on hold to see if lower energy prices and slowing growth push down inflation. For one, the slowing in potential growth expected by the Fed's staff is in part a short-lived phenomenon that merely compensates for several exceptionally strong years.

Moreover, many Fed policy makers appear more optimistic than the central bank's staffers. Chairman Ben Bernanke said in late August that recent developments didn't require a "significant rethinking of long-term productivity trends." Yesterday, Fed governor Susan Bies said, "Although productivity growth has stepped down from the scorching pace seen early in the recovery, factors remain in place for continued solid growth over the next few years."

In the near term, economists see reason to believe productivity growth will remain at or below 2%. For one thing, productivity tends to cool in the latter part of an economic expansion: When output growth slows, companies don't immediately cut work hours or lay people off, so output per hour slows, too. "We're in a mature phase of an expansion," says J.P. Morgan's Mr. Feroli. "For that reason alone we should expect productivity to decelerate."

Beyond that, companies as a whole don't appear to have been investing as much in the kind of high-tech equipment that helped fuel the productivity boom. Investment in information-processing gear and

software, for example, grew at an inflation-adjusted, annualized rate of about 8% in the second quarter, down from almost 21% in the second half of the 1990s.

Part of the drop in high-tech investment stems from a slowdown in the rate at which the price of computing power has fallen. In the second quarter of 2006, prices of high-tech capital goods were falling at an annualized rate of about 1%, compared with an average 5% drop over the past decade.

Some economists believe the surge in productivity since 2001 has had little or nothing to do with technology. Robert Gordon, an economics professor at Northwestern University, sees it mainly as the result of "savage cost cutting" as executives, motivated by pay packages tied to their companies' stock price, sought to boost profits in the wake of the 2001 stock-market swoon.

Most economists agree that the nation's long-term productivity growth will range somewhere between 2% and 2.5% -- down from the past five years, but still close to the level of the late 1990s. "We're not going to see a replay of the last 10 years, but that doesn't mean we can't have excellent economic performance," says Peter Ireland, an economics professor at Boston College.

The drivers will likely be different. Instead of spending on information technology alone, businesses are focusing more on improving their operations -- investing in things like better warehouses, machines and logistics. Some of that investment helps them get more mileage out of previous advances in information technology. The flexibility of U.S. labor, product and capital markets also play a role by making it easier for companies to adapt and get the money they need to do so.

Take, for example, UPS. Together with an upgrade of its information systems, it is changing the way it packs trucks and plans routes. Among other things, this allows its drivers to avoid left turns, which burn up extra gas.

Other companies, such as Bissell and Seaman, are boosting productivity in more pedestrian ways. Next year, for example, Bissell is planning to install new machinery on several lines in its Grand Rapids, Mich., plant that will allow 16 bottles of rug shampoo to be automatically filled at a time, instead of eight. For its part, Seaman recently completed a five-year, \$20 million upgrade of its machines, which allowed it to increase the width of its fabric to 76 inches from 56 inches and double output per worker.

"Improving productivity is important," says Richard Seaman, president and CEO of Wooster, Ohio-based Seaman, which makes industrial textiles used for truck tarps, military tents, and single-ply roofing. "You're making yourself more capable, more nimble."

--Greg Ip contributed to this article.

Write to Mark Whitehouse at mark.whitehouse@wsj.com³

URL for this article:

<http://online.wsj.com/article/SB116247430762811342.html>

Hyperlinks in this Article:

(1)

<http://release.theplatform.com/content.select?pid=eqyPEIp0BWr6uSPQ3FLT5z1Fm-HmmTEY>

(2)

<http://release.theplatform.com/content.select?pid=eqyPEIp0BWr6uSPQ3FLT5z1Fm-HmmTEY>

(3) <mailto:mark.whitehouse@wsj.com>

(4) <http://online.wsj.com/documents/bbbiz-20061102.pdf>

(5) http://online.wsj.com/page/mdc/2_0500-prod-18.html

(6) <http://online.wsj.com/documents/bbjobs-20061102.htm>

(7) http://online.wsj.com/page/mdc/2_0500-claims-18.html

(8) <http://online.wsj.com/documents/bbfac-20061102.pdf>

(9) http://online.wsj.com/page/mdc/2_0500-facord-18.html

Copyright 2006 Dow Jones & Company, Inc. All Rights Reserved

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.