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ECONOMY | ECONOMIC DATA

Productivity Slump Threatens Economy's Long-Term Growth

Measure's longest losing streak since 1979 could keep Fed from raising rates to past levels

An employee inspecting an Action Craft Boats vessel at the company's manufacturing facility in Cape Coral, Fla., on Aug. 2. Nonfarm business productivity, measured as the output of goods and services produced by American workers per hour worked, decreased at a 0.5% seasonally adjusted annual rate in the second quarter as hours increased faster than output, the Labor Department said Tuesday. *PHOTO: MARK ELIAS/BLOOMBERG NEWS*

By BEN LEUBSDORF

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The longest slide in worker productivity since the late 1970s is haunting the U.S. economy's long-term prospects, a force that could prompt Federal Reserve officials to keep interest rates low for years to come.

Nonfarm business productivity—the goods and services produced each hour by American workers—decreased at a 0.5% seasonally adjusted annual rate in the second quarter as hours worked increased faster than output, the Labor Department said Tuesday.

It was the third consecutive quarter of falling productivity, the longest streak since 1979. Productivity in the second quarter was down 0.4% from a year earlier, the first annual decline in three years. That was a further step down from already tepid average annual productivity growth of 1.3% in 2007 through 2015, itself just half the pace seen in 2000 through 2007, and the trend shows little sign of reversing.

"In the short term, it's hard to be anything other than pessimistic, just because this has been going on for so long now," said Paul Ashworth, chief U.S. economist at consultancy Capital Economics.

Productivity is a key ingredient in determining future growth in wages, prices and overall economic output. It has slowed dramatically since the information technology-fueled boom of the late 1990s, when strong productivity gains translated into robust growth for household incomes and the overall economy.

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The slowdown in recent quarters has likely been reinforced by weak business investment in new equipment, software and facilities that could help boost worker efficiency.

Over time, persistently weak productivity would weigh on American living standards by restraining the economy's ability to grow quickly and generate higher incomes without stoking too much inflation. Already, some economists say slow productivity may be restraining wage growth.

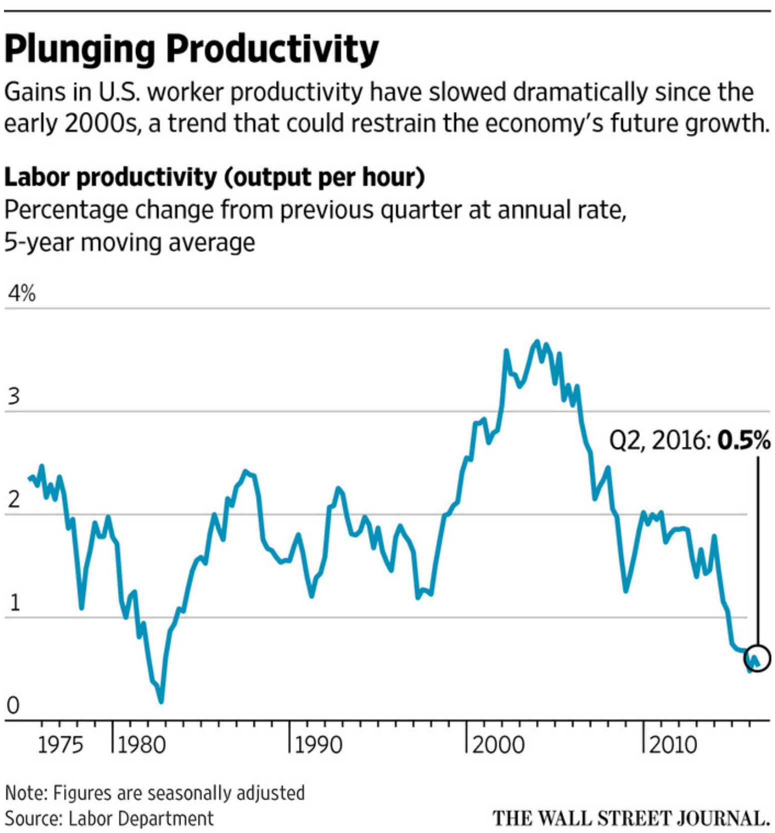
Stagnant productivity and rising labor costs also could squeeze corporate profits, which have been under pressure from the energy sector's downturn and other forces.

To be sure, economic growth and wages could pick up in the near term despite slumping prospects for productivity. Forecasting firm Macroeconomic Advisers on Tuesday said it expected gross domestic product, the broadest measure of goods and services produced across the economy, to expand at a 3% annual rate in the third quarter. An Atlanta Fed gauge predicted 3.7% growth. The Commerce Department last month estimated that GDP expanded at a modest 1.2% pace in the second quarter.

There are signs of acceleration in wages and income as the labor market has tightened in recent years. Average hourly earnings of private-sector workers rose 2.6% in July from a year earlier, matching the fastest annual growth since mid-2009, the Labor Department said last week. Unit labor costs at nonfarm businesses rose at a 2% annual rate in the second quarter, up from a 0.2% decline in the first three months of 2016, according to Tuesday's report.

Fed officials will decide whether to raise short-term interest rates in the coming months based on the health of the labor market, the outlook for inflation and their assessment of risks to growth at home and overseas. A move could come as soon as mid-September; the Fed in late July said that "near-term risks to the economic outlook have diminished."

But in the long run, slow productivity growth and other forces could keep interest rates depressed compared with levels seen in the past.



"It's a signal that the economy is not going very fast and interest rates should stay low," said IHS Global Insight economist Patrick Newport. "If we see no growth, which is what we've seen over the last year, it would matter a lot."

Officials at the U.S. central bank already have lowered their expectations for future growth and interest rates. Most policy makers in mid-2012 saw the economy's longer-run growth rate in the 2.3%-to-2.5% range, and their median projection for the long-run level of their benchmark federal-funds rate was 4.25%. Four years later, their median projections were for 2% growth and a fed-funds rate of 3% in the long run.

The economy's potential future growth will be slower than previously expected unless productivity recovers, and their economic projections suggest Fed officials "see current policy as less accommodative, the labor market as less tight and inflationary pressures as more limited," former Fed Chairman Ben Bernanke said Monday on his blog.

The policy implications, Mr. Bernanke said, "are generally dovish, helping to explain the downward shifts in recent years in the Fed's anticipated trajectory of rates."

Sluggish productivity growth isn't limited to the U.S., and a similar pattern has played out across other advanced economies. But its underlying cause or causes remain a bit of a mystery.

Some economists have seen the slowdown as reflecting a secular trend of more modest efficiency gains from new technologies compared with past advances. Others have placed the blame on persistent aftereffects of the financial crisis and 2007-09 recession, and predict it will rebound in coming years. And some have argued productivity is being mismeasured and could be higher than commonly thought.

Fed Chairwoman Janet Yellen in June described the outlook for productivity growth as a "key uncertainty for the U.S. economy" and a "very difficult question" that has divided the economics profession.

"Some are relatively optimistic, pointing to the continuing pace of innovations that promise revolutionary technologies, from genetically tailored medical therapies to self-driving cars," she said. "Others believe that the low-hanging fruit of innovation largely has been picked and that there is simply less scope for further gains."

Ms. Yellen described herself as "cautiously optimistic" but said it "would be helpful to adopt public policies designed to boost productivity," such as promoting investment.

Business investment has been a notable sore spot for the economy in recent months. A closely watched measure of business spending, fixed nonresidential investment, has declined for the past three quarters, according to Commerce Department data. A proxy for spending on new equipment—new orders for nondefense capital goods excluding aircraft—has declined on a year-over-year basis almost continuously for the past year and a half.

If wages continue to climb, companies may seek to contain labor costs by ramping up their investments in new equipment to boost efficiency, aided by low interest rates, or by raising prices.

“We remain extremely focused on managing our labor expense through continued efforts and investments to improve our labor productivity, as well as through targeted price increases,” sandwich-shop chain Potbelly Corp. Chief Financial Officer Michael Coyne told analysts last week.

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