

PRODUCTIVITY SLOWDOWN FINISHES THIRD YEAR

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The economy grew at a respectable 3.4 percent annual rate in the 2nd quarter, driven by strong growth in structure investment, government expenditures and a reduction in the size of the trade deficit. However, with hours also growing at a healthy pace, productivity growth is likely to come in at under 2.0 percent for the quarter. This performance, coupled with downward revisions to GDP growth, puts the average rate of productivity growth since the 2nd quarter of 2004 at 1.5 percent, the same rate as during the long slowdown from 1973-1995. The prolonged weakness in productivity growth must raise questions as to whether the post-1995 up-tick is over.

The report gives reasons for questioning whether the economy can sustain a healthy growth pace going forward. The improvement in the trade deficit accounted for more than one-third of the growth reported for the quarter. While trade has been adding to growth in the last year, it is entirely attributable to a slower rate of growth of imports. Exports have actually been growing less rapidly in the last year than in the period from 2004-2006. The deficit will probably trend downward, but at a somewhat slower pace than in the 2nd quarter, barring a sharper fall in the dollar.

A jump in government spending, led by defense, accounted for almost a fourth of the growth in the quarter. This spending is erratic and will almost certainly grow at a slower rate in future quarters. A 22.1 percent surge in structure investment accounted for almost a fifth of 2nd quarter growth. Structure investment was depressed when residential construction was pulling away workers and equipment, which created a backlog. It has now increased by 21.4 percent since the 4th quarter of 2005. It is unlikely to rise much further from its current level.

Consumption grew at just a 1.3 percent annual rate, the weakest performance since a 1.2 percent rate in the 4th quarter of 2005. This weakness reflects stagnant real wages coupled with declining housing wealth. With house prices dropping in large chunks of the country, many homeowners are finding that they no longer have equity against which to borrow. While the wealth effect from the run-up in house prices contributed hugely to the consumption boom that drove the economy for the last five years, falling prices will have the opposite effect.

The best hope for the economy in dealing with the end of the housing boom was always that a surge in investment would offset weakness in housing and consumption. There is little evidence of any surge in the category of equipment and software investment. It grew at a 2.3 percent rate in the quarter and stands just 0.1 percent above its year ago level.

There were several other important revisions to the prior year's data, in addition to the downward revisions to the GDP numbers. Corporate profits were revised down by 3.8 percent in 2006, which now appears likely to be the profit peak of the current cycle. With the new data, the capital share of income in the corporate sector in 2006 was 20.8 percent. This is an increase of 0.75 percentage points from the 1997 profit peak. While this increase is not trivial, it is smaller than the 1.5 percentage point rise from the 1988 peak to 1997. This growth in the profit share cannot explain much of the weakness in real wage growth for most of the workforce. This must be attributed to upward distribution among wage earners. (The after-tax profit share of 14.3 percent is slightly lower than the 14.5 percent share in 1997.)

The revisions also showed a higher savings rate in 2005 and 2006, as consumption was revised lower and income was revised higher. This pushed the savings rate into positive territory, 0.4 percent and 0.4 percent for 2005 and 2006, respectively.

On net, this report should provide considerable grounds for concern about the future strength of the economy. With no hope for a turn around in the housing market any time soon, consumption growth will not rebound from its current pace. Unless investment and trade pick up the slack, the economy risks recession.