Louisiana Corporate Credit Union

ECONOMIC & FINANCIAL DIGEST

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Weak Productivity Is Stifling Growth

With the economy struggling to grow at a measly 1 percent pace over the past three quarters – the weakest for such a stretch since the end of the Great Recession – it may be appropriate to ask if the seven-year old recovery is running on fumes. Economists are notorious for not being able to forecast a recession and, true to form, very few see any on the horizon this time. But the disappointments are piling up, including, most recently, the unexpected weakness revealed in the second-quarter GDP report. Most forecasters were looking for a solid rebound from the previous two quarters, each of which posted growth rates of less than 1 percent. Instead, the second quarter turned out to be not much better, as GDP increased by a 1.2 percent annual rate, far less than the expected 2.5 percent

Nor was it just the headline growth rate that provided grim news. Some of the underlying details of the report were just as disappointing. Business investment spending contracted for the third consecutive quarter, something that hasn't happened since the recession. Just as disconcerting, residential outlays declined for the first time in over two years. It's rare that both nonresidential and residential outlays fall together outside of a recession; indeed, a contraction in residential activity is, by itself, a time-honored leading indicator of a recession. So is it time to throw in the towel on the recovery? Probably not.

True, the unwillingness of businesses to ramp up investment spending is worrisome, if only because it suggests that corporate leaders lack confidence in the economy's future prospects. But much of the weakness in business investment over the past year has been related to the energy sector, where the slump in oil prices spurred a massive retrenchment in spending on oil rigs and other capital expenditures related to drilling and exploration. That drag may be nearing an end, as oil prices have stabilized this year and overcapacity in the industry has been whittled down. Meanwhile, the residential setback in the second quarter is not emblematic of an adverse turn in the housing market. By all accounts, home sales and homebuilding activity are strengthening and industry experts expect further improvement over the second half of the year. With the job market still improving and generating increased purchasing power for households – the economic engine's main growth driver – there is every reason to believe that the economy is poised to pull out of its three-quarter slump and, perhaps, deliver some upside surprises over the second half of the year.

Producing Less With More

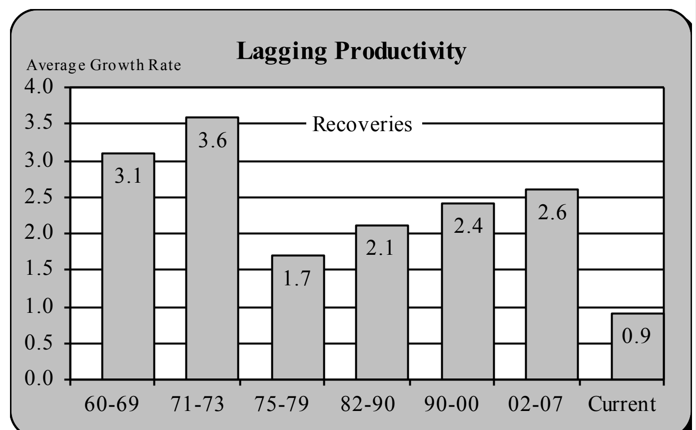
When the economy emerged from the 2001 recession and, to a lesser extent, the 1990-91 downturn, economists were fretting that the nation was mired in a "jobless recovery". For a while, it appeared that a similar trend was unfolding over the first year or so of the current upturn, as it took a while for the economy's jobs engine to kick in. All three episodes had one thing in common – a burst of productivity early in the recovery that enabled companies to increase output without hiring new workers.

This "dark side" of productivity growth is usually tolerated because it occurs alongside of strengthening economic activity that in time feeds back into more hiring, rising wages and increased investment; that, in turn, sets in motion a virtuous circle that fuels the expansion until an inflation-fighting tighter Fed policy or some external event (war or spiking oil prices) brings on a recession. This time, however, the virtuous circle is spinning much more slowly than in past recoveries. Jobs have been created at a decent clip in recent years, but output growth has been the weakest of the postwar recoveries. As a result, the amount of goods and services produced by each worker has been not been growing as it has in the past.

Indeed, the slowdown in worker productivity has occurred earlier and has been much more dramatic than in past recoveries. Since mid-2009, productivity has increased at an annual rate of 0.9 percent compared to 2.6 percent in the 2001-2007 recovery and an average of 2.4 percent over the previous five recoveries dating back to 1960. And it's getting worse. In the second quarter, labor productivity declined by 0.5 percent, marking the third consecutive quarterly decline. That's the longest stretch of declining productivity since the late 1970s.

It's a Puzzle

Economists and policymakers are baffled by the extended



weakness in productivity. Indeed, Fed chairwomen Janet Yellen recently said that it was one of the great puzzles in the economic picture. To be sure, productivity growth tends to slow at the mature stage of a recovery, when it becomes harder to find qualified workers in a tight labor market and operating capacity is stretched to the limit. At that point, companies usually ramp up investment spending, both to expand capacity and to enhance productivity by giving workers more efficient tools to work with. Not so this time.

Instead of spending more, businesses have cut back on fixed investment outlays for three consecutive quarters. As noted earlier, most of the decline has occurred in the energy patch, but other industries have not stepped up to the plate. In fact, nonresidential investment spending outside of the energy sector has declined in two of the past three quarters. Hence, instead of the boost to growth typical of a recovery in its later stage, the pullback in investment outlays has been a major drag on GDP, reducing the overall growth rate by about one-third over the past three quarters.

There is a chicken-and-egg quality to the atypical resistance of businesses to increase investment spending. By holding back, it is depriving the recovery of much-needed fuel to grow faster. But the slower growth, in turn, is discouraging businesses from investing more. That's because, despite seven years of recovery, the revival in output has been far too slow to soak up the huge excess capacity created during the Great Recession. In July, for example, the capacity utilization rate for industrial companies stood at 75.9 percent, fully 4.1 percentage points below the long-term average.

Possible Culprits

No doubt, worker productivity would have been stronger if businesses invested in new plant and equipment as they had in past recoveries. But many economists believe that other factors may explain why productivity has been so dismal in recent years. Some even question if productivity has been as weak as the official data suggest. It's much harder to measure the output of services than of manufactured goods, and the service sectors have been growing much faster than the factory sector for some time. Others blame demographic changes; the wave of older workers heading into retirement tend to have more skills and are more productive than the younger workers replacing them.

There is also the argument that productivity is not benefiting as much from current technology as in the past. Some experts believe that the latest most important innovation – the Internet – is less transformative than earlier inventions, such as indoor plumbing, electricity and the internal combustion engine. Worse, some economists, as Janet Yellen recently noted, "believe that the low-hanging fruit of innovation largely has been picked and that there is simply less scope for further gains." If that's the case, the outlook for future productivity gains is grim indeed.

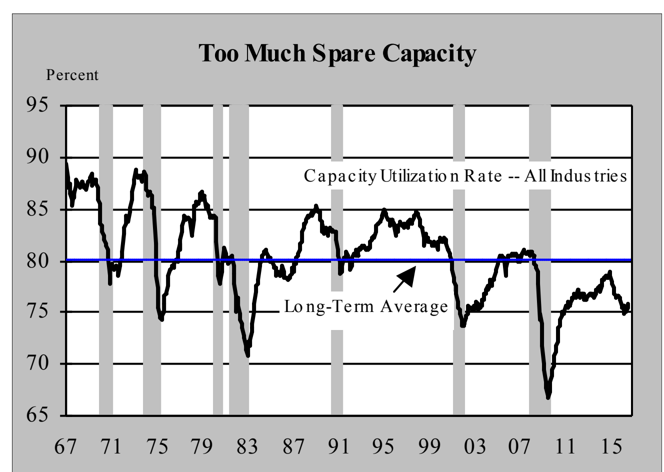
In all likelihood, the productivity weakness reflects some of all of the above as well as others that are not easily identified. But one thing is certain: the economy has little chance of pulling out of the slow-growth syndrome unless productivity picks up. Keep in mind that the economy's growth potential is determined by the increase in the labor force combined with productivity growth. Both have slowed dramatically over the past decade, spurring policy makers to lower their long-run growth expectations for the economy. The diminished growth potential, in turn, underpins the notion that the U.S. is firmly in the grip of secular stagnation, a stubbornly slow-growth economy that portends a weaker rise in living standards than has historically been the case.

Nothing is Inevitable

While the lackluster recovery so far fits the definition of secular stagnation – 2 percent growth and stagnant living standards – the grim prognosis that it will persist is hardly set in stone. True, demographic forces are holding back growth in the labor force, as the bulge in aging baby boomers is set to continue. But the steep decline in the labor force participation rate since 2007 reflects other forces that are starting to reverse. The steady improvement in the labor market, for example, is encouraging workers who had given up on the job search in recent years to re-enter the labor force. This influx of workers from the sidelines should continue and offset the wave of retirements.

Nor is productivity growth doomed to remain in its dismal state. It is far from certain that the "low-hanging fruit" from current technology has been picked; businesses are constantly finding productive new uses for wireless technology, and are just scratching the surface in the ways artificial intelligence and robotics can augment the output of workers in a wide swath of industries. Early adopters of wireless technologies are already achieving significant gains in productivity, which will inevitably prod latecomers to join the parade or risk losing sales to competitors.

The key will be to motivate a broader swath of businesses to step up investment in productivity-enhancing capital goods – physical as well as software – that would cause the virtuous circle to spin faster. One time-honored way of doing that is to coax business leaders to expect faster economic growth in the future, providing assurance that the demand for their goods and services will be greater than it has been in the recent past. This will be no easy feat, given the lackluster performance of the economy throughout the recovery. But policy makers have the ability to lift expectations of stronger growth. One positive omen is that the Federal Reserve's strenuous growth-boosting efforts in recent years should be reinforced by some fiscal pump-priming fairly soon. In an otherwise highly divisive presidential campaign, both parties are proposing significant increases in infrastructure spending, a 180 degree turn away from the austerity mind-set that has long prevailed on Capitol Hill. It will take time before these funds actually flow through the economy, but forward-looking businesses could well act sooner than later in anticipation of their demand-boosting effects.



KEY ECONOMIC AND FINANCIAL INDICATORS

*FINANCIAL INDICATORS**

	July	June	May	April	March	February	January	12-Month Range High	Low
Prime Rate	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.25
3-Month Treasury Bill Rate	0.30	0.27	0.27	0.23	0.29	0.31	0.26	0.31	0.02
5-Year Treasury Note Rate	1.07	1.17	1.30	1.26	1.38	1.22	1.52	1.70	1.07
10-Year Treasury Note Rate	1.50	1.64	1.81	1.81	1.89	1.78	2.09	2.32	1.50
30-Year Treasury Bond Rate	2.23	2.45	2.63	2.62	2.68	2.62	2.86	3.07	2.23
Tax-Exempt Bond Yield	2.83	3.20	3.29	3.30	3.38	3.30	3.41	3.79	2.83
Corporate Bond Yield (AAA)	3.28	3.50	3.65	3.62	3.82	3.96	4.00	4.15	3.28
Conventional 30-Year Mortgage Rate	3.44	3.57	3.60	3.61	3.69	3.66	3.87	4.05	3.44
Dow Jones Industrial average	18341	17755	17692	17844	17302	16300	16305	18341	16300
S&P 500 Index	2149	2084	2067	2076	2022	1918	1918	2149	1918
Dividend Yield (S&P)	2.11	2.17	2.16	2.18	2.17	2.31	2.28	2.31	2.07
P/E Ratio (S&P)	20.4	19.8	19.5	19.2	19.1	17.6	17.7	20.4	17.4
Dollar Exchange Rate (vs. Major Currencies)	90.9	89.7	89.8	89.4	91.5	93.2	95.3	95.3	89.4

** Monthly Averages*

ECONOMIC INDICATORS

	July	June	May	April	March	February	January	12-Month Range High	Low
Housing Starts (In Thousands)	1211	1186	1128	1155	1113	1213	1128	1213	1073
New Home Sales (Thousands of Units)		592	572	572	537	525	526	592	457
New Home Prices (Thousands of Dollars)		307	289	320	311	311	291	509	289
Retail Sales (% Change Year Ago)	2.3	2.9	2.2	2.9	1.7	3.6	2.8	3.6	1.6
Industrial Production (% Change Year Ago)	-0.5	-0.7	-1.3	-1.3	-2.0	-1.4	-1.4	0.4	-2.1
Operating Rate (% of Capacity)	75.9	75.4	75.1	75.2	74.9	75.6	75.7	76.7	74.9
Inventory Sales Ratio (Months)		1.4	1.40	1.40	1.41	1.41	1.41	1.41	1.37
Real Gross Domestic Product (Annual % Change)		1.2			0.8			2.0	0.8
Unemployment Rate (Percent)	4.9	4.9	4.7	5.0	5.0	4.9	4.9	5.3	4.7
Payroll Employment (Change in Thousands)	255	292	24	144	186	233	168	295	24
Hourly Earnings (% Change Year Ago)	2.6	2.6	2.5	2.5	2.3	2.4	2.5	2.6	2.2
Personal Income (% Change Year Ago)		2.7	2.9	3.3	3.6	3.5	3.9	4.4	2.7
Savings Rate (Percent of Disposable Income)		5.3	5.5	5.7	6.2	6.0	6.2	6.2	5.3
Consumer Credit (Change in Mil. Of Dollars)		12320	17913	16980	24340	13854	12739	24340	6561
Consumer Prices (% Change Year Ago)	0.8	1.0	1.0	1.1	0.9	1.0	1.4	1.4	0.0
CPI Less Food & Energy (% Change Year Ago)	2.2	2.3	2.2	2.1	2.2	2.3	2.2	2.3	1.8
Wholesale Prices (% Change Year Ago)	-0.2	0.3	-0.1	0.0	-0.1	0.0	-0.2	0.3	-1.6

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