Slowing Productivity Fogs Broader Outlook

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WASHINGTON -- U.S. productivity growth rebounded in the fourth quarter of 2006 but still appears to be slowing overall, clouding the outlook for economic growth, inflation and corporate profits in the months ahead.

Nonfarm labor productivity -- a measure of the average worker's output per hour -- rose at an annual rate of 3% in the fourth quarter, bouncing back from an unusual decline of 0.1% in the previous quarter, the Labor Department reported. Growth in labor costs per each unit of output, meanwhile, slowed to an annual rate of 1.7% in the quarter from the third quarter's 3.2%.

Rising productivity means companies are squeezing more output out of their workers. Those gains allow profit margins and wages to grow while minimizing the need to raise prices. That's why increased productivity is the key to higher living standards. Productivity also helps to determine how fast the economy can expand without igniting unwelcome inflation.

Advances in information technology, among other factors, have led to a decadelong surge in the nation's productivity. More recently, however, the surge has shown signs of fatigue.

For 2006 as a whole, nonfarm productivity gains slowed to 2.1% from 2.3% in 2005 and a recent peak of 4.1% in 2002. Economists say last year's productivity growth was probably even weaker, and they expect the revised figure to come in lower when the government issues an update next month. Meanwhile, unit labor costs rose 3.2% last year, up from 2% in 2005 and the biggest increase since 2000.

So far, slowing productivity growth and rising labor costs haven't crimped corporate profits, but that seems likely to change. Research firm Thomson Financial expects annual earnings growth among companies in the Standard & Poor's 500-stock index to slow to 4.8% in the first quarter of 2007 from 10.6% in the final quarter of 2006. For 2007 as a whole, Thomson expects profits to rise 7.2%, less than half of last year's growth rate.
Whether the productivity growth reprises its fourth-quarter advance or continues its broader slowdown is also a major variable in the outlook for the nation's economic growth and inflation. Slower productivity gains would pressure businesses to raise prices, particularly since the strong labor market is making it harder to restrict workers' pay.

In a speech yesterday, Charles Plosser, president of the Federal Reserve Bank of Philadelphia, warned that the recent signs of economic strength mean the Fed may not be done raising interest rates. "Additional monetary-policy action may be needed to keep us moving along the path to price stability," he said.

If productivity picks up, however, businesses may have more flexibility to absorb higher labor or raw-materials costs without raising prices, restraining inflation and lessening the need for higher interest rates.

Separately, the Federal Reserve said consumer-credit growth slowed sharply in December as credit-card and other revolving debt expanded at a slower rate. The nation's consumer credit outstanding rose about $6 billion, or 3%, in December to $2.401 trillion, after an upwardly revised $13.7 billion, or 6.9%, expansion in November.

Credit card and revolving credit grew by $608.9 million in December to $876.2 billion, down from a $9.9 billion expansion in November and the slowest since March, when revolving credit shrank.

For the whole of 2006, consumer credit grew 4.6%, compared with a 4.2% expansion in 2005. Revolving credit grew by 6%, while nonrevolving credit slowed to a 3.8% expansion in 2006.