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Productivity Rebounds Slightly in the First Quarter

Nonfarm productivity rose at a 0.8 percent annual rate during the first quarter as businesses cut employment and hours worked slightly faster than they slashed production. Businesses have done a good job of reining in costs, which is one of the reasons first quarter earnings came in slightly better than was widely feared.

Cost Cutting Lifted Productivity

Nonfarm productivity growth rebounded slightly in the first quarter, with output per worker rising at a 0.8 percent annual rate. The increase follows a 0.6 percent drop in the fourth quarter and suggests businesses are doing a better job of aligning employment and hours with production schedules.

Productivity means different things at different points of the business cycle. When the economy is growing, stronger productivity growth means that businesses are finding new ways to produce more goods and provide more services for each hour worked. Stronger productivity growth in this environment means the economy can grow at a faster rate and wages can increase without igniting inflationary pressures.

When the economy is in recession, as it is now, stronger productivity growth means businesses are having some success at squeezing efficiencies out of their operations. These efficiencies generally result from reducing employment and hours worked faster than they reduce output. This is precisely what happened in the first quarter, when hours worked fell at a 9.0 percent annual rate, while output fell at an 8.2 percent pace.

The improved productivity numbers for the first quarter suggest the pace of layoffs will moderate, which is what we have been seeing in weekly first time unemployment claims. While layoffs may slow somewhat, there is no indication hiring is set to pick up. Compensation per hour worked rose at a 4.1 percent annual rate in the first quarter. Unit labor costs, which are the difference in compensation costs and productivity, rose at a 3.3 percent annual rate. With nominal GDP declining, such an increase means that businesses will remain focused on cost cutting. They just do not need as sharp a knife as they needed a few months ago.

While nonfarm productivity improved, results from the factory sector were clearly disappointing. Output per hour in manufacturing declined at a 3.4 percent annual rate, as output plunged at a 22.4 percent pace and hours worked declined at a 19.7 percent pace. The largest losses were in durable goods, where output tumbled at a 31.0 percent pace and hours worked declined at a 23.4 percent pace. The net result was a 10 percent plunge in productivity. Much of the problem is in the auto sector, where reductions in output do not yield much savings in compensation costs. The first quarter numbers show compensation costs rising at a 15.7 percent annual rate, which puts unit labor costs up at a stunning 28.5 percent pace and 17.1 percent year-to-year. ***In an environment where so many manufacturers, particularly automakers, are having trouble selling products, much less raising prices, these types of increases are lethal and will require significant further employment cuts in the sector.***