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Economics Group

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Productivity Growth Surged on Cost Cutting

Nonfarm productivity surged at a 6.4 percent pace in the second quarter, as hours worked fell much more than output. Productivity gains also bolstered profits, which may reduce the need for further large cutbacks.

Businesses Slashed Hours in Order to Protect the Bottom Line

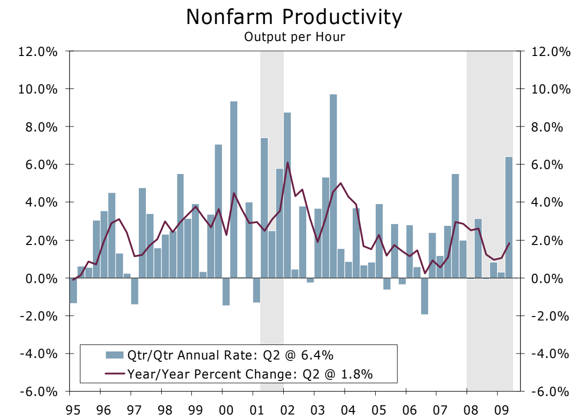
A great deal will likely be made of this morning's moonshot of a productivity report even though some of the increase was expected. Nonfarm productivity surged at a 6.4 percent annual rate, which marks the strongest quarterly gain in six years. Productivity growth in the factory sector rose at a 5.3 percent pace but remains down 1.3 percent year-to-year.

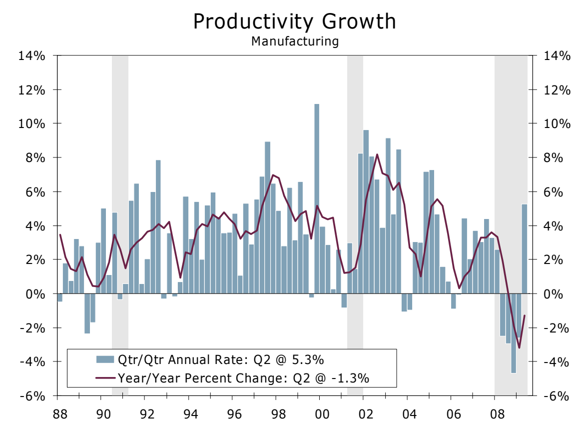
While the second quarter's productivity gain is good news, the gain is almost entirely the result of cost cutting, not improved ways of producing goods and providing services. ***Businesses have been very aggressive at cutting costs throughout the recession and became almost obsessive about it after the financial markets collapsed last fall.*** The financial crisis set off fears that sales would decline even more than they actually did and many firms prepared for the worst. Hours worked in the nonfarm sector plunged at a 7.6 percent annual rate in the second quarter, following a 9.0 percent annual rate of decline in the previous quarter and an 8.3 percent drop during the fourth quarter of last year. Hours worked are now down 7.3 percent over the past year, which marks the largest year-to-year drop since the series began back in 1947. By contrast, hours worked declined at a much more modest 1.3 percent pace in the year leading up to the financial crisis.

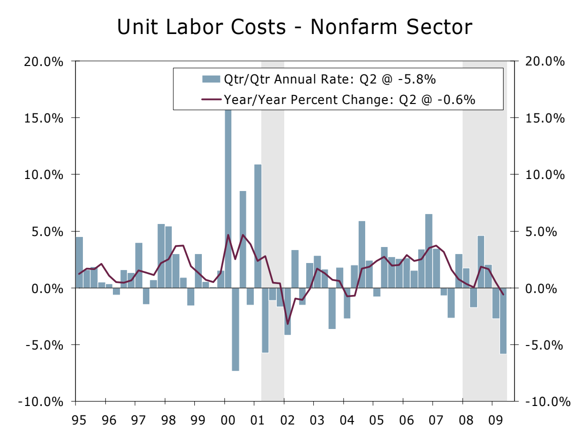
While hours worked plunged during the second quarter output fell much less, declining at just a 1.7 percent pace. Apparently production and distribution of goods and services are now better aligned with sales. The more modest drop in output follows an 8.8 percent plunge in the first quarter and 7.6 percent drop in the fourth quarter of last year. Output is down 5.6 percent over the past year. With hours worked falling more than output, productivity growth surged in the second quarter and is now up a solid 1.8 percent over the past year. The year-to-year increase is roughly in line with nonfarm productivity growth over the past few years.

Businesses May not be Finished With Costs Cuts Just Yet

During a recession, and particularly a deep one like we just went through, cutting costs is one of the few options available for businesses to protect their balance sheet and live to fight another day. ***There is some hope that the excessive caution undertaken by businesses in this downturn will mean we will not have to endure another jobless recovery as we did following the last two recessions. Today's productivity data <u>do not</u> support this notion.*** Productivity gains are actually a little smaller than they were surrounding the end of the last recession, particularly in the factory sector. Unit labor costs are also down less than they were at the tail end of the last recession, so there may be even more costs cuts ahead.







Source: U.S. Department of Labor and Wells Fargo Securities, LLC.

Wells Fargo Securities, LLC Economics Group

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