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Will Productivity Gains Sustain US Economic Recovery if Employment Remains Subdued?

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Concern is growing that productivity gains on their own are not sufficient for a sustainable recovery. But we believe strong productivity gains are the lifeblood of a strong economy, and will eventually lead to new job creation while promoting steady improvements in wealth and living standards.

From the depths of recession, the US economy has returned to life by posting a 4% gain in annualized GDP over the past six months, nearly double the rate of early recoveries in 1991 and 2002. However, even as growth has beaten consensus estimates, there is a growing sense of unease about the heavy reliance on productivity improvements in generating GDP growth.

Productivity gains have exceeded the increase in real GDP by three percentage points **(Display 1)**, as companies slashed costs, especially for labor. Massive payroll losses over the last six months of 2009 illustrate the extent of job cuts in the US economy. To some analysts, the spurt in GDP looks like a short-lived victory, because improving productivity through job cuts may deprive the economy of the natural feedback from growth—rising workers' income that is required for sustainable economic expansion.

According to this argument, without income from job creation, final demand will eventually weaken when it is taken off the life support of extensive fiscal stimulus, thereby jeopardizing the recovery. Although these concerns are legitimate, we believe productivity gains are critical for overall economic performance, profitability and standard of living improvements, and will help offset any near-term risk of weak employment for three main reasons.

Productivity Aids Healthy Growth

First, there is no empirical evidence to support the view that recoveries which are initially driven by productivity gains are any less sustainable than those propelled largely by job creation. In our view, productivity-driven recoveries may in fact be healthier and more durable, as they are characterized by a strong rebound in operating profits that should eventually lead to more investment and growth.

Indeed, the same companies that become more efficient through downsizing will eventually seek to grow in the future, and will need to hire in order to expand operations. Even for companies likely to expand mainly through capital investment, job creation would follow in the industries that supply the new capital equipment.

Second, sustained productivity gains generate benefits that flow to consumers and workers in the form of lower prices. For example, over the last 15 years, productivity gains in US durable manufacturing have averaged 4.3%, well above the 2.8% gain in the nondurable manufacturing sector **(Display 2, next page)**. Consumers have been the clear beneficiaries of these substantial productivity

Display 1
Productivity Gains Outstrip GDP Growth

Source: Bureau of Economic Analysis, Bureau of Labor Statistics and Haver Analytics gains—durable goods prices fell on average by an annual 0.8 % per year over the past decade **(Display 3)**, while consumer prices for nondurable goods rose 2.6%. So gains in productivity that flow to prices increase consumer purchasing power, which in turn can bolster demand and growth over time.

Third, strong productivity gains also help improve the competitiveness of US companies on world markets. As we have noted in previous commentaries, over the past decade, the US manufacturing sector's productivity gains have been among the strongest in the world, outpacing all G-7 economies and only exceeded by South Korea and Taiwan. These improvements have undoubtedly contributed to a 39% annualized rebound in US merchandise exports over the past six months—the biggest surge since the mid-1980s.

What's Different This Time?

Strong cyclical rebounds in productivity have been a recurring theme in all economic recoveries during the postwar period. However, the difference this time is that the productivity gains originated during the downturn, with record job losses, and continued during the upturn with a combination of volume gains and incremental reductions in payrolls.

It's not the first time that big productivity gains during the initial stages of recovery included employment cutbacks. During the early stages of the 2002 recovery, a similar pattern emerged, as companies slashed payroll employment during the first 18 months of recovery in order to reduce costs and boost productivity.

We believe, however, that there are significant differences in the macro and micro backdrops of 2002 and 2010, which suggest that the underlying trend in employment should improve this year. Indeed, in 2002, companies were forced to cut costs drastically to alleviate severe stress on their balance sheets. Today, the liquidity positions of US companies are stronger than they have been for decades, according to most metrics.

Drastic Response to Deep Recession

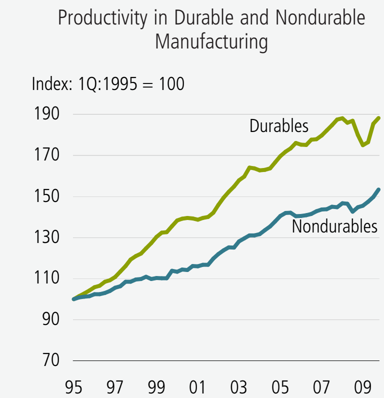
Moreover, during the recent recession, US companies slashed payrolls and inventories by record amounts, as the deepest and longest downturn in postwar history required a drastic response. In contrast, the 2001 downturn was one of the shortest and shallowest recessions on record, and companies did not sufficiently repair their balance sheets or operations to position themselves for renewed expansion.

Back then, the weak operating position was clearly visible on the global scene as US firms lost market share at home and abroad, leading many US companies to shift investments and production to international locations and to forge alliances with foreign firms.

Today, in contrast, US companies are gaining market share abroad and the shift in the global competitive landscape—tied in part to US manufacturing productivity gains—is prompting foreign manufacturers to consider shifting investments and production to the US.

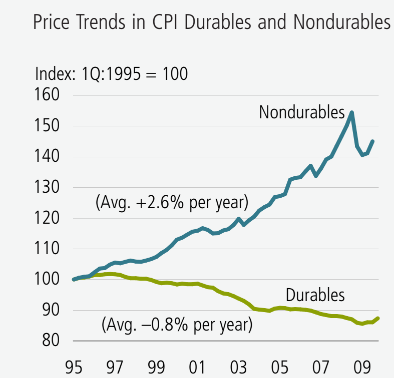
In our view, productivity gains should be embraced—not criticized—as they are the lifeblood of strong economic performance, promoting net job creation in new industries and supporting steady increases in living standards. Whether viewed from the perspective of an individual company or the broader economy, the list of benefits far outweighs any short-term costs incurred in achieving a more productive US economy.

Display 2
Fast Productivity Gains in Durable Manufacturing…



Source: Bureau of Labor Statistics and Haver Analytics

Display 3
…Have Led to Price Declines for Consumers



Source: Bureau of Labor Statistics and Haver Analytics