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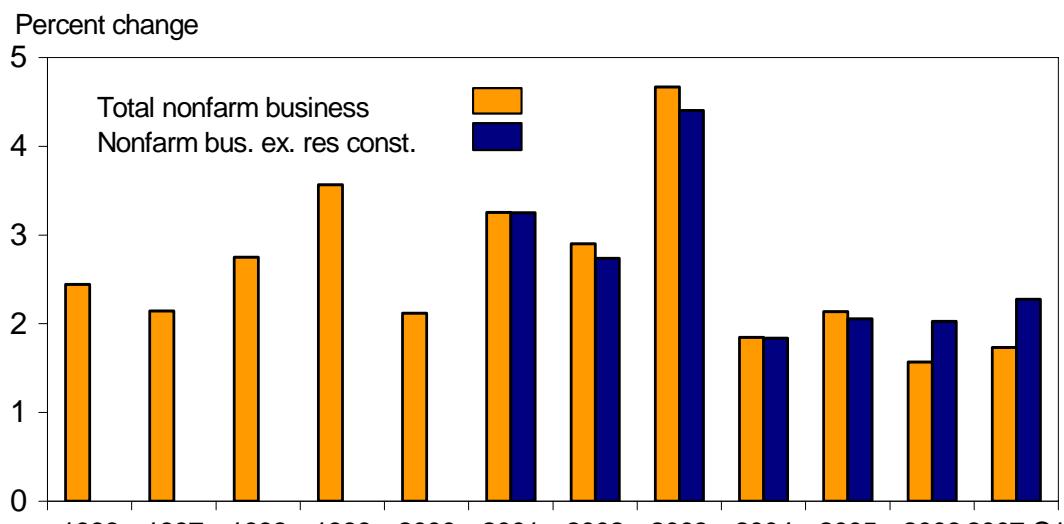
Residential Building and the Productivity Puzzle

Growth in labor productivity slowed noticeably in 2006 and early 2007, with employment growth remaining quite brisk as real output growth moderated. Output per worker hour in the nonfarm business sector rose only 1.6 percent during 2006, and the first quarter of 2007 would predict a 1.7 percent increase for this year. Those rates compare to a 2.8 percent per year average rise in productivity from 1995 through 2005. Recent changes in the residential building sector may be sizeable enough to explain much of this disconnect between output and employment.

The sharp contraction in residential investment that started in late 2005 had a significant effect on the overall growth in real GDP. However, the adjustment of jobs in the sector lagged considerably the contraction in building activity. For example, real residential investment was reduced by 13 percent in 2006, on a fourth quarter to fourth quarter basis, while jobs in the sector were down only about 0.5 percent. In the first quarter of 2007, the differential was similar.

This stark difference in the adjustment of output and jobs in residential building suggests that some of recent slowing in labor productivity growth is temporary. Based on our estimates of the change in productivity in residential building and the relative value-added contribution of the sector, in 2006 and the first quarter of 2007, the sector imposed about a 0.5 percentage point (annualized) cyclical drag on nonfarm business productivity growth. The effect is expected to unwind as the adjustment in employment catches up with the decline in output.

Labor Productivity: Nonfarm Business



* Years are changes over four quarters.

2007:Q1 is the quarterly change at a seasonally adjusted annual rate.

Source: BLS and FRBSF calculations

May 2007