

*Economy*

## **Fitting Growth Data Into the Unemployment Puzzle**

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When the Commerce Department publishes first-quarter growth estimates Friday, it will accentuate a puzzle with implications for interest rates, growth and U.S. living standards: With the economy growing so slowly, why is unemployment falling?

Explanations range from measurement problems to the peculiar behavior of construction jobs to the possibility that productivity growth is rising.

Wall Street estimates the economy grew 1.9% at an annual rate in the first quarter, the slowest in more than a year. That would bring growth for the past four quarters down to a sluggish 2.2%, below most economists' estimates of the economy's potential growth rate, which hovers around 3%. Potential is the rate at which the economy can grow over the long term, given growth in the work force and worker productivity.

A year of below-potential growth ordinarily would push up unemployment, because the economy isn't growing fast enough to employ all the new entrants to the work force. Instead, the unemployment rate has fallen to 4.4% in March from 4.7% a year earlier.

The answer to this puzzle has huge implications for inflation and interest rates. For the Federal Reserve, the most troubling explanation is that potential growth is closer to 2% than 3%. That may be because the work force is growing more slowly for demographic reasons, or because productivity growth has slowed, perhaps because companies are investing less in labor-saving technology.

If so, that would mean the economic slowdown has failed to create the spare economic capacity the Fed is counting on to damp inflation. Indeed, inflation (excluding food and energy) rose to 2.5% in March from 2.1% a year earlier, although Fed officials attribute that principally to the indirect effect of higher energy prices and to the behavior of rents. Slower productivity growth also would mean a slower advance in living standards.

Fed Gov. Frederic Mishkin said Friday that the recent slowdown in productivity growth is probably not fundamental, but "a normal cyclical transition." He added, "I also recognize a potential downside risk...given the weakness in business investment."

A more benign explanation for the puzzle is that growth may be underestimated. Theoretically, gross domestic product -- the sum of total spending -- should equal gross domestic income, the sum of all income. But in the four quarters through December, GDI grew 0.7 percentage point faster than GDP. On the other hand, income may be overestimated.

A third explanation is that the link between growth and unemployment may have broken down in construction, but remained intact in the rest of the economy. Housing starts have plunged 23% in the past 12 months, but in the same period construction payrolls have risen 0.3%. That suggests productivity is plummeting in construction, but growing solidly elsewhere. Fed officials suspect construction employment is bound to decline.

It is possible it already has, but the data don't show it. The payroll survey may not adequately capture many small, unincorporated construction companies, and doesn't cover the self-employed. The separate survey of households finds the unemployment rate among construction workers has risen to 9% from 8.5% in the past 12 months, but even that survey may undercount illegal workers.

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