ECONOMIC UPDATE

REGIONS

August 9, 2017

Q2 2017 Labor Productivity And Costs: As Miracles Go, We're Not All That Impressed

- Nonfarm labor productivity rose at an annualized rate of 0.9 percent in Q2; unit labor costs rose at an annualized rate of 0.6 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 0.4 percent and unit labor costs are rising at a rate of 1.0 percent.

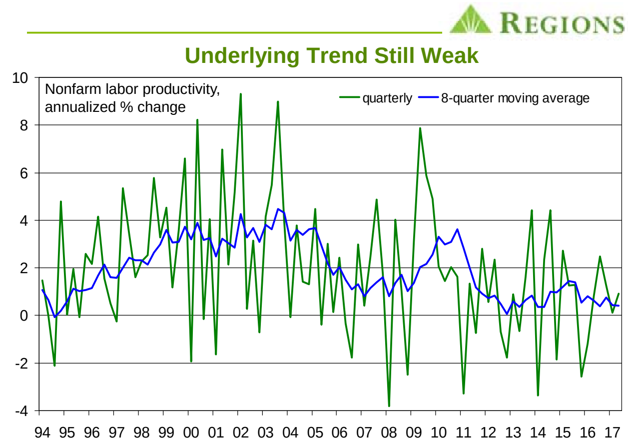
Labor productivity in the nonfarm business sector rose at an annualized rate of 0.9 percent in Q2 2017, ahead of our forecast of 0.4 percent growth, while unit labor costs rose at an annualized rate of just 0.6 percent. Such is the state of productivity growth that, when compared to the 0.1 percent annualized growth logged in Q1 and the anemic trend rate of 0.4 percent growth, the 0.9 percent growth in Q2 almost feels like that productivity miracle we and others have been waiting on for some time. As miracles go, however, this one isn't really all that impressive.

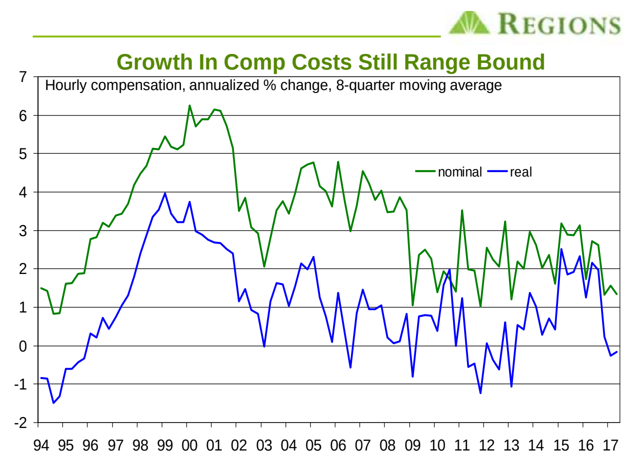
From the initial estimates of the Q2 NIPA data, we knew that real output in the nonfarm business sector rose at an annualized rate of 3.4 percent in Q2. Our miss on our forecast of productivity growth comes from us having overestimated aggregate hours worked in the nonfarm business sector. Aggregate private sector hours worked amongst those covered in the monthly employment reports grew at an annualized rate of just under 3.0 percent in Q2 while aggregate hours worked by those reporting to be self-employed rose at an annualized rate of over 8.0 percent. Hours worked by other groups accounted for in the productivity data, however, went in the other direction, as the BLS reports growth aggregate hours worked in the nonfarm business sector rose at an annualized rate of just 2.5 percent, yielding the 0.9 percent annualized rate of productivity growth. In any event, as we routinely note, the productivity data are inherently volatile from one quarter to the next and, as such, it is far more important to key in on the underlying trend rate of growth. Our preferred manner of doing so is to track the 8-quarter moving average, as we show in our top chart. On this basis, the trend rate of productivity growth is not only weak but has been decelerating over the past several quarters, and stands at 0.39 percent as of Q2 2017.

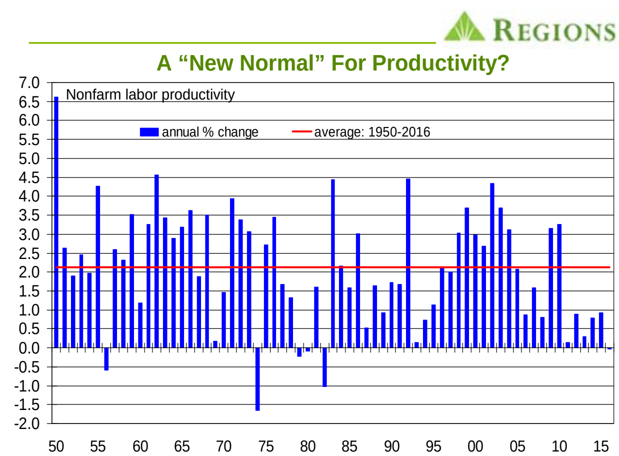
The trend rate of growth in unit labor costs remains similarly anemic, with the 0.6 percent annualized growth in Q2 leaving the 8-quarter moving average at 0.96 percent. As seen in our middle chart, hourly compensation costs continue to grow at a notably slow pace, and after adjusting for inflation hourly compensation costs have been down year-on-year for three consecutive quarters. The Q2 productivity data incorporate revised data on labor compensation from the NIPA accounts which, as we discuss in our August *Monthly Economic Outlook*, resulted in sharp downward revisions in the growth of aggregate wage and salary earnings. In the productivity data, this is reflected in downward revisions to growth in hourly compensation costs, real and nominal, over the past several quarters.

There is general agreement that measurement issues make it difficult to properly gauge productivity growth. Where the disagreement comes, however, is the extent to which these measurement issues cause productivity growth to be understated. We think these errors to be smaller than some other analysts argue is the case, so we are not as dismissive of the weak trend rate of productivity growth as are those analysts. Our premise has for some time been that over the course of this expansion, firms had access to a sizeable pool of relatively cheap labor. This has incentivized firms to substitute labor for capital, and an environment of persistently slow economic growth has enabled them to make this substitution and still satisfy demand. The result has been significant underinvestment on the part of firms over the course of this expansion, which has acted as a drag on labor productivity growth. At some point, as the labor market tightens to a sufficient degree, firms will be incentivized to make greater investments in their capital stocks to either make current workers more productive or to automate tasks now performed by labor. Only then will we see a material and sustained pick-up in labor productivity growth.

In the interim, however, there are many implications of the tepid trend rate of productivity growth, none of which are good. These include restrained wage growth and a notably low rate of noninflationary growth for the U.S. economy, which in turn has implications for monetary policy. By no means do we see this as permanent, but neither is it a situation that will change quickly.







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