ECONOMIC UPDATE

REGIONS

February 1, 2018

Q4 2017 Labor Productivity And Costs: Fumbling Towards Normal

- Nonfarm labor productivity fell at an annualized rate of 0.1 percent in Q4; unit labor costs rose at an annualized rate of 2.0 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 0.96 percent and unit labor costs are rising at a rate of 0.14 percent.

Labor productivity in the nonfarm business sector fell at an annualized rate of 0.1 percent in Q4, lagging our forecast of 0.4 percent growth and mocking the consensus forecast of 1.2 percent growth. Unit labor costs, which measure the labor costs of each unit of output produced, rose at an annualized rate of 2.0 percent, just shy of our forecast of 2.2 percent growth but well ahead of the consensus forecast of 0.9 percent growth. Today's release reflects the preliminary estimate of the BLS, and there will be two main areas of revision – the BEA's estimates of growth in real nonfarm business output and the benchmark revisions of the BLS's establishment data from which estimates of nonfarm employment, hours, and earnings are derived. That said, the pending revisions are unlikely to make the Q4 data look much better and, more significantly, the revisions won't materially alter the diagnosis of the trend rate of productivity growth – better, but still far short of normal.

The initial estimate of Q4 real GDP shows that real output in the nonfarm business sector grew at an annualized rate of 3.2 percent in Q4. Accounting for those on nonfarm payrolls and those self-employed, the productivity data show that aggregate hours worked rose at an annualized rate of 3.3 percent in Q4 – our forecast anticipated 2.8 percent growth in hours worked, hence our miss on productivity growth.

The inputs into the estimate of productivity growth tend to be highly volatile on a quarter-to-quarter basis, as is evident in our top chart. This is why we emphasize the longer-term trends in productivity growth, which we gauge by the 8-quarter moving average, shown in the blue line in our top chart. On this basis, the underlying trend shows productivity growth of 0.96 percent as of Q4 2017, better than in recent quarters but still far from normal. For 2017 as a whole, nonfarm labor productivity increased by 1.2 percent which, while the "best" year since 2012, is well below the long-term average. For 2017 as a whole, unit labor costs rose by just 0.2 percent, which reflects better growth in productivity coupled with only middling growth in hourly compensation.

One may be tempted to ask why productivity growth has been so anemic over the course of the current expansion, and to further ask why does it matter. As to the former, there are no doubt measurement issues that make it difficult to accurately gauge productivity. Where we differ from some other analysts, however, is that we believe measurement issues to be a secondary, as opposed to the primary, factor behind weak productivity growth. We have for years now argued that the primary culprit behind tepid productivity growth has been underinvestment in capital on the part of firms over the current expansion. Investment has been so weak for so long that not only is the size of the capital stock an issue, but so too is the age of the capital stock, with each factor spawning inefficiencies that hold down productivity growth. To this end, we have been encouraged by the strength in business investment over the past three quarters, but will also note that there is a lag between stepped up capital investment and faster productivity growth. Moreover, in order to have a meaningful and lasting impact on productivity, the recent run of growth in business investment will have to be sustained.

As to why it matters, the rate of productivity growth has profound implications for the rate of growth in workers' living standards over time. Faster productivity growth enables firms to raise wages without having to push for higher output prices while still preserving profit margins. Additionally, along with labor force growth, productivity growth determines an economy's "speed limit," i.e., the rate at which it can grow on a sustained basis without sparking inflation pressures. At present, the speed limit of the U.S. economy is notably low, and as remaining slack is wrung out, inflation becomes more of a threat. This in turn has implications for monetary policy. Weak productivity growth is not destiny, as some argue to be the case, but neither is it something that changes quickly. With less and less slack remaining in the U.S. economy, sooner would be better in terms of improved productivity growth.

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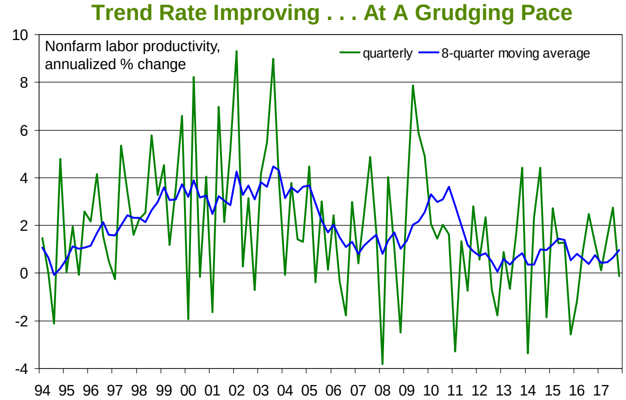
Trend Rate Improving . . . At A Grudging Pace



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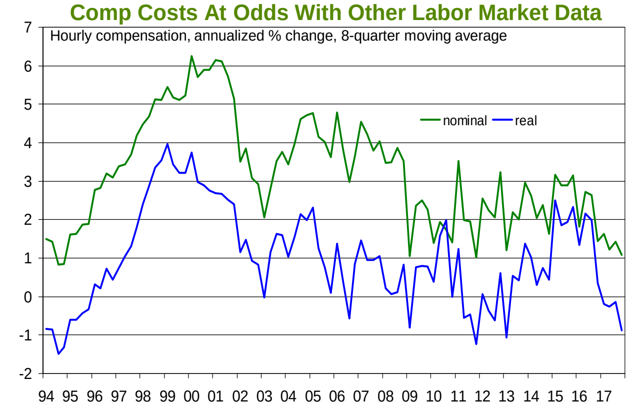
Comp Costs At Odds With Other Labor Market Data



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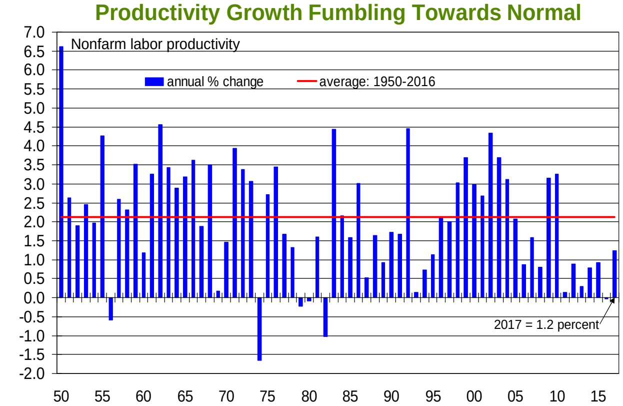
Productivity Growth Fumbling Towards Normal



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