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## Q2 2018 Labor Productivity And Costs: Trend Productivity Growth Grinding Higher

- > Nonfarm labor productivity rose at an annualized rate of 2.9 percent in Q2; unit labor costs fell at an annualized rate of 0.9 percent.
- > On an 8-quarter moving average basis productivity is growing at a rate of 1.3 percent and unit labor costs are rising at a rate of 2.0 percent.

Labor productivity in the nonfarm business sector rose at an annualized rate of 2.9 percent in Q2 while unit labor costs fell at an annualized rate of 0.9 percent. Productivity growth came in ahead of expectations, but there was not much conviction in forecasts of the Q2 data as today's release incorporates comprehensive revisions to the historical data on labor productivity and costs. Like the spike in real GDP growth in Q2, the spike in productivity growth in Q2 is not sustainable. But, as we routinely note, productivity growth tends to vary sharply from one quarter to the next, and what matters much more is the trend rate of productivity growth, which has been steadily increasing, albeit at a modest pace, over the past several quarters. So, while this puts us nowhere near "productivity miracle" territory, there is at least reason for hope given the recent strength of business investment spending.

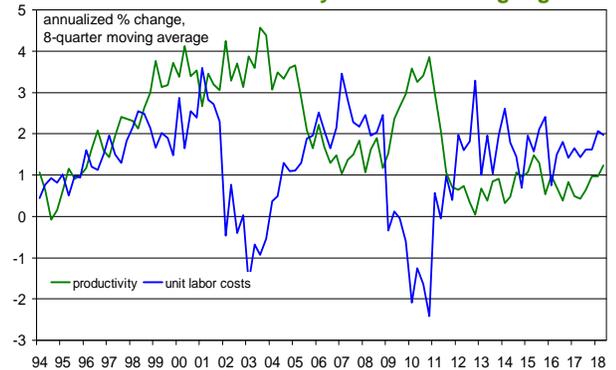
As we knew in advance from the GDP data, real nonfarm business output advanced at an annualized rate of 4.8 percent in Q2. The productivity data show 1.9 percent annualized growth in aggregate hours worked, well below what is implied by the data contained in the monthly employment reports. The data on growth in output and hours yields the 2.9 percent (annualized) rate of productivity growth. With hourly compensation rising at just a 2.0 percent annualized rate – down from 3.7 percent in Q1 – the jump in productivity growth pushed unit labor costs, which can be thought of as the labor costs of producing each unit of output, down at a 0.9 percent (annualized) rate. Again, the quarterly changes in these metrics tend to be quite volatile, which is why we emphasize the underlying trend rates of change, for which we use the 8-quarter moving average of the quarterly growth rates. This yields a trend rate of productivity growth of 1.3 percent as of Q2 2018 and a trend rate of growth in unit labor costs of 2.0 percent. While the trend rate of productivity growth has been grinding higher, it nonetheless remains shy of historical norms and even further from the 3.0 percent average annual growth seen over the 1996-2005 period, a period fondly referred to as the "productivity miracle."

We have for some time argued that the main culprit behind what has been notably weak productivity growth over the course of the current expansion has been underinvestment on the part of firms. Investment had 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. As we have frequently noted, an extended period in which firms were underinvesting simply reflected them responding to the incentive set facing them. In an environment of persistently slow economic growth in which firms were sitting on considerable idle capacity while able to access an abundant pool of relatively cheap labor, firms had little incentive to expand their capital stocks. But, as the degree of idle capacity diminished (and some of this idle capital became obsolete) and the labor market tightened, firms were facing a different incentive set, and they responded by stepping up capital investment. This began last year, i.e., prior to the 2017 tax bill, but we think the tax bill has only amplified firms' incentives to upgrade and, yes, expand their capital stocks. But, while we have been encouraged by the strength of capital spending over recent quarters, we'll also note that there is a lag between stronger 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. And, while we do not dismiss the argument that technological change may spawn rapid productivity growth, as was the case during the 1990s, we think it valid to note that the technological advances seen during the 1990s were to a large measure concentrated in business applications, which has not so much been the case recently.

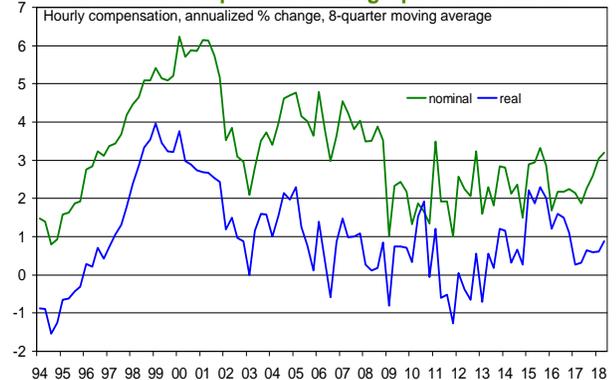
Productivity growth is a key determinant of the economy's "speed limit," i.e., how rapidly it can grow on a sustained basis without sparking inflation pressures. Weak productivity growth is not destiny, as some argue to be the case, but neither is it something that changes quickly. With less and less slack remaining in the U.S. economy, sooner would be better in terms of improved productivity growth.



### Trend Rate Of Productivity Growth Grinding Higher



### Growth In Comp Costs Picking Up At Uneven Pace



### U.S. Economy's "Speed Limit":

#### Sustainable Rate Of Noninflationary Growth

