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Q3 2017 Labor Productivity And Costs: A Puzzle And A Miracle, All In One

- > Nonfarm labor productivity rose at an annualized rate of 3.0 percent in Q3; unit labor costs rose at an annualized rate of 0.5 percent.
- > On an 8-quarter moving average basis productivity is growing at a rate of 0.7 percent and unit labor costs are rising at a rate of 1.0 percent.

In the ten-year period spanning 1996 through 2005, labor productivity in the nonfarm business sector grew at an average annual rate of 3.0 percent, a run fondly referred to as the "productivity miracle." After some sharp swings surrounding the 2007-09 recession, average annual productivity growth from 2011 through 2016 was 0.5 percent, a run not so fondly referred to as the "productivity puzzle." Today the BLS reported labor productivity in the nonfarm business sector rose at an annualized rate of 3.0 percent in Q3. While that headline conjures up memories of the productivity miracle, what remains an anemic trend rate of growth tells us the productivity puzzle has yet to be solved.

From the initial estimates of Q3 GDP, we knew ahead of today's release that real output in the nonfarm business sector rose at an annualized rate of 3.8 percent in Q3. Based on the data from the monthly employment reports, our forecast anticipated a 0.4 percent increase, annualized, in aggregate hours worked in Q3, hence our forecast of annualized productivity growth of 3.4 percent. Today's release shows aggregate hours worked, which accounts for not only those on nonfarm payrolls but also those self-employed, rose at an annualized rate of 0.8 percent in Q3, hence our miss on our forecast of productivity growth. Still, as we routinely note, 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 reflect in the 8-quarter moving average, shown in the blue line in our top chart.

We make the same point about unit labor costs, or, the labor costs associated with producing each unit of output. In Q3, unit labor costs rose at an annualized rate of just 0.5 percent, which reflects annualized growth in (nominal) hourly compensation of 3.5 percent and annualized productivity growth of 3.0 percent. While some might interpret the rapid growth in hourly compensation as a sign of significantly tighter labor market conditions, keep in mind this is an annualized change coming off of a meager 1.8 percent annualized increase in Q2. Again, the longer-term trends are more meaningful, and on an 8-quarter moving average basis unit labor costs are growing at a rate of just 1.0 percent, with the trend rate of growth in hourly compensation at just 1.7 percent. Still, the Q3 data provide a good illustration of a point we frequently make, which is that faster productivity growth is a critical buffer between higher labor costs and corporate profit margins as it enables firms to pay higher wages without resorting to raising output prices. That productivity growth has been so anemic for so long is one reason many analysts worry that faster wage growth will lead firms to (at least attempt) to raise prices.

That measured productivity growth is so inherently volatile from one quarter to the next does not stand in the way of observers spinning any given quarter's growth number to fit whatever their underlying narrative happens to be. Talk about a productivity drain. In any event, the far more relevant question is why trend productivity growth has been so anemic over the past several years. Our argument has been that underinvestment on the part of firms over the course of this expansion coupled with a capital stock as old as at any point on record has been a significant drag on productivity growth. This one reason we have been so encouraged by the growth in business investment in equipment and machinery, as well as in intellectual property products, seen to date in 2017. We'll caution, however, that the link between such investment and productivity growth takes some time to form, but nonetheless improved capital spending is encouraging. We also have argued what was a significantly higher regulatory burden over the past decade acted as a drag on productivity growth, and this drag figures to abate over coming quarters.

The long-term rate of productivity growth has profound implications for the rate of growth in workers' living standards and the economy's sustainable rate of growth. By no means do we see anemic productivity growth as permanent, but neither is it a situation that will change quickly.

