ECONOMIC UPDATE

REGIONS

August 9, 2016

This Economic Update may include opinions, forecasts, projections, estimates, assumptions and speculations (the "Contents") based on currently available information which is believed to be reliable and on past, current and projected economic, political and other conditions. There is no guarantee as to the accuracy or completeness of the Contents of this Economic Update. The Contents of this Economic Update reflect judgments made at this time and are subject to change without notice, and the information and opinions herein are for general information use only. Regions specifically disclaims all warranties, express or implied, with respect to the use of or reliance on the Contents of this Economic Update or with respect to any results arising therefrom. The Contents of this Economic Update shall in no way be construed as a recommendation or advice with respect to the taking of any action or the making of any economic, financial or other plan or decision.

Q2 2016 Productivity And Costs: Trend Productivity Growth Remains Weak

- Nonfarm labor productivity fell at an annualized rate of 0.5 percent in Q2; 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 0.41 percent and unit labor costs are rising at a rate of 2.02 percent.

Labor productivity in the nonfarm business sector fell at an annualized rate of 0.5 percent in Q2 2016 while unit labor costs rose at an annualized rate of 2.0 percent. Expectations – ours and the consensus – were for a 0.4 percent increase in productivity. As we routinely point out, the productivity and costs data are jumpy on a quarter-to-quarter basis so it is more important to focus on the longer run trends. Our preferred basis of drawing out the underlying trends is to take the 8-quarter moving averages of the quarterly growth rates, which is what we show in our top chart. On this basis, the news isn't any more encouraging, as trend productivity growth is running at 0.41 percent while unit labor costs are rising at a trend rate of 2.02 percent.

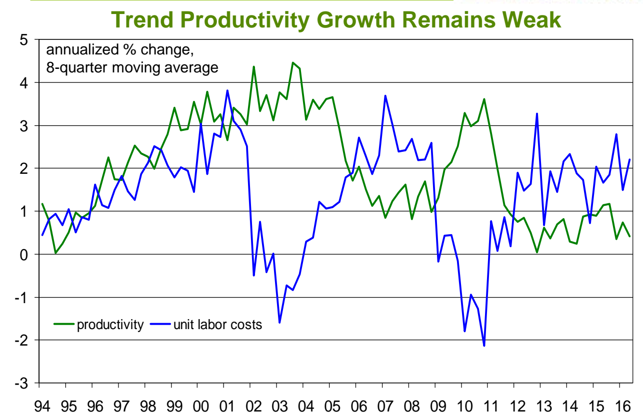
From last month's release of the GDP data, we knew real output in the nonfarm business sector grew at an annual rate of 1.2 percent in Q2. We also knew from the monthly employment reports that aggregate private sector hours worked grew at an annual rate of 0.6 percent in Q2. Yet, today's release shows 1.8 percent annualized growth in hours worked. Unlike the monthly employment reports, the productivity data incorporate hours worked by the self-employed, which grew at an annual rate of 11 percent in Q2. This apparently led to the larger than expected jump in hours worked reported in Q2, and this miss on hours worked is why we missed on headline productivity growth. In that sense, the reported decline in productivity in Q2 seems overstated.

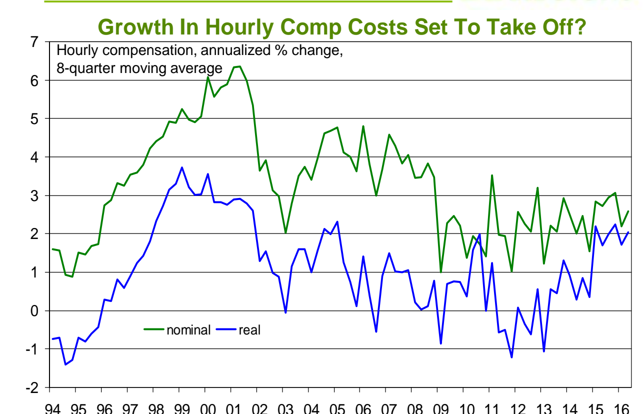
Be that as it may, hourly compensation grew at an annual rate of 1.5 percent in Q2, though on an inflation adjusted basis hourly compensation fell for a second consecutive quarter. Even on an 8-quarter moving average basis, growth in hourly compensation remains quite jumpy, as seen in the middle chart and there is as of yet no clearly established trend, which to some extent is a reflection of the remaining slack in the labor market. If we truly are approaching full employment, such a trend would be in evidence. Note the behavior of compensation costs during the 1990s, a decade in which we saw robust productivity growth and broad based gains in real wages across the private sector.

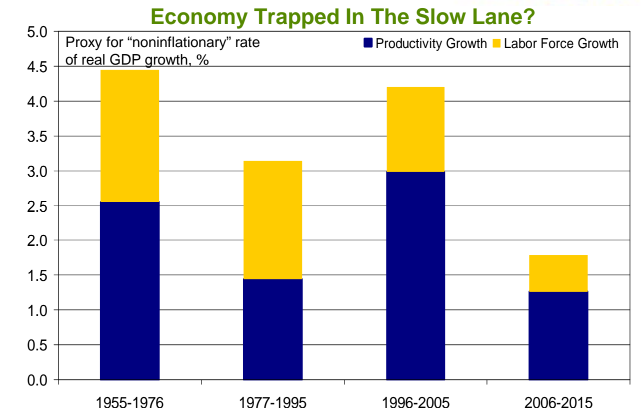
This illustrates why we and other analysts emphasize productivity growth as much as we do. Productivity growth is the main driver of growth in workers' real wages, and in turn living standards, over time. That productivity growth has been so anemic over the course of the current expansion is one reason real wages have yet to gain traction. Productivity growth allows corporations to raise workers' wages without having to raise output prices while still preserving profit margins. What we have seen over the past several quarters, however, is corporate profit margins coming under pressure even with what remains tepid growth in unit labor costs, which is a reflection of how little pricing power firms have. In other words, higher labor costs are being absorbed by contracting margins.

Productivity growth is also a key determinant of how rapidly an economy can grow over time without fostering inflation pressures, or, its noninflationary "speed limit" as we refer to it. The bottom chart shows how low the economy's speed limit has been over the current expansion (we delineate time periods by productivity cycles, not calendar decades), reflecting slower growth in both the labor force and productivity. This has implications, none of them good, for monetary policy as well – once the remaining slack has been wring out of the labor market and the broader economy the implication is that we will see inflation pressures build at a slower rate of GDP growth than would be the case with a faster trend rate of productivity growth.

It is, more or less, the worst of both worlds. We point to underinvestment on the part of businesses over the course of the current expansion as a key factor behind anemic productivity growth. Neither of these things changes quickly, nor does the trend rate of labor force growth. This suggests the U.S. economy will be stuck in the slow lane for some time to come.







Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com