ECONOMIC UPDATE

REGIONS

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Q4 2015 Productivity And Costs: Anemic Trend The Bigger Issue

- Nonfarm labor productivity fell at an annualized rate of 2.2 percent in Q4; unit labor costs rose at an annualized rate of 3.3 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 0.34 percent and unit labor costs are rising at a rate of 2.49 percent.

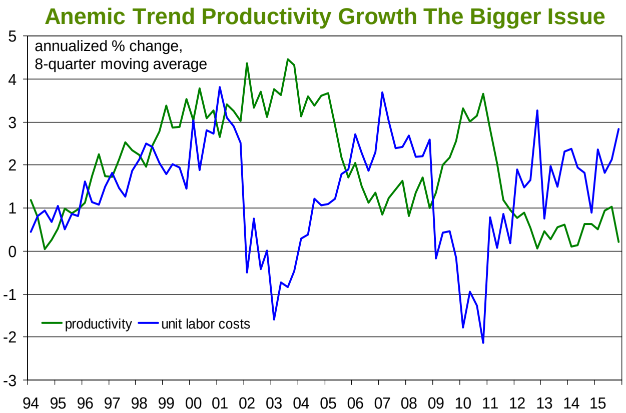
Revised data show labor productivity in the nonfarm business sector fell at an annual rate of 2.2 percent in Q4 2015 compared to the initial estimate of a 3.0 percent annualized rate of decline. With productivity growth not falling as rapidly as first estimated, unit labor costs in turn did not grow as rapidly as initially estimated; the BLS now reports annualized growth of 3.3 percent in Q4 compared to the initial estimate of 4.5 percent annualized growth. As we consistently point, the productivity data are extremely jumpy on a quarter-to-quarter basis and our preferred means of drawing out the underlying trends is to analyze the 8-quarter moving average. On this basis, as shown in the top chart, trend productivity growth is running at a rate of 0.34 percent while unit labor costs are rising at a trend rate just shy of 2.5 percent. Or, if you prefer the highly technical explanation, the lines in the top chart are pointing in the wrong directions.

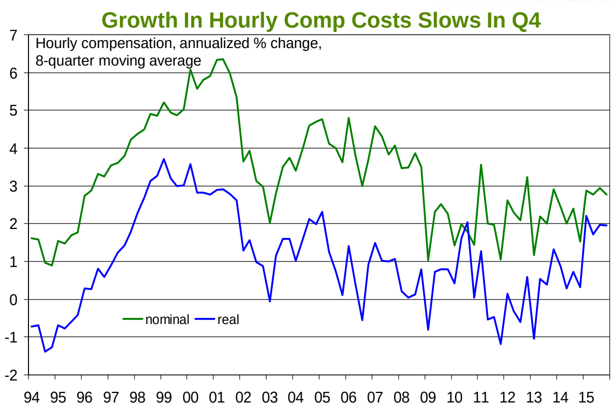
The reality is that while the productivity data may seem abstract and arcane, the rate of productivity growth is not only an important determinant of an economy's sustainable rate of noninflationary growth, but also impacts corporate profit margins and the growth in workers' real wages over time. The bottom chart illustrates our point about the rate at which an economy can grow over time without generating inflation pressures, which is a function of the rates of productivity growth and labor force growth. We've delineated the time periods based on productivity cycles, not calendar decades, and note the running 8-quarter moving average of productivity growth is now significantly below the average shown for the 2006-15 period. It is clear from the chart the U.S. economy is currently trapped in the slow lane, with both labor force growth and productivity growth having slowed over the past decade. While we look for labor force growth to pick up a bit over coming years, we do not expect it to return to its historical trend rate, which makes the rate of productivity growth even more vital as a driver of economic growth.

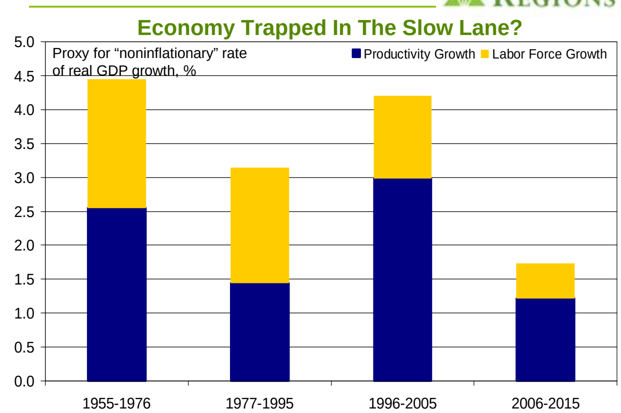
There is at present considerable debate as to the causes for the slowdown in productivity growth as well as the outlook for productivity growth going forward. There are those who largely dismiss slower productivity growth as a statistical mirage stemming from the inability to measure productivity in today's economy. On the other extreme, some argue we've simply seen the last of the types of big innovations, at least those that can translated into business purposes, which have in past decades led to periods of rapid productivity growth. We don't buy either of these arguments – yes, we do think there clearly are measurement issues that lead productivity to be understated, but think the magnitude is much smaller than those who argue these measurement issues are the key factor behind the deceleration in reported productivity growth.

We also think there are other issues impacting productivity growth. One is an aged capital stock that is simply not as efficient, nor does it allow workers to be as efficient, as otherwise would be the case. This stems in part from what we've contended all along has been persistent underinvestment on the part of firms since the end of the 2007-09 recession. We think this underinvestment is the product of an environment in which there has been persistently slow economic growth coupled with what has been an abundant supply of cheap and readily available labor. To the extent firms do need to add capacity, it has been cheaper to do so by adding labor, not capital. This helps reconcile what many have seen as a disconnect between reported GDP and employment growth over the past several years. The logical extension would be that as labor becomes more costly, there would be a shift towards adding more capital, but we do not believe we are at this point in the cycle yet and, indeed, growth in hourly labor compensation slowed in Q4.

We do not see meaningfully faster, sustained productivity growth on the horizon. As such, profit margins will come under increased pressure even as wage growth falls short of historical norms, and the economy will remain firmly rooted in the slow lane.







Source: Bureau of Labor Statistics; Regions Economics Division

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