ECONOMIC UPDATE

REGIONS

February 2, 2017

Q4 2016 Productivity And Costs: Underlying Trend Still Weak

- Nonfarm labor productivity rose at an annualized rate of 1.3 percent in Q4; unit labor costs rose at an annualized rate of 1.7 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 0.73 percent and unit labor costs are rising at a rate of 2.32 percent.

Labor productivity in the nonfarm business sector rose at an annualized rate of 1.3 percent in Q4 2016, down from growth of 3.5 percent in Q3 but still easily ahead of the trend rate of growth. Unit labor costs rose at an annualized rate of 1.7 percent in Q4, up from the 0.2 percent annualized growth logged in Q3. For all of 2016, labor productivity increased by 0.2 percent, reflecting a decline in productivity over the first half of the year being negated by decent growth over the second half of the year. The swings seen over the course of 2016 raise the question of which way productivity growth will go in 2017.

We knew from the initial estimate of Q4 GDP that real output in the nonfarm business sector grew at an annualized rate of 2.2 percent in Q4, leaving the change in hours worked as the unknown variable in forecasts of productivity growth. We know from the nonfarm employment data that aggregate private sector hours worked grew at an annualized rate of 1.3 percent in Q4 while aggregate hours worked by the self-employed rose at an annualized rate of 11.5 percent. The productivity data, however, show aggregate hours worked rose at an annualized rate of just 0.9 percent in Q4, and our miss here accounts for our miss on our forecast for 0.6 percent productivity growth. It is our hope that before we leave this earth we will unravel the mysterious formula by which aggregate hours worked are calculated in the productivity data. You have your bucket list, we have ours.

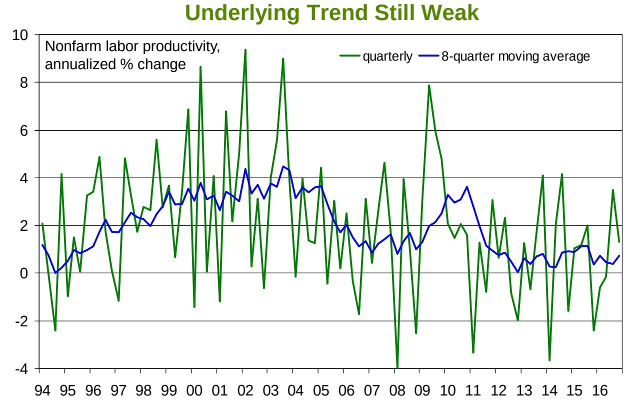
In any event, as we routinely note, the productivity data are inherently volatile from one quarter to the next and, as such, it is far more important to key in on the underlying trend rate of growth. Our preferred manner of doing so is to track the 8-quarter moving average, as we show in our top chart. On this basis, the trend rate of productivity growth is a notably weak 0.73 percent. Looking at the data on an annual basis, as we do in our bottom chart, doesn't improve the view at all. As noted above, productivity grew by just 0.2 percent in 2016, and this marks the sixth consecutive year in which productivity growth badly lags the 2.12 percent average rate of productivity growth from 1950 on.

There are reasons to care about the anemic trend rate of productivity growth. For starters, 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 listless over the course of the current expansion is one reason real wage growth has yet to gain traction. Productivity growth allows firms 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, reflecting how little pricing power firms have. In other words, higher labor costs are being absorbed by contracting margins.

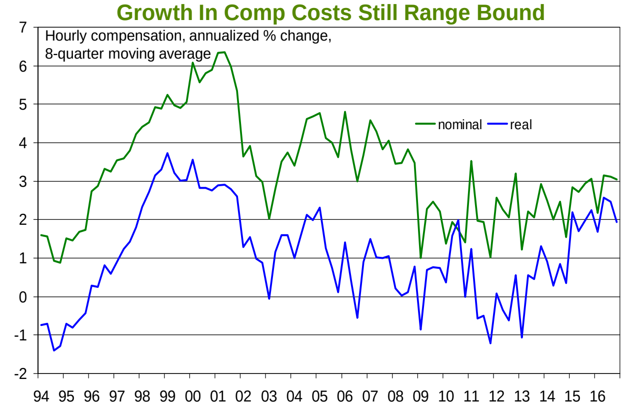
Additionally, productivity growth is a key determinant of how rapidly an economy can grow over time without fostering inflation pressures, or, its noninflationary "speed limit" as we refer to it. The rate of labor force growth is the other main determinant of this speed limit. At present, the economy's speed limit is roughly 1.5 percent, and one of the key questions about the looming changes to fiscal and regulatory policy is whether they will do anything to raise the economy's speed limit – we see avenues through which policy changes can impact both productivity and labor force growth. This has implications for monetary policy – once the remaining slack has been wrung out of the economy, the implication is that inflation pressures will build at a slower rate of GDP growth than would be the case with a higher speed limit. Anyone who doubts the FOMC views the world in this manner, if not in these same terms, would do well to listen to public comments by FOMC members on this topic, most recently those by Governor Brainard.

We do not view the economy as being stuck in the slow lane, but we do think that a carefully crafted policy mix is a necessary condition for productivity growth, and in turn real GDP growth, to break out into at least the middle lane if not the fast lane.

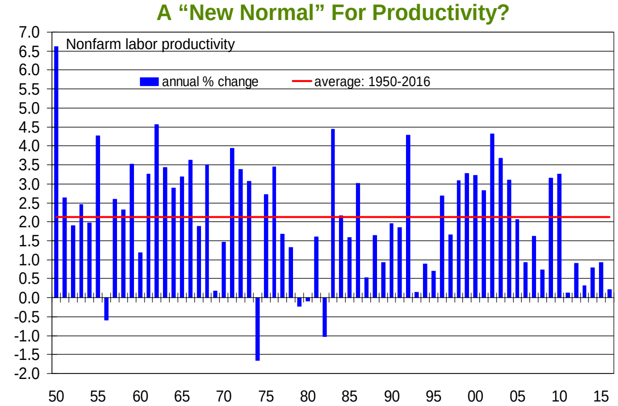
Underlying Trend Still Weak



Growth In Comp Costs Still Range Bound



A "New Normal" For Productivity?



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