ECONOMIC UPDATE

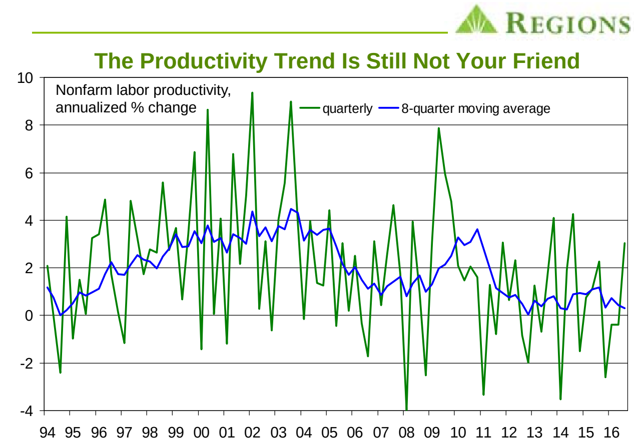
REGIONS

November 3, 2016

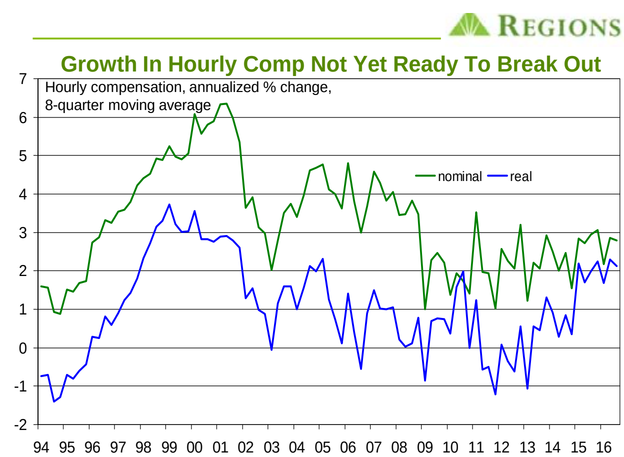
Q3 2016 Productivity And Costs: The Productivity Trend Is Still Not Your Friend . . .

- Nonfarm labor productivity rose at an annualized rate of 3.1 percent in Q3; unit labor costs rose at an annualized rate of 0.3 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 0.29 percent and unit labor costs are rising at a rate of 2.48 percent.

Labor productivity in the nonfarm business sector rose at an annualized rate of 3.1 percent in Q3 2016, the fastest growth since Q3 2014. After three consecutive quarters in which productivity declined we get that today's data will elicit sighs of relief, but we'd caution against getting too carried away. As we routinely note, and as we show in our top chart, the quarterly productivity data are highly volatile, making it far more important to focus on the underlying trend. That trend, however, is clearly not your friend, even with the robust growth reported for Q3. On an 8-quarter moving average basis, our preferred gauge of the underlying trend, labor productivity in the nonfarm business sector is growing at a rate of just 0.29 percent. So, in other words, enjoy the Q3 headline number but don't mistake it for the start of a new "productivity miracle."

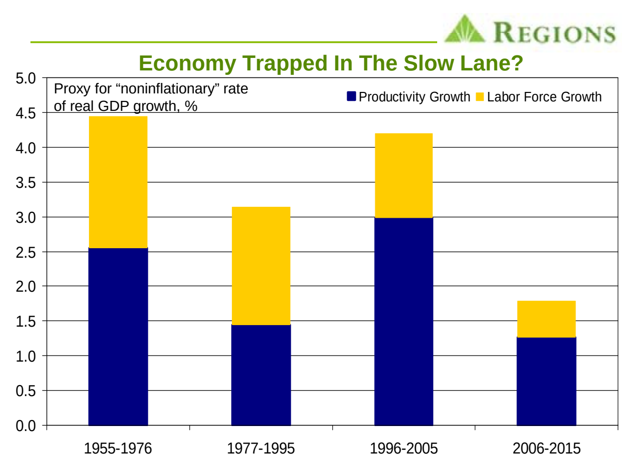


Real output in the nonfarm business sector grew at an annualized rate of 3.4 percent in Q3 which, combined with annualized growth of just 0.3 percent in aggregate private sector hours worked, yields productivity growth of 3.1 percent. This points to one of the quirks of the productivity data that we have yet to unravel. The monthly employment reports show aggregate private sector hours worked grew at an annualized rate of 1.4 percent in Q3. At the same time, however, aggregate hours worked by those reporting to be self-employed fell at an annualized rate of 11.6 percent. Together – though we don't really get how – this yields the 0.3 percent increase reported in the productivity data.



Unit labor costs, which measure the hourly labor costs of producing each unit of output, rose at an annualized rate of 0.3 percent in Q3. Again, though, the quarterly data are inherently volatile and the underlying trend is far more relevant. On an 8-quarter moving average basis, unit labor costs are growing at 2.48 percent. Hourly compensation grew at an annualized rate of 3.4 percent in Q3, which translates into a year-on-year increase of 2.3 percent. Note this is an all-in compensation figure, accounting for not only wages but also benefits and other forms of compensation. The data on compensation costs from the productivity accounts are basically in line with data from other sources, such as the Employment Cost Index, which show gentle acceleration in the growth of compensation costs but at a rate below what would be consistent with full employment.

To be sure, productivity can be a somewhat nebulous concept and we often get questions as to why we place so much emphasis on it. One main reason is that 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 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. While Q3 provided a welcome respite, the underlying trend remains concerning.



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 for monetary policy as well – once the remaining slack has been wrung out of the labor market, the implication is that inflation pressures will build at a slower rate of GDP growth than would be the case with a faster trend rate of productivity growth. Trend productivity growth is not something that changes rapidly, nor does the rate of labor force growth. This suggests the U.S. economy will be stuck in the slow lane for some time to come, as the rapid productivity growth reported for Q3 is simply not sustainable.

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203

Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com