ECONOMIC UPDATE
REGIONS
May 3, 2018

Q1 2018 Labor Productivity And Costs: Productivity Improving, But No Miracle In Sight

- Nonfarm labor productivity rose at an annualized rate of 0.7 percent in Q1; unit labor costs rose at an annualized rate of 2.7 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 1.3 percent and unit labor costs are rising at a rate of 0.9 percent.

Labor productivity in the nonfarm business sector rose at an annualized rate of 0.7 percent in Q1, a bit shy of the 0.9 percent growth rate we and the consensus expected. Unit labor costs rose at an annualized rate of 2.7 percent, falling short of the 3.0 percent pace we and the consensus expected. Today's release incorporates revisions to prior estimates of aggregate hours worked and hourly compensation costs, while the estimate of growth in real output in the nonfarm business sector is the BEA's initial estimate and hence subject to potentially sizeable revision. Those caveats aside, the productivity story remains pretty much the same – the trend rate of productivity growth is improving but remains well below the rate necessary to put the economy on a sustainable trajectory of faster growth.

The initial estimate of Q1 real GDP shows that real output in the nonfarm business sector grew at an annualized rate of 2.8 percent. Accounting for those on nonfarm payrolls and those self-employed, the productivity data show that aggregate hours worked rose at an annualized rate of 2.1 percent in Q1 – our forecast anticipated 1.9 percent growth in hours worked, hence our miss on productivity growth. The inputs into the estimates of productivity growth and unit labor costs tend to be highly volatile on a quarter-to-quarter basis, which is why we prefer to focus on the longer-term trends. In our view, the best gauge of underlying trends in productivity growth is 8-quarter moving average of the quarterly growth rates. We show this, along with the 8-quarter moving average of growth in unit labor costs, in our top chart. On this basis, the underlying trend shows productivity growth of 1.27 percent as of Q1 2018, with steady improvement over the past several quarters. Still, trend productivity growth remains shy of historical norms and even further from the 3.0 percent average annual growth seen over the 1996-2005 period, a period fondly referred to as the "productivity miracle."

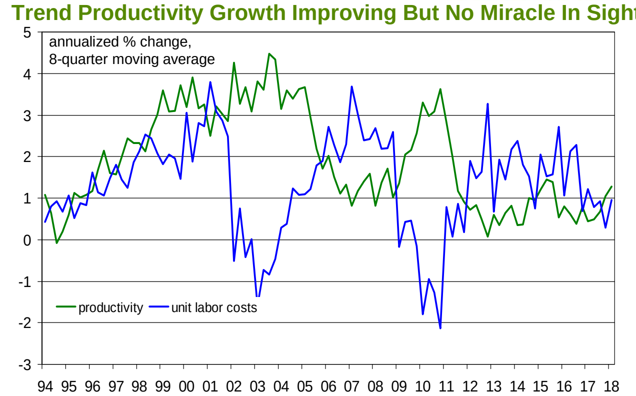
Over the past eight quarters, annualized growth in unit labor costs has averaged just 0.95 percent (unit labor costs were up 1.1 percent year-on-year in Q1). While growth in unit labor costs figures to pick up over coming quarters, any such acceleration will be consistent with a gradually tightening labor market as opposed to signaling a labor market on the boil. Growth in hourly compensation costs is firming but, as seen in our middle chart, still below longer-term norms. What we expect to see in the quarters ahead is faster growth in both compensation costs and labor productivity, but the main question to be answered is which will grow at a faster pace, the answer of course determining the path of corporate profit margins.

We have for some time argued that the main culprit behind what has been notably weak productivity growth over the course of the current expansion has been underinvestment on the part of firms. Investment had been so weak for so long that not only is the size of the capital stock an issue, but so too is the age of the capital stock, with each factor spawning inefficiencies that hold down productivity growth. To this end, we have been encouraged by the strength in business investment over recent quarters, but will also note that there is a lag between stepped up capital investment and faster productivity growth. Moreover, in order to have a meaningful and lasting impact on productivity, the recent run of growth in business investment will have to be sustained. And, while we do not dismiss the argument that technological change may spawn rapid productivity growth, as was the case during the 1990s, that is not a sure bet. One thing to keep in mind is that the technological advances seen during the 1990s were to a large measure concentrated in business applications, which has not so much been the case recently.

Productivity growth is a key determinant of the economy's "speed limit," i.e., how rapidly it can grow on a sustained basis without sparking inflation pressures. Weak productivity growth is not destiny, as some argue to be the case, but neither is it something that changes quickly. With less and less slack remaining in the U.S. economy, sooner would be better in terms of improved productivity growth.

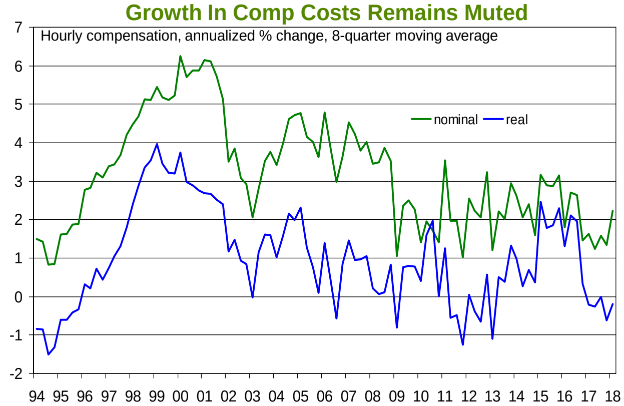
REGIONS

Trend Productivity Growth Improving But No Miracle In Sight



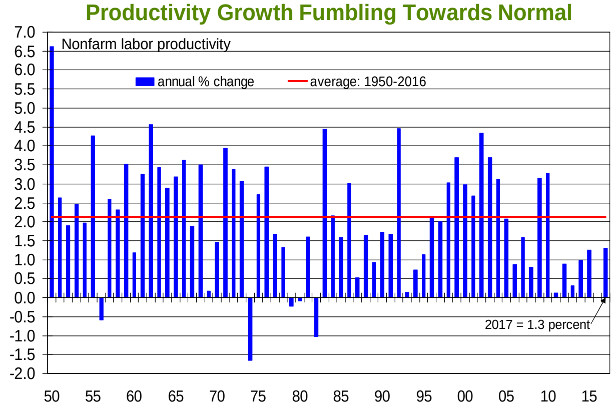
REGIONS

Growth In Comp Costs Remains Muted



REGIONS

Productivity Growth Fumbling Towards Normal



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