ECONOMIC UPDATE
REGIONS
May 2, 2019

Q1 2019 Labor Productivity And Costs: Better, But Still A Long Road To Normal

› Nonfarm labor productivity rose at an annualized rate of 3.6 percent in Q1; unit labor costs fell at an annualized rate of 0.9 percent.
› On an 8-quarter moving average basis productivity is growing at a rate of 1.7 percent and unit labor costs are rising at a rate of 1.1 percent.

Labor productivity in the nonfarm business sector rose at an annualized rate of 3.6 percent in Q1, while unit labor costs fell at an annualized rate of 0.9 percent. Our forecast anticipated productivity growth of 3.0 percent and a 0.2 percent decline in unit labor costs, while the consensus forecast looked for productivity growth of 2.2 percent and a 1.5 percent increase in unit labor costs. As reported in the Q1 GDP data, real output in the nonfarm business sector grew at an annualized rate of 4.1 percent in Q1, so our miss on our forecast of productivity growth comes from growth in aggregate hours worked rising by less than our forecast anticipated. The combination of productivity growth being faster than we anticipated and growth in hourly compensation costs being slower than we anticipated pushed unit labor costs down at a faster rate than our forecast anticipated. Still, as we regularly note, the data on labor productivity and costs are very jumpy from one quarter to the next, so the underlying trend rates of growth are much more relevant. We measure the trend rate of productivity growth and the trend rate of growth in unit labor costs by taking the 8-quarter moving average of each series, which we show in our top chart. On the productivity growth front, one has to be heartened by the steadily rising trend rate of productivity growth – as of Q1 2017, the 8-quarter moving average stands at 1.74 percent, the highest reading since Q2 2011. At the same time, however, there is still a long way to go before productivity growth approaches the longer-term average rate of 2.12 percent, and even further to go before we get to "productivity miracle" territory, i.e., the annual average of 3.0 percent growth seen over the 1996-2005 period which to a large extent reflected rapid technological advances over that period.

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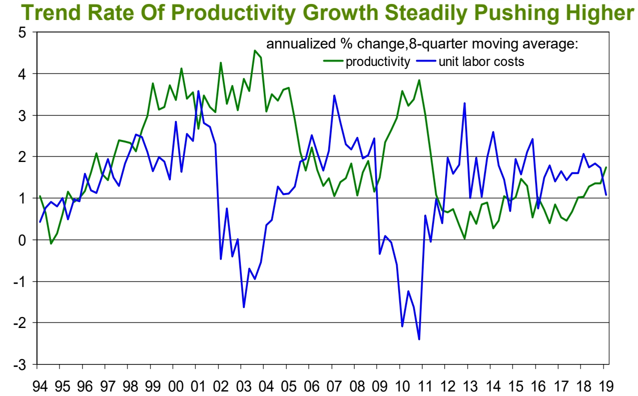
Trend Rate Of Productivity Growth Steadily Pushing Higher



As reported in the productivity data, aggregate hours worked in the nonfarm business sector increased at an annualized rate of just 0.5 percent, considerably below the 1.87 percent increase (annualized rate) in aggregate private sector hours worked based on the data in the monthly employment reports. The productivity data also include hours worked by the self-employed (which declined at an annualized rate of 17.4 percent in Q1 based on the monthly employment reports), nonfarm proprietors, and unpaid family members, but the mapping of hours worked by these various groups into the estimate used to arrive at productivity growth is one of life's grand mysteries which we've given up on ever being able to solve. In any event, hourly compensation grew at an annualized rate of 2.6 percent in Q1, considerably below the average pace of 3.7 percent seen over the back half of 2018. Again, though, the underlying trend rate of growth is more relevant here, and we show this on both a nominal and real (or, adjusted for inflation) basis in our middle chart. While growth in hourly compensation costs (which includes wages/salaries, supplemental payments, employer contributions to employee benefit plans, and employer-paid taxes) has picked up, growth remains fairly orderly, which is in line with the story being told by the Employment Cost Index, the preferred measure of growth in labor costs. This is another illustration of a point we frequently make, which is that despite a prolonged period of improving labor market conditions and an unemployment rate below 4.0 percent, there is still a good deal of labor market slack yet to be pared down.

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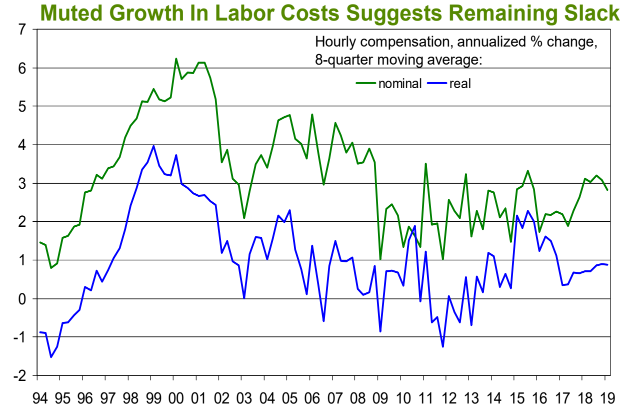
Muted Growth In Labor Costs Suggests Remaining Slack



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. That said, the GDP data show growth in business investment spending, on equipment/machinery and intellectual property products, picked up considerably in Q1 2017, and while there was a lull in growth of spending on equipment and machinery in Q1 2019, the higher frequency data suggest some firming of late. Keep in mind that faster growth in R&D outlays, included in intellectual property investment, typically leads improvements in productivity growth by several quarters. Even if growth in spending on business equipment does slow, our view is that tighter labor market conditions will incent firms to continue to invest in R&D as a means of driving greater labor productivity. This takes on added importance given a relatively dim outlook for labor force growth, and we expect the upward trend in productivity growth to persist.

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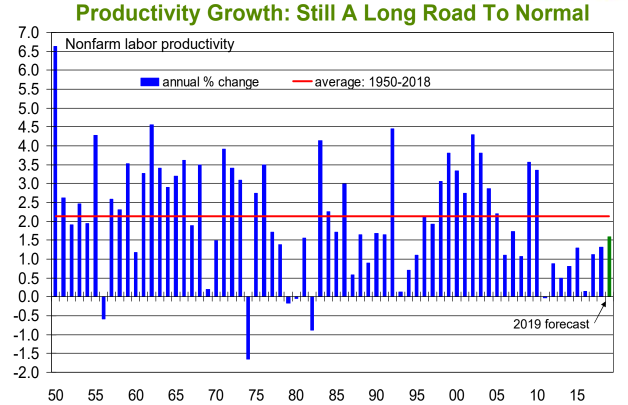
Productivity Growth: Still A Long Road To Normal



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