ECONOMIC UPDATE

REGIONS

May 7, 2014

Q1 2014 Productivity And Costs: The Trend, Not The Q1 Headline, Is What's Concerning

- Nonfarm labor productivity declined at an annualized rate of 1.7 percent in Q1.
- Unit labor costs rose at an annualized rate of 4.2 percent.
- On an 8-quarter moving average basis, productivity is rising at a rate of 0.72 percent and unit labor costs are rising at a rate of 1.35 percent.

Worker productivity in the nonfarm business sector fell at an annualized rate of 1.7 percent in Q1, reflecting the sharp slowdown in the rate of overall economic activity, with output in the nonfarm business sector rising at an annual rate of just 0.3 percent. Reflecting the decline in productivity, unit labor costs, or, the labor cost of producing each unit of output, jumped at an annualized rate of 4.2 in Q1.

While there is no arguing the headline numbers from today's report are eye catching, what we should be watching, and what we should be more concerned about, are the longer run trends in productivity and unit labor costs. Given what can be sizeable quarter-to-quarter swings in the data, as is the case with the Q1 data, we prefer to look at the productivity and cost data on an 8-quarter moving average basis. As indicated in the middle chart, this longer term view shows productivity growth has settled in to a less than impressive pace, averaging just 0.7 percent over the last eight quarters, with unit labor costs advancing at a rate of just 1.35 percent over this same period.

The slower productivity growth seen over the past several quarters to some extent reflects underinvestment on the part of businesses in the type of equipment and software that would enhance productivity. The bigger factor, however, is that firms have already wrung most of the productivity gains out of their current work forces. In many regards, the pattern of productivity growth seen since the end of the 2007-09 recession is typical of that seen over past cycles. In the early stages of recovery firms typically rely on boosting output via productivity gains from current workers. As recoveries mature and give way to expansion, firms then begin to add hours and take on additional workers, which push recorded productivity growth lower. What is atypical about the current cycle, however, is the handoff from productivity growth to hiring has taken so long due to how tepid overall growth has been over the course of the current cycle. Still, the silver lining here is with productivity growth having settled into a slow trend rate, the faster rate of GDP growth we and most other analysts expect over the remainder of 2014 would necessitate a stepped up rate of hiring.

Growth in hourly compensation, both real and nominal, remains modest, which is simply another illustration of what remains an elevated degree of labor market slack. This is one factor that has led to the swelling of, and the preservation of, corporate profit margins despite what over the course of the recovery has been sluggish growth in top-line revenue. Both revenue growth and compensation growth will pick up over coming quarters, though the latter will be slower than the former, indicating stepped up hiring need not be a threat to profit margins, at least not initially.

For the longer run, the main issue is whether the true underlying rate of productivity growth is the 1.0 percent seen of late or the faster rate seen prior to the 2007-09 recession. This will be a key determinant of the economy's potential growth rate and the rate of growth of labor income.

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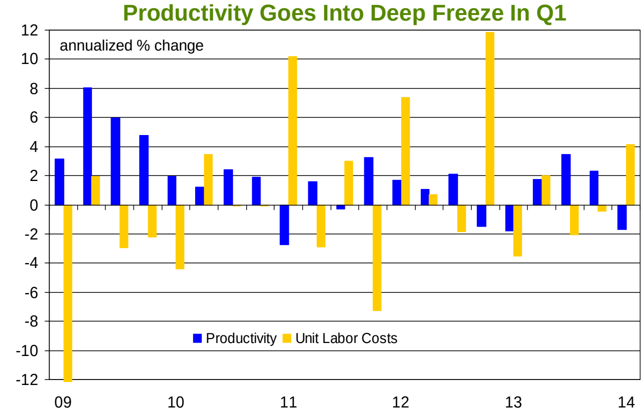
Productivity Goes Into Deep Freeze In Q1



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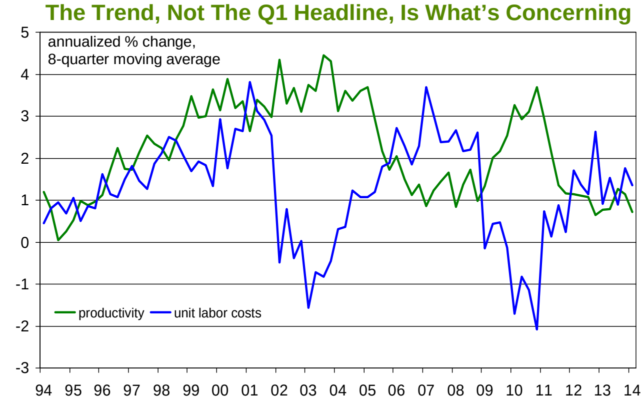

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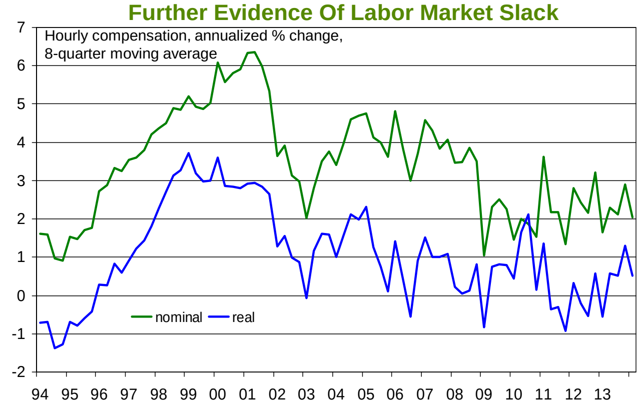
Further Evidence Of Labor Market Slack



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