ECONOMIC UPDATE
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Q3 2014 Productivity And Costs: Bounce In Productivity Growth Only Matters If Sustained

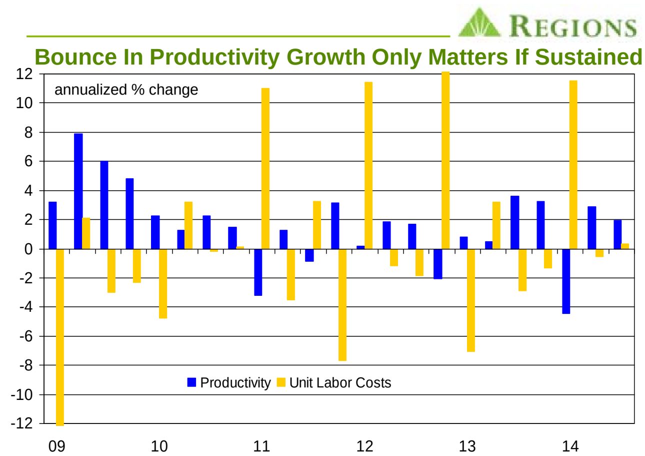
- Nonfarm labor productivity grew at an annualized rate of 2.0 percent in Q3 while unit labor costs rose at an annualized rate of 0.3 percent.
- On an 8-quarter moving average basis, productivity is growing at a rate of 0.8 percent and unit labor costs are rising at a rate of 2.0 percent.

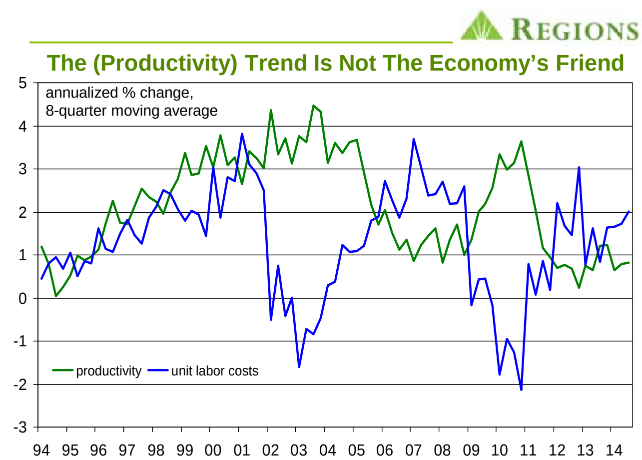
Worker productivity in the nonfarm business sector rose at an annualized rate of 2.0 percent in Q3, ahead of expectations, while productivity growth for Q2 was revised up to an annualized rate of 2.9 percent. The improved pace of labor productivity growth over the past two quarters has helped rein in growth of unit labor costs (or, the total labor costs of producing each unit of output), with unit labor costs rising at an annual rate of just 0.3 percent in Q3 after having fallen at an annual rate of 0.5 percent in Q2.

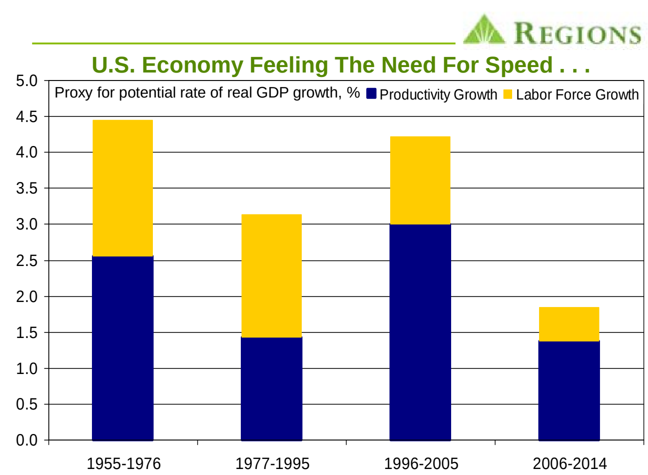
As we do each quarter, we will note the productivity data are more properly viewed on the basis of longer-term trends, and on this basis the news is not so good, with productivity growth of just 0.8 percent on an 8-quarter moving average basis. That said, that period includes 2014's first quarter, during which the economy pretty much went into a deep freeze, with real GDP contracting by 2.1 percent and measured productivity growth tumbling 4.5 percent (annual rates). Absent that decline, productivity growth has been firmer since the second half of 2013 and, with the recent upturn in business investment in equipment and software, this firmer growth should be sustained over coming quarters barring a reversal in capital spending trends. This has meaningful implications for the economy's potential growth rate and, in turn, monetary policy.

Output in the nonfarm business sector rose at an annualized rate of 4.4 percent in Q2, easily ahead of the 3.5 percent growth seen in real GDP, while aggregate hours worked in the nonfarm business sector rose at an annualized rate of 2.3 percent. This is a bit slower than suggested by the data in the monthly employment report, on which our forecast for 1.6 percent productivity growth was based, and the difference could be that hours worked by those reporting to be self-employed declined during Q3. Hourly compensation rose at an annualized rate of 2.3 percent in Q3, matching the growth posted in Q2. The prints on productivity growth and hourly compensation combine to yield the 0.3 percent in unit labor costs. Year-over-year, unit labor costs rose 2.4 percent in Q3, which is in line with the 2.3 percent over-the-year increase recorded in the Employment Cost Index. Both of these measures incorporate both wage and nonwage compensation, unlike the more widely followed average hourly earnings metric from the monthly employment report. Unit labor costs and the ECI are telling a similar story of still-restrained growth in labor compensation despite what has been a stepped-up pace of growth in nonfarm employment. It is also interesting to note the productivity data contain a measure of unit non-labor costs (i.e., the total non-labor cost of producing each unit of output), and these non-labor costs are reported to have risen at an annual rate of 3.4 percent in Q3, down considerably from the 5.5 percent growth (annualized) logged in Q2. On a year-over-year basis, however, unit non-labor costs are up just 0.3 percent as of Q3 and the longer-term trend, as reflected in the 8-quarter moving average, has shown unit non-labor costs decelerating over the past several quarters. In terms of margins, then, this suggests there is room for further increases in labor compensation costs without profit margins suddenly eroding.

The bottom chart illustrates the significance of the longer-term trends in productivity growth which, along with the rate of labor force growth, governs an economy's potential (or, noninflationary) rate of growth. As seen in the bottom chart, over the past several years the economy's potential growth rate has slowed markedly. True, the rate of labor force growth can be expected to rise at least moderately over coming quarters. But, even should the rate of labor force growth approach its historical norm without a meaningful increase in the rate of productivity growth the economy's potential growth rate will fall short of 2.0 percent. This is why we state at the top of the page the stepped-up rate of productivity growth seen over recent quarters (setting aside Q1 2014 of course) will only have meaning if sustained, which puts the focus squarely back on business capital spending and whether or not recent growth there will be sustained.







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