ECONOMIC UPDATE

REGIONS

December 3, 2014

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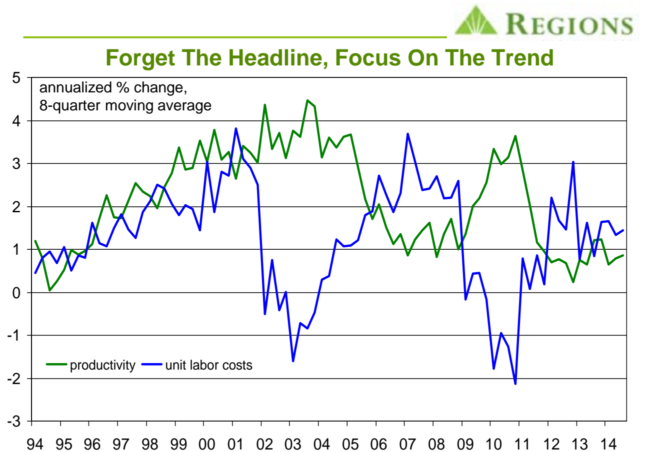
Q3 2014 Productivity And Costs: Forget The Headline, Focus On The Trend

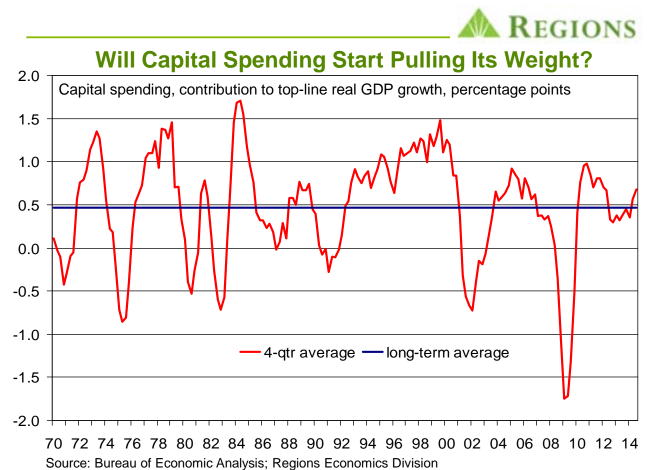
- Nonfarm labor productivity rose at an annualized rate of 2.3 percent in Q3 while unit labor costs fell at an annualized rate of 1.0 percent.
- On an 8-quarter moving average basis, productivity is growing at a rate of 0.9 percent and unit labor costs are rising at a rate of 1.4 percent.

Revised data show worker productivity in the nonfarm business sector rose at an annualized rate of 2.3 percent in Q3, up from the initial estimate of 2.0 percent. There were upward revisions to both the growth of real output in the nonfarm business sector (up 4.9 percent) and aggregate hours worked (up 2.5 percent) with the net result being a 2.3 percent increase in worker productivity (these are all annualized rates). In addition to the upward revision to productivity growth, growth in compensation costs in Q3 was revised lower, with the net result being a 1.0 percent annualized decline in unit labor costs, or, the total labor costs of producing each unit of output.

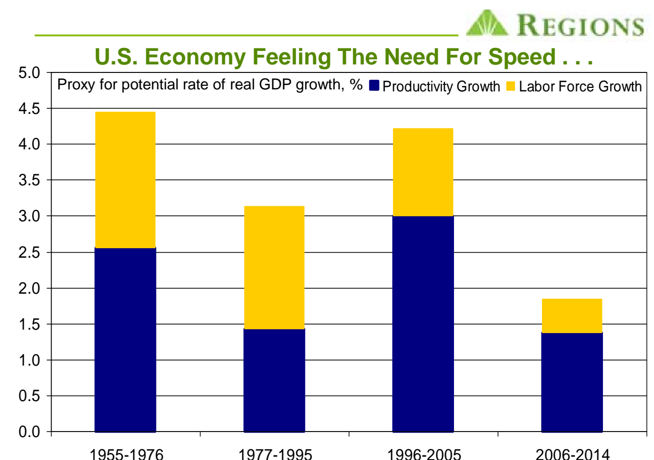
As always, we will note the productivity data are more properly viewed on the basis of longer-term trends, and on this basis the news is not so good, with productivity growth of just 0.9 percent on an 8-quarter moving average basis. That said, that period includes 2014's first quarter, during which the economy pretty much went into a deep freeze and measured productivity growth tumbled 4.5 percent (annual rate). 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.



We have held a key factor behind the middling trend rate of productivity growth has been underinvestment on the part of businesses, although over the past few quarters the news has been better on this front as seen in the middle chart. As would be expected, business spending on equipment and software fell sharply during the 2007-09 recession, and at least some of the bounce back in the early stages of the recovery was fueled by tax incentives that altered the timing of such outlays. Moreover, a good portion of the early gains in business investment during this cycle was devoted to replacement investment. Clearly, in what for the most part has been a slow growth environment, there has been little inventive for business to expand the capital stock, but that seems to have changed over the past few quarters. One factor is the advanced age of the capital stock, with the average age of business equipment and machinery older than at any point since the early 1990s – before a prolonged period of rapid growth in business capital spending – while the age of business structures is greater than at any point in the life of the data. As such, businesses have had to increase outlays to revitalize the capital stock, a process which we believe is in but the early stages. Another driver of better business investment spending has been a stepped-up rate of growth in the U.S. economy, which has businesses feeling more confident and thus willing to increase capital spending. Clearly, the softer global growth environment poses a threat to business confidence, as would another bout of uncertainty stemming from an unclear fiscal policy outlook. But, the bottom line is continued growth in business capital spending is a necessary condition for improving the trend rate of productivity growth.



In turn, faster growth in worker productivity is a necessary condition for faster and sustained growth in worker compensation which has been notably soft over the course of the current cycle. Another reason it is critical to see an improvement in the trend rate of productivity growth is that, along with the rate of growth of the labor force, the rate of productivity growth is a main driver of an economy's potential (or, noninflationary) rate of growth which, over the past several years, 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 are encouraged by the better rate of productivity growth seen over recent quarters (setting aside Q1 2014) while at the same time being uncertain as to whether it will continue. This puts the focus squarely back on business capital spending and whether or not recent growth there will be sustained.



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