ECONOMIC UPDATE

REGIONS

February 5, 2015

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Q4 2014 Productivity And Costs: Forget The Headlines, Focus On The Trends

- Nonfarm labor productivity declined at an annualized rate of 1.8 percent in Q4 while 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 1.06 percent and unit labor costs are rising at a rate of 0.04 percent.

Worker productivity in the nonfarm business sector declined at an annualized rate of 1.8 percent in Q4, exceeding our forecast of a 1.1 percent annualized decline and a universe away from the consensus estimate of a 0.1 percent annualized increase. Real output in the nonfarm business sector rose at an annualized rate of 3.2 percent, which we knew from the BEA's initial estimate of Q4 real GDP. At the same time, however, aggregate hours worked in the nonfarm business sector are reported to have risen at an annual rate of 5.1 percent in Q4, the largest increase since Q4 1998. This surprising jump is the source of our miss on the productivity growth forecast, as we had built in a 4.2 percent increase. We know from the monthly employment data aggregate hours in the private sector rose at an annualized rate of 3.5 percent in Q4 while aggregate hours worked by those reporting to be self-employed rose at an annualized rate of 13.0 percent. What, even after all the years of having done this, we still have not unraveled is the seemingly mysterious way in which the hours worked by the self-employed are blended in with the aggregate hours worked from the monthly employment reports but, at this point, any further efforts along these lines are, well, a drain on our productivity.

Be that as it may, with the decline in productivity, unit labor costs, which measure the labor costs of each unit of output produced, rose at an annualized rate of 2.7 percent in Q4, topping our forecast of a 2.3 percent increase. For those tempted to interpret this increase in unit labor costs as a sign that the much awaited acceleration in wage growth is finally upon us, as much as we hate to be the bearers of bad news, that would be an incorrect conclusion. Compensation per hour worked rose at an annualized rate of just 0.9 percent in Q4, a smaller increase than the 1.3 percent increase posted in Q3. Total compensation took a hit in Q4 with the decline in hourly earnings reported in December and the halving of what had been initially reported as a sizeable gain in November. There is, however, a positive side to this, as real hourly compensation rose at an annual rate of 2.1 percent in Q4, yet another instance in which the steep decline in gasoline prices, which in turn has driven headline inflation significantly lower, is working its way through the top-tier economic data. But, the bottom line is the sharp deceleration in inflation is stretching still disappointing gains in nominal compensation farther than suggested by the headline numbers.

There were some significant revisions to the Q3 data – worker productivity is now reported to have jumped at an annual rate of 3.7 percent compared to the prior estimate of 2.3 percent growth due to the sharp upward revision to Q3 real GDP growth. In any event, as we are constantly pointing out, the productivity data can fluctuate sharply from quarter to quarter and thus are more properly viewed on the basis of longer-term trends. Sadly, this won't make you feel any better about the data – as seen in the top chart the longer-term trend shows productivity growth that barely qualifies as mediocre. On our preferred 8-quarter moving average basis, productivity growth remains barely over 1.0 percent and this has both near-term and longer-term – barring a material improvement – implications on several fronts. We have held a key factor behind the middling trend rate of productivity growth has been underinvestment on the part of businesses, which looked to have reversed in a big way in Q2 and Q3 2014 but the decline in business spending on equipment and machinery in Q4 raises a concerning question as to the underlying rate of such spending. Our premise is that underinvestment has contributed to the capital stock being older than at almost any point in the history of the data, which in turn is weighing on productivity growth, which in turn is a prime factor behind still listless wage growth. There are also longer term implications of lower productivity growth, primarily on the economy's "speed limit," or, the rate of sustainable noninflationary growth. Hence, while perhaps seeming nothing more than an abstract statistic, productivity growth has very meaningful implications for the broader economy, and the signals sent over the past few years have not been at all encouraging.

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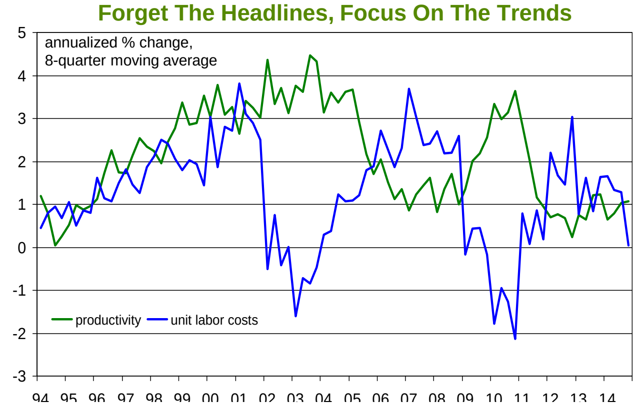
Forget The Headlines, Focus On The Trends



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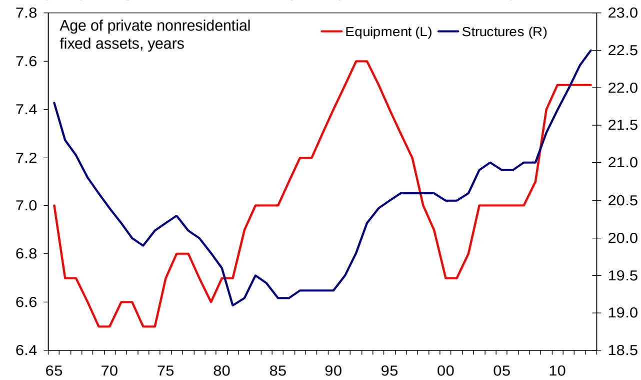
Aging Capital Stock Weighing On Productivity Growth?



Source: Bureau of Economic Analysis; Regions Economics Division

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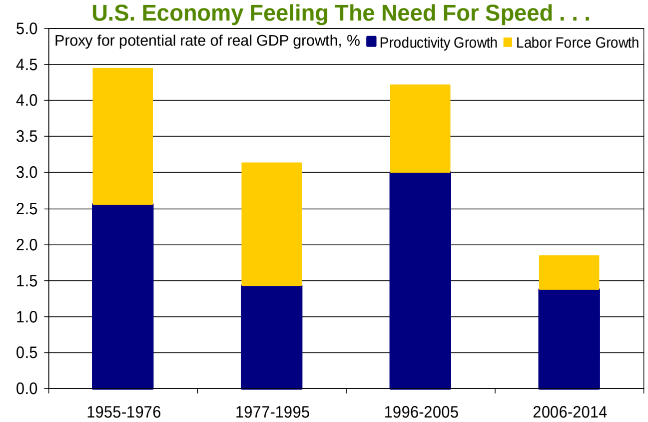
U.S. Economy Feeling The Need For Speed . . .



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