Q4 2014 Productivity And Costs: Productivity Growth Settled In To Weak Trend

- Revised data show labor productivity fell at an annualized rate of 2.3 percent in Q4; unit labor costs rose at an annualized rate of 4.1 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 0.98 percent and unit labor costs are rising at a rate of 0.37 percent.

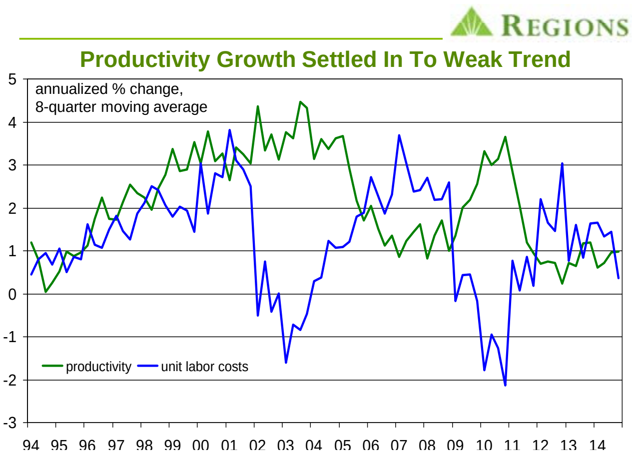
Revised data show labor productivity in the nonfarm business sector declined at an annualized rate of 2.3 percent in Q4, a downward revision from the initial estimate of a 1.8 percent decline. Along with top-line real GDP growth, Q4 growth in real nonfarm business output was revised down, with growth now pegged at an annualized rate of 2.6 percent compared to the initial estimate of 3.2 percent growth. At the same time, growth in unit labor costs, or, the labor cost of producing a unit of output, are now reported to have risen at an annualized rate of 4.1 percent in Q4, up from the initial estimate of a 2.7 percent increase. Along with the larger decline in productivity, growth in worker compensation was revised higher, hence the upward revision in unit labor costs.

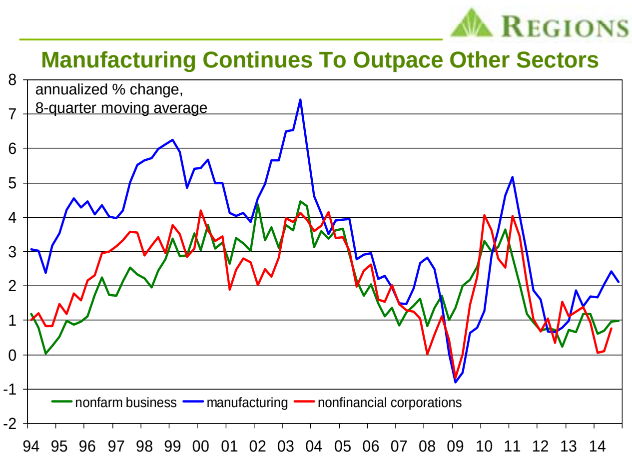
As we stress in this space each quarter, the proper context in which to assess the data on productivity and labor costs is by examining the longer term trends. Our preferred platform is the 8-quarter moving average, which is what we show in the top chart as plotting the annualized quarterly changes, the basis on which the data are reported, is basically the economists' equivalent of the Rorschach test. Still, while easier on the eye, and perhaps the mind, the implications of the data underlying our top are not at all encouraging, either from a near-term or a long-term perspective.

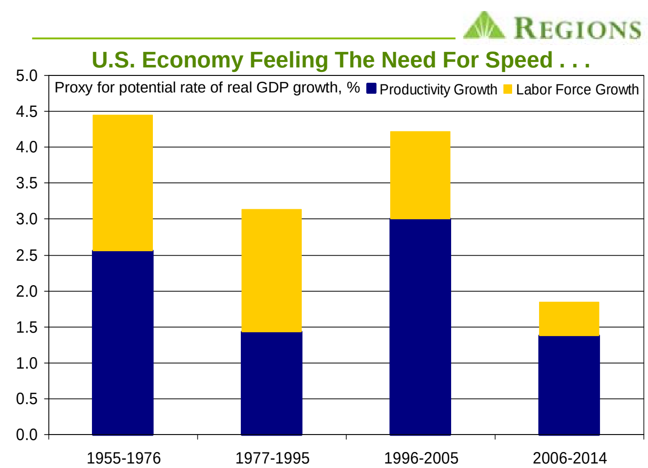
One often overlooked element of the considerable discussion of still sluggish growth in hourly earnings is the correspondingly sluggish rate of productivity growth. On our 8-quarter moving average basis, labor productivity is growing at a rate of just 0.98 percent, a far cry from the average annual 3.0 percent growth seen over the 1996-2005 period. Think about it this way – if output per hour worked is rising at a rate of 1.0 percent and inflation is running at 1.3 percent (the change in the PCE deflator in 2014), this suggests hourly compensation should be rising at a rate of 2.3 percent – growth in excess of this rate squeezes profit margins and would contribute to broader inflation pressures. There are many who wrongly conclude any wage growth is inflationary, in reality wage growth ahead of productivity growth is inflationary and hourly earnings growth of just over 2 percent is roughly in line with trend productivity growth.

We have held a key factor behind the middling trend rate of productivity growth has been underinvestment on the part of businesses since the end of the 2007-09 recession. Whether, or to what extent, this trend has reversed remains an open question given the unevenness seen in business investment over recent quarters. What the data do tell us, however, is the age of the capital stock is currently greater than at almost any point in the life of the data and, while there are some who disagree, in our view this is a primary factor behind the weak trend rate of productivity growth. It is worth noting the disparate rates of productivity growth in different sectors of the economy. Manufacturing, which over the years has become increasingly capital intensive, has long boasted productivity growth well ahead of the economy's overall average. Nonfinancial corporations, by contrast, have seen productivity growth lag the overall average (though clearly there are measurement issues in this sector) and as the economy has shifted more and more to a services base, this is having a greater impact on overall productivity growth.

As to the longer term implications of weak trend productivity growth, the bottom chart is one we use often to illustrate this point. Productivity growth is one determinant of the economy's "speed limit," or, the rate of sustainable noninflationary growth. Accounting for growth in the labor force and the trend rate of productivity growth, the implications the broader economy, including long-term growth in labor income, are not at all encouraging. One implication is a lower trend rate of noninflationary growth implies the Fed has less latitude in managing its policy rate once the economy broaches its speed limit. Above-trend growth with little or no inflation pressure is possible when there is, as at present, slack to absorb, but as that slack is pared down, inflation becomes more of a viable threat to which the central bank will ultimately have to respond to.







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