ECONOMIC UPDATE
REGIONS
August 11, 2015

Q2 2015 Productivity And Costs: Q2 "Rebound" Doesn't Do Much For Weak Trend

- Nonfarm labor productivity rose at an annualized rate of 1.3 percent in Q2; unit labor costs rose at an annualized rate of 0.5 percent.
- On an 8-quarter moving average basis productivity is growing at a rate of 0.66 percent and unit labor costs are rising at a rate of 1.59 percent.

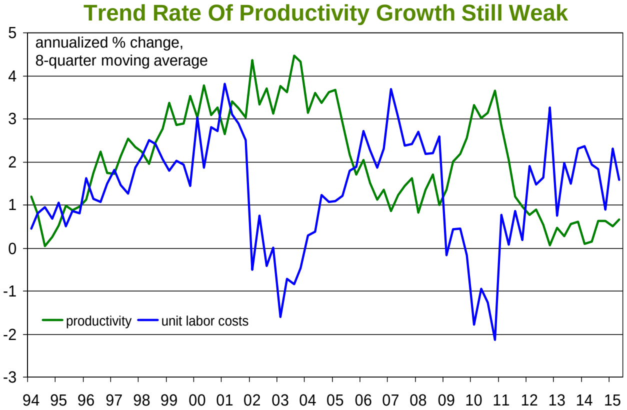
Labor productivity in the nonfarm business sector rose at an annual rate of 1.3 percent in Q2 2015 according to the initial estimate by BLS. While this won't remind anyone of the "productivity miracle" – average productivity growth of 3.0 percent over the 1996-2005 period – it may nonetheless feel like somewhat of a blessing in light of what has been an anemic trend rate of productivity growth. Unfortunately, however, trend productivity growth remains less than 1.0 percent on our preferred 8-quarter moving average basis, as seen in the top chart. Revisions to the data on nonfarm business output (which come from the revised GDP data) mean prior estimates of productivity growth were also revised, with a slight downward revision to productivity growth in 2012 and a sharp downward revision in 2013 while prior estimates for 2014 were left intact. Unit labor costs, or, the labor cost of producing a unit of output, rose at an annualized rate of 0.5 percent in Q2 2015, putting the longer-term trend rate of growth at 1.6 percent.

Today's initial estimate of Q2 productivity growth will be revised higher in the next pass, as today's estimate is based on the BEA's first estimate of Q2 GDP. In that first estimate, top-line real GDP growth was pegged at 2.3 percent, annualized, with growth in real nonfarm business output (which is the basis for measuring productivity growth) estimated at 2.8 percent, annualized. The subsequent flow of data suggests Q2 real GDP growth will be revised up to around 3.0 percent, with a commensurate upward revision to real growth in nonfarm business output. Be that as it may, we make it a point to stress that the proper context in which to view the productivity data is the longer-term trend, and even if today's estimate of Q2 productivity growth is revised higher as we expect, it won't salvage what will remain a weak underlying trend rate of productivity growth..

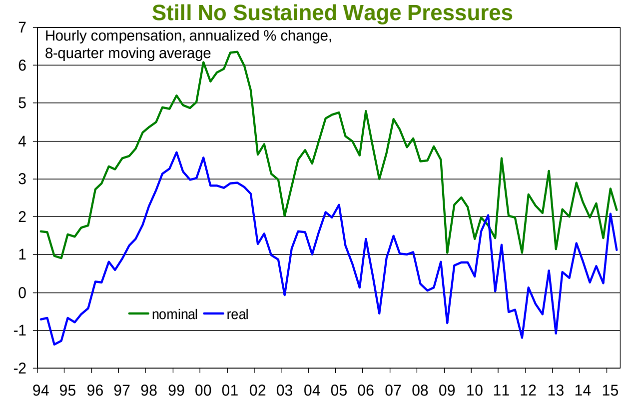
Nominal hourly compensation rose at an annual rate of 1.8 percent in Q2 but on a real, or, inflation adjusted, basis, hourly compensation fell at an annual rate of 1.1 percent in Q2, though this comes on the heels of two quarters of better than 4 percent growth in real hourly compensation. Again, though, the data are better seen on a longer-term trend basis, which we show in the middle chart. The bottom line is, as of yet, there is no sustained upward pressure on growth in hourly compensation, either nominal or real. This is consistent with the story being told by other indicators of wage growth – despite a prolonged period of, to borrow the FOMC's term, solid job growth, we have yet to see meaningful and sustained acceleration in wage growth.

One aspect of a weak trend rate of productivity growth that, in our view, cannot be stressed enough is the implication for the economy's "speed limit," i.e., the rate of sustainable noninflationary growth. Along with the rate of labor force growth the rate of productivity growth sets the economy's speed limit. The bottom chart shows the actual data through 2014 and our forecasts from 2015-2018 and, as can be seen in the chart, the picture is not exactly inspiring. And, if anything, our forecasts for labor force growth may be on the optimistic side but the more significant component is productivity growth, which we harbor little hope for, at least at present. Productivity growth is also a main element behind the rate of wage growth over the longer-term – wage growth in excess of productivity growth forces firms to choose between accepting lower profit margins or raising output prices, and a lower trend rate of productivity growth forces firms to make this choice at a lower threshold. In turn, a lower speed limit forces the Fed to raise interest rates sooner than they otherwise, as inflation pressures begin to build at a lower rate of economic growth than would be the case with a higher speed limit. Above-trend growth without 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. In short, there are many implications, none of them good, for wage growth, economic growth, and monetary policy of a weak trend rate of productivity growth.

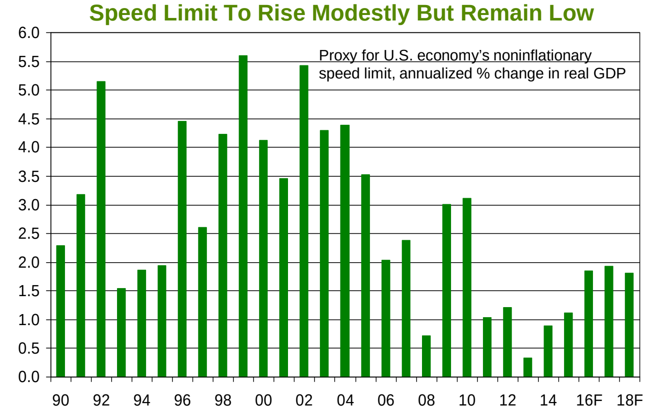
Trend Rate Of Productivity Growth Still Weak



Still No Sustained Wage Pressures



Speed Limit To Rise Modestly But Remain Low



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