Economic Indicator — November 7, 2024

Ignore the Headline Miss—Productivity Firming This Cycle

Summary

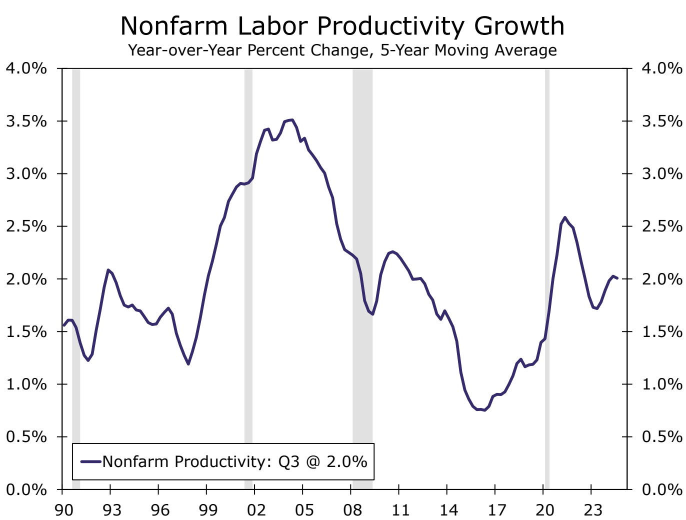
Despite nonfarm labor productivity coming in short of expectations in the third quarter, revisions show a more robust productivity environment in recent years. Nonfarm productivity growth has increased at an average annualized rate of 1.8% this cycle, up from a 1.6% average prior to revisions and a 1.5% pace the past cycle.

Revisions also showed a stronger pace of unit labor costs (ULCs) than previously reported. On a four-quarter moving average basis, ULCs were 3.0% year-over-year in Q3—above the Federal Reserve's 2% inflation target but still a marked improvement from 2022. On balance, these data support the FOMC easing monetary policy at a more gradual pace in the coming months.

Economist(s)

Sarah House
Senior Economist | Wells Fargo Economics
Sarah.House@wellsfargo.com | 704-410-3282

Nicole Cervi
Economist | Wells Fargo Economics
Nicole.Cervi@wellsfargo.com | 704-410-3059



Source: U.S. Department of Labor and Wells Fargo Economics

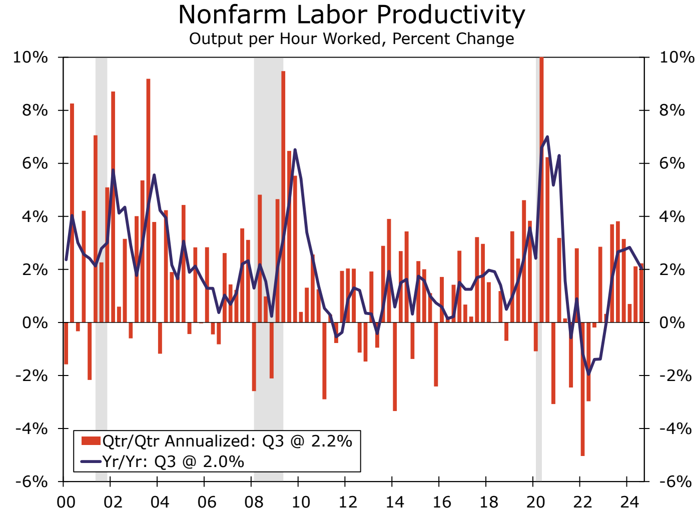
It's Better Than It Looks

Nonfarm labor productivity, defined as output per hour worked, increased at a 2.2% annualized rate in the third quarter. The outturn was a bit less than expected and comes on the heels of a downward revision to the prior quarter (2.1% from 2.5% previously) that was largely driven by a lower measure of output during the quarter. Incorporating the revisions, nonfarm labor productivity was 2.0% year-over-year in Q3.

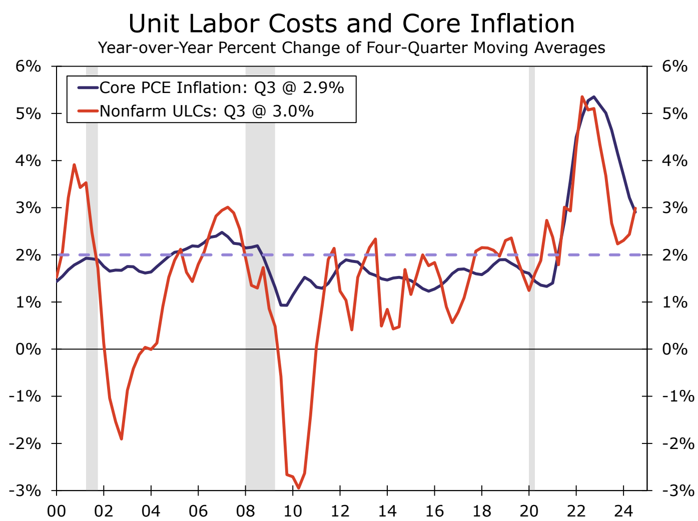
Despite the third quarter's miss and downward revision to the prior quarter, the trend in worker efficiency continues to look solid. Recent benchmark revisions to GDP showed stronger nonfarm output in recent years, which has led labor productivity to grow at an average annualized rate of 1.8% since the pandemic, up from a prior estimate of 1.6% and the past business cycle's 1.5% average (2007–2019). Relative to Q4-2019, real output of the nonfarm business sector has expanded 12% while hours worked have increased a more modest 4%. The differential suggests that workers are finding a way to produce more with less, and early evidence from the Bureau of Labor Statistics points to the broader adoption of remote work as one key factor.

Firming labor productivity growth is important in quelling the labor market's inflationary impulse. Compensation per hour worked increased at a 4.2% annualized rate in Q3. This measure tends be more volatile than other measures of compensation, such as the Employment Cost Index, which showed a more benign pace of labor cost growth in Q3. Nominal labor costs are a significant input to production, yet from the perspective of inflation pressures, compensation per unit out output is what matters. In that regard, unit labor costs (ULCs) were running at a 1.9% annualized pace in Q3.

The choppiness in labor productivity growth can make discerning a trend in unit labor costs difficult. When we smooth annual growth with a four-quarter moving average, ULCs were 3.0% in Q3, a notable pickup from the prior published reading of 1.2% that preceded the Bureau of Economic Analysis' upward revisions to income and thus compensation. Unit labor cost growth will likely be revised back down at least somewhat once benchmark revisions to the Current Establishment Survey are finalized (the preliminary estimates show 818K fewer workers on the payrolls in March 2024, pointing to lower aggregate hours worked). However, piecing together the upwardly revised pace of labor productivity growth and still strong ULCs, we suspect the FOMC will ease monetary policy at a more gradual pace in the coming months.



Source: U.S. Department of Labor and Wells Fargo Economics



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Economics

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Economics Group

Jay H. Bryson, Ph.D.	Chief Economist	704-410-3274	Jay.Bryson@wellsfargo.com
Sam Bullard	Senior Economist	704-410-3280	Sam.Bullard@wellsfargo.com
Nick Bennenbroek	International Economist	212-214-5636	Nicholas.Bennenbroek@wellsfargo.com
Tim Quinlan	Senior Economist	704-410-3283	Tim.Quinlan@wellsfargo.com
Sarah House	Senior Economist	704-410-3282	Sarah.House@wellsfargo.com
Azhar Iqbal	Econometrician	212-214-2029	Azhar.Iqbal@wellsfargo.com
Charlie Dougherty	Senior Economist	212-214-8984	Charles.Dougherty@wellsfargo.com
Michael Pugliese	Senior Economist	212-214-5058	Michael.D.Pugliese@wellsfargo.com
Brendan McKenna	International Economist	212-214-5637	Brendan.Mckenna@wellsfargo.com
Jackie Benson	Economist	704-410-4468	Jackie.Benson@wellsfargo.com
Shannon Grein	Economist	704-410-0369	Shannon.Grein@wellsfargo.com
Nicole Cervi	Economist	704-410-3059	Nicole.Cervi@wellsfargo.com
Jeremiah Kohl	Economic Analyst	212-214-1164	Jeremiah.J.Kohl@wellsfargo.com
Aubrey Woessner	Economic Analyst	704-410-2911	Aubrey.B.Woessner@wellsfargo.com
Delaney Conner	Economic Analyst	704-374-2150	Delaney.Conner@wellsfargo.com
Anna Stein	Economic Analyst	212-214-1063	Anna.H.Stein@wellsfargo.com
Ali Hajibeigi	Economic Analyst	212-214-8253	Ali.Hajibeigi@wellsfargo.com
Coren Miller	Administrative Assistant	704-410-6010	Coren.Miller@wellsfargo.com

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