

US Macroeconomics

May 4, 2023

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What to Make of Weak Productivity and Soaring Labor Costs

GDP growth can be viewed in many ways. One way is a top-down version where GDP is a function of productivity and labor force growth. Since trends in the latter tend to be slow moving, it is mainly cyclical changes in productivity that determine quarterly changes in economic output.

Last quarter, real GDP grew only 0.9%. This occurred alongside weak labor force growth. Consequently, it was not a surprise when productivity shrunk 2.7% last quarter. It is now 1% below where it was in Q1 2022.

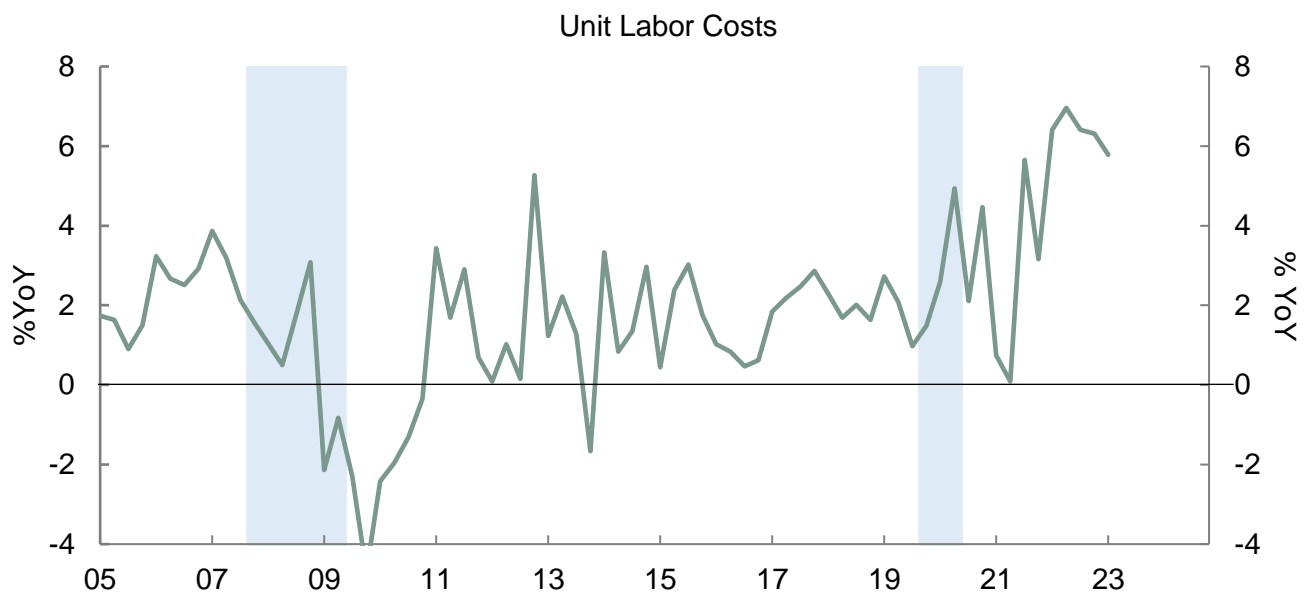
But **over the last five quarters, productivity has declined a massive 2%**. This is the second weakest performance on record since the five quarters ending Q3 1974.

Besides depressing living standards, falling productivity growth also tends to put upward pressure on unit labor costs. They rose a large 6.3% last quarter and are up nearly 6% over the last year.

With nominal GDP growth running only marginally higher at 7%, the surge in labor costs implies that economy-wide corporate profit margins are deteriorating. In response, firms will try to raise prices but if they encounter resistance, the only other way to maintain profit margins is to cut capital spending and/or labor.

If firms can raise prices, this means that monetary policy will remain tight until demand slows enough to inhibit further price hikes. In this case, a restrictive Fed runs the risks of causing a recession. **However, if demand slows and margins shrink, which has been the recent trend, firms will be forced to cut outlays.** This, too, increases the risk of recession.

Against this backdrop it is not surprising that financial markets have been range-bound but on edge.



Sources: BLS, NBER, Haver, SMBC Nikko

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