Strong Productivity Growth, Slow Growth in Unit Labor Costs in Second Quarter Contributing to Easing Inflation

- Productivity growth in the second quarter was strong at 2.3%, and has been strong over the past couple of years. Productivity gains allow consumers to enjoy a higher standard of living over time.

- Unit labor cost growth was a modest 0.9% in the second quarter. Slower growth in unit labor costs since mid-2022 has contributed to the ongoing softening in inflation.

Nonfarm business labor productivity increased 2.3% at an annual rate in the second quarter, according to the preliminary estimate from the Bureau of Labor Statistics. Over the past year productivity has increased a strong 2.7%, close to its pace for the last three quarters. Unit labor costs—the labor cost of producing an additional unit of output, taking into account productivity, hours worked, and employee compensation—rose 0.9% in the second quarter, and were up 0.5% over the previous year. This is the weakest year-over-year growth in unit labor costs since 2016.

Strong productivity growth and modest increases in unit labor costs are key factors behind slowing inflation. As productivity increases businesses need less labor to produce the same amount of output. At the same time employee compensation growth is slowing as the labor market cools off somewhat and there is less competition for workers. This combination means that businesses don’t need to raise prices as much to cover their labor costs, leading to lower inflation.

Productivity and unit labor cost growth have seen huge swings since the pandemic. Productivity growth soared in the initial stages of the pandemic, as businesses laid off low-wage employees with fewer skills. Then productivity actually fell 3% from mid-2020 to mid-2022 as businesses ramped up hiring in response to very strong demand, taking on workers with fewer skills and less experience. But since then productivity growth has resumed as workers have gained experience and businesses have invested in technologies that make their employees more productive. With falling productivity and strong wage growth unit labor costs soared in the two years immediately after the pandemic-related shutdowns, but unit labor cost growth has been much weaker over the past couple of years, a big reason why inflation has slowed. Productivity growth is important for the economy over the long run because it allows consumers to have a higher standard of living with low inflation.
Output in the nonfarm business sector was up 3.3% annualized in the second quarter, with hours worked up 1.0%. Hourly compensation rose 3.3% in the second quarter, down from 4.2% growth in the first quarter (unrevised) as the labor market continues to cool. Unit labor costs rose 3.8% in the first quarter, revised lower from 4.0% growth, while productivity growth in the first quarter was 0.4%, revised higher from 0.2% growth.

Manufacturing productivity growth was 1.8% in the second quarter, with unit labor cost growth of 3.2%. Over the past year manufacturing productivity has increased a weak 0.4%, with unit labor cost growth of 4.3%.

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