Hope for the best on productivity, but prepare for the worst

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The poor performance poses challenges to politicians, policy makers and business

In the second quarter of this year, output per hour worked in the UK economy was 16 per cent lower than if the trend rate of increase from the start of 1999 to the end of 2007 had continued. In other words, British workers are much less productive than we expected – and this has big consequences for us all. In the long run, the rate at which productivity rises is the chief determinant of the standard of living. Yet policy makers are largely ignoring the implications of this collapse. Can they be right to do so?

Between 1999 and 2007, output per hour grew at a trend rate of 2.3 per cent. But between the first quarter of 2008 and the second quarter of this year, it fell by 2.2 per cent. This weakness is not just true of service industries, whose output per hour fell by 0.8 per cent. It is also true of production industries, whose output per hour fell by 4.2 per cent.

Comparisons across countries show recent performance in a sharper light. Between 2007 and 2013 output per hour in the UK fell by 3 per cent. This was the worst performance among the Group of Seven leading high-income countries. In the US output per hour rose by 7.6 per cent, in Japan by 4.8 per cent, in Canada by 2.7 per cent, in Germany by 1.8 per cent and in France by 1.3 per cent. Even in Italy it fell by just 1.3 per cent.

It is normal for economies to be smaller after financial crises than pre-crisis trends would have suggested. It is also normal for growth rates to be lower. But stagnation in productivity is rare. Is it temporary or permanent? The answer to this is vital. It will determine the UK’s economic prospects.

Since these data are for output per hour, shifts from full time to part-time work cannot be the explanation. The falling output of oil is an important factor, as is the decline in remuneration in financial services for service industries. But even productivity in manufacturing has performed poorly.

The optimistic theory was that weak productivity has been a desirable consequence of a flexible labour market in the context of a collapse in demand. But the continued poor productivity performance in the upswing damages that hypothesis. Also doubtful is the theory that failures in the credit system explained the weakness, since the financial system has been recovering. If either view had been correct, one might have expected productivity to have surged recently. But unemployment has collapsed, instead, with the rate falling from 7.7 per cent to 6 per cent in the year to July 31 2014.

Why has the productivity collapse been largely ignored in the public debate? For the government, poor productivity is the reverse of job creation, which it hails as its vindication. Gross domestic product in the second quarter of 2014 was only 2.1 per cent above its pre-crisis level. With normal productivity growth, unemployment would undoubtedly far exceed 10 per cent.

For the Labour opposition, a focus on productivity, rather than low wage growth and rising prices, would have reduced the effectiveness of the party’s “cost of living” campaign. Yet the strikingly low productivity growth must be the most important explanation for what it has been complaining about – even if it is not the only one.

The productivity performance poses challenges to politicians, policy makers and business. It is also a challenge to the Monetary Policy Committee of the Bank of England, which must take action for an economy whose prospective capacity is highly uncertain. It has decided to err on the side of optimism. This is the right choice, particularly given declining inflationary pressures. One must still hope that, as demand strengthens and investment rises, productivity performance will improve. If so, capacity will show itself to be greater than is feared. It will be better to take this gamble and, if proved wrong, tighten, rather than let the economy stagnate in response to a self-fulfilling prophecy of productivity pessimism and tight policy.
Yet it is possible that something has indeed happened to the trend. For this reason, policy that supports growth-enhancing public and private investment, has to be a top priority. There can be no compelling justification for long-term productivity stagnation, since the UK’s average output per hour was only 76 per cent of US levels in 2013 and well behind levels in France and Germany (which were 88 per cent and 85 per cent of US levels, respectively). The UK’s room for catch up remains very substantial.

The stagnant productivity has allowed the economy to combine weak growth with buoyant employment, at the price of falling real wages. This has been fortunate. But, as labour markets tighten, the UK must now hope the stagnation ends. It must do more than hope. It must try to make that hope a reality.

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