The Productivity Puzzle

By Howard Davies

Would better allocation of capital make a difference?

In all major economies, the so-called productivity puzzle continues to perplex economists and policymakers: output per hour is significantly lower than it would have been had the pre-2008 growth trend continued. The figures are stark, particularly so in the United Kingdom, but also across the OECD. And while it goes without saying that economists have many ingenious explanations to offer, none has yet proved persuasive enough to create a consensus.

According to the United Kingdom's Office for National Statistics, output per hour in France was 14 percent lower in 2015 than it would have been had the previously normal trend growth rate been matched. Output was 9 percent lower in the United States and 8 percent lower in Germany, which has remained the top performer among developed economies, albeit only in relative terms. If this new, lower growth rate persists, by 2021 average incomes in the United States will be 16 percent lower than they would have been had the United States maintained the roughly 2 percent annual productivity gain experienced since 1945.

The United Kingdom exhibits a particularly chronic case of the syndrome. British productivity was 9 percent below the OECD average in 2007; by 2015, the gap had widened to 18 percent. Strikingly, UK productivity per hour is fully 35 percent below the German level, and 30 percent below that of the United States. Even the French could produce the average British worker's output in a week, and still take Friday off. It would seem that, in addition to the

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factors affecting all developed economies, the United Kingdom has particularly weak management.

Some contributing factors are generally acknowledged. During the crisis and its immediate aftermath, when banks' efforts to rebuild capital constrained new lending, ultra-low interest rates kept some firms' heads above water, and their managers retained employees, despite making a relatively low return.

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On the other hand, new, more productive, and innovative firms found it hard to raise the capital they needed to grow, so they either did not expand, or did so by substituting labor for capital. In other words, low interest rates held productivity down by allowing heavily indebted zombie companies to survive for longer than they otherwise would have done.

The Bank of England has acknowledged that trade-off, estimating that productivity would have been 1 percent to 3 percent higher in the United Kingdom had it raised interest rates to pre-crisis levels in the recovery phase. But they believe the consequences—slower income growth and higher unemployment—would have been unacceptable.

This argument has now been extended beyond the banking system, to the capital markets themselves. Critics of central banks have claimed that a sustained policy of exceptionally low interest rates, reinforced by huge doses of quantitative easing, have caused asset prices to rise indiscriminately. That has not only had adverse consequences for the distribution of wealth; it has also muted the ability of capital markets to distinguish between productive, high-potential firms and others that deserve to fail. According to this view, a rising tide lifts even fundamentally unseaworthy boats.

This argument has some explanatory power, though it says little about the value added by highly paid asset managers and whether they really are prepared to put their money to work simply on the basis of a monetary-policy effect on relative prices, paying no attention to individual companies' strategies and performance. But the key question the argument raises is what to do about it.

Would it really have been preferable to tighten policy far earlier, to kill off weaker companies in the interests of improving productivity? The Bank of England has given an explicit answer, and the other major central banks implicit answers, to that question. They do not think so.

A preferable approach to resolving the problem might be more vigorous use of the tools available to market regulators. These authorities tend to focus more on investor protection than on the allocational efficiency of the markets they oversee. Investor protection is important, of course, but as the Nobel laureate Eugene Fama put it, "the primary role of the capital market is allocation of ownership of the economy's capital stock."

A regulator focused on that objective would be especially rigorous in overseeing the transparent disclosure of information, and would seek to promote vigorous competition among companies and also, crucially for this objective, among investors. It should not be acceptable for asset managers to earn extravagant returns for following a market benchmark.

There are, no doubt, other dimensions to the productivity puzzle. Maybe we are not measuring output well. As developed economies become more service-based, our measures of output become less objective. In many service industries, outputs are effectively measured by inputs. Maybe we are not measuring enhancements in quality, which may mean that output increases are understated. Maybe we have reached a point at which the productivity boost from Internet-based technology has been cashed, and we need another technological leap to move forward again.

Maybe the productivity boost from Internet-based technology has been cashed.

But one key challenge for central banks, as we edge toward the normalization of interest rates, will be to develop a framework for thinking about the impact of monetary policy on the allocation of capital. The task is urgent, as the social and political implications of a prolonged period of no productivity or real wage growth may be very serious. Indeed, arguably they have been factors behind the political upheavals in the United States and the United Kingdom already. ◆