

Why low productivity growth will hurt investors

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- [THE AUSTRALIAN](#)
- JUNE 09, 2015 12:00AM

Many investors like to keep updated lists of the major influences likely to affect their investments. Currently, most of those lists include:

- Prospects for the first increase in the US cash rate since 2008
- Any hints of inflation returning in the US or Europe
- The problems of keeping Greece within the eurozone
- The risks of a hard landing for China
- And the lacklustre economic growth in Australia.

Another big influence on the investment outlook is now calling the attention of investors (and central banks!). It's the slowing, here and abroad, of productivity growth. Productivity measures how efficiently the economy uses labour and capital to produce its output of goods and services.

As Paul Krugman, a Princeton professor of economics, famously pointed out a couple of decades ago, "Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker."

In Australia, productivity surged in the 1990s: labour productivity increased, on average, by 2.2 per cent a year, and by 25 per cent over the decade. That followed the big economic reforms of the 1980s and our quick adoption of new information technologies. We felt good; inflation dropped and asset markets moved strongly higher.

In the first decade of this century, our productivity growth slowed to an annual average of 1.5 per cent. But this financial year, productivity growth looks to be about zero — even with the boost in productivity in the resources sector.

Our governments have made few productivity-enhancing reforms in recent years and the Rudd-Gillard changes to industrial relations reduced the flexibility of the labour market even relative to the legacy of the Hawke-Keating years.

Productivity has also slowed in other countries. John Fernald is a staffer in the US central bank and a guru on productivity. He points out that "the exceptional boost to (US) productivity growth from information technology in the late 1990s and early 2000s has vanished during the past decade. Although there is considerable uncertainty, a relatively slow pace is the best guess for the future."

And the Bank of England recently reported that, "despite robust output growth in the past few years, productivity growth has remained subdued with the increases in output having been met mainly through an increase in total hours worked".

Below-par growth in productivity, if it continues, will hurt investors. The rates of increase in average real wages and profits would be constrained. Governments would find it even harder to generate the tax receipts to pay for the future costs of ageing populations. Also, a slowing in productivity growth raises the risks of inflation.

Perversely, though, slowing growth in productivity helps job creation in the short term. Currently the US, Britain and Australia are creating more jobs for every percentage point increase in GDP than if productivity growth were stronger.

There are economists and investment strategists (including Martin Feldstein, who chaired the US Council of Economic Advisers under Ronald Reagan, and Jan Hatzius of Goldman Sachs) who point out the difficulties of measuring productivity growth and argue that the much-vaunted weakness in productivity growth is a statistical myth.

They say the usual measures of productivity growth prepared by government statisticians understate growth in GDP (and in productivity) and overstate inflation.

They say the traditional measures of productivity fail to incorporate the dramatic gains in the quality of products and services, particularly those making heavy use of software and digital content.

Professor Feldstein writes: “Consider the higher price of a day of hospital care. How much of that higher price reflects improved diagnosis and more effective treatment? And what about valuing all the improved electronic forms of communication and entertainment that fill the daily lives of most people? In short, there is no way to know how much of each measured price increase reflects quality improvements and how much is pure price increase.”

Mr Hatzius says rapid technological change means productivity growth is being underestimated by “a meaningful amount” — thus there’s even less inflation than official figures show. “If true inflation is even lower than measured inflation — and especially if this gap is bigger than it has been historically — the case for keeping monetary policy accommodative strengthens further,” he says.

I think it’s all very well to acknowledge the big effects on the quality and content of many of the products and services available to us that flow from rapidly changing technology. But when it comes to what most people see as their real incomes, or to measuring inflation, or to considering the extent to which there’s slack in the overall economy, we need to be cautious in how much additional “value” is put on the developments in or from technology.

An understanding of what’s happening to productivity will be of special importance to central banks in coming years. Any sustained weakening in the “true” rates of growth in productivity would require central banks to tighten monetary policy earlier and more markedly in the next economic upswing than they would otherwise need to.

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