

MARKETWATCH
What Next



Is the UK set to repeat US productivity miracle?

Steven Bell of Deutsche Asset Management compares the two economies and asks the UK has the right conditions to emulate America's late 1990s economic miracle

The performance of the US economy in recent years has been truly remarkable. For most of the post-war period, productivity in the United States was higher than in Europe and Japan but grew more slowly. Economists explained this in terms of Europe and Japan 'catching up' on the more established US experience. Yet in the mid-1990s something dramatic and unexpected began to happen. US labour productivity growth¹ picked up and, far from being a temporary phenomenon, seemed to accelerate as the decade wore on. This occurred at a time when productivity growth in other countries, notably Japan, seemed to be slowing.

Even more remarkable was the fact that US labour productivity was rising at a time when large numbers, literally millions, of inexperienced workers were being absorbed into the US labour force. These workers were immigrants, previously unemployed, or otherwise discouraged workers who typically have low productivity rates which would tend to drag the average down.

Revitalised economy

As economists struggled to understand this phenomenon, they constructed a story centred around micro-economic factors. The extensive restructuring that occurred in US industry in the 1980s had left companies 'leaner and meaner'. Once demand picked up they were able to boost output by adding large amounts of cheap capital and hiring new workers without pushing up wages. Highly flexible labour markets meant that firms in declining sectors were able to shed workers quickly. Finally, highly skilled management, focused on shareholder value, were able to deploy new technology to boost

Like the US, UK companies have engaged in large-scale restructuring, management is focused on shareholder value and labour markets have become more flexible

productivity amongst white collar workers and the service sector in general – areas that have traditionally had negligible productivity growth.

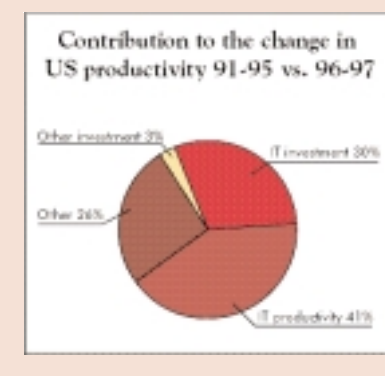
Similar goings on across the pond

Look around the world for a country that shares these characteristics and you will light upon the UK. After all, companies in the UK have also engaged in large-scale restructuring, management is focused on shareholder value and



Steven Bell

FIGURE 1

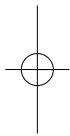


labour markets have become decidedly more flexible. So is the UK poised to imitate the US's success?

To answer this question we need to be rather more rigorous in explaining the rise in US productivity. Recent work by two economists, Stephen Oliner and Daniel Sichel², at the Washington Federal Reserve is very useful in this respect. They split the productivity increase into a series of components (see Figure 1).

Where IT's at

First, and most obviously, is the contribution of the IT industry. This sector has exhibited truly remarkable productivity growth as an industry. At its simplest, the enormous scalability of software manufacturing. Microsoft invested huge resources to produce Windows 2000 but the cost of reproduction thereafter is minimal. It will ship 114m copies this year, double the 1995 equivalent, implying a massive increase in productivity. But more importantly, it could ship many more copies without hiring significantly extra workers. Capacity is virtually limitless. IT hardware manufacture is a more complex story but also displaces



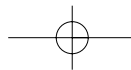
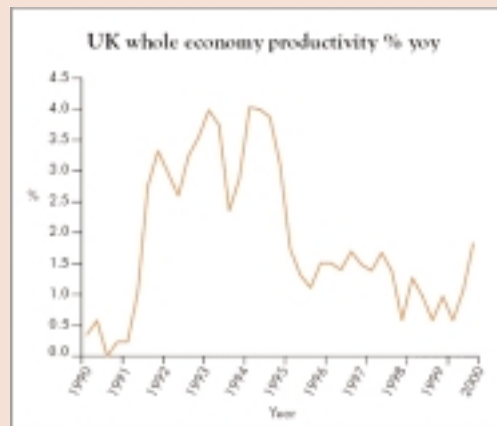

FIGURE 2

FIGURE 3


extraordinary productivity growth.

Scaled down version

The UK does have an IT sector and some world beating companies, but its share of GDP is much lower than the US equivalent. Oliner and Sichel estimate that IT productivity is the biggest single component of the rise in US productivity growth, accounting for almost half of the 109 basis point rise. The UK might enjoy an increase of 10 or 15 points from this factor.

The next biggest component is the application of IT to existing businesses: this accounts for another 37 basis points. There is a real prospect that the UK will imitate much of this effect. Figure 2 shows that investment as a share of GDP is at record levels. This is mainly in IT and is predominantly in the service sector: traditional investment in plant and equipment is declining. Note also that the rise has been fairly recent – it takes time for a build up in investment to feed through to increased productivity.

The final major category is 'other', the usual catch-all for unknown or unquantifiable influences. By definition, we cannot be confident about what is in this group, but it seems reasonable to assume that it represents an improvement in general business efficiency. Once again we might expect the UK to repeat some, but not all of this.

We've never had it so good...

All this suggests that UK productivity growth might rise by perhaps 0.5% per annum or a little more. This would take our annual trend growth rate up to around 3%. The benefits to living standards from this would be

considerable – we have not enjoyed this rate of trend growth since the early 1960s.

But before we get too carried away, it is worth looking at the actual data on UK productivity. Figure 3 shows that annual productivity growth actually fell to just 1% for 1996-99, although there has recently been something of a rebound. Far from enjoying a productivity miracle, this suggests something of a productivity disaster.

Back to work

The truth is actually a little more complicated as compositional and demographic effects were at work during this period. A large number of previously unemployed workers were pushed off the register and into work. The productivity of these workers tends to be below average. By employing more the average level of productivity is dragged down even though the economy is clearly functioning more efficiently. There was also a substantial rise in part-time working which obviously implies lower output per worker, as opposed to output per hour.

Similar factors were also at work in the US over this period. Oliner and Sichel estimate that it cut annual productivity growth there by 13 basis points. But the underlying improvement was sufficient to overwhelm this effect. One possible reason why the UK did not enjoy a similar success is that we have failed to give growth a chance and conducted an excessively tight monetary and fiscal policy under New Labour. It is only in the last few months, when the monetary policy committee (MPC) has been more relaxed about low unemployment and (for political reasons)

Gordon Brown has ended the fiscal squeeze, that we can see whether the UK economy can imitate the US. Time will tell.

All this suggests that we should be cautious before assuming that a UK productivity miracle is just around the corner. At Deutsche Asset Management we believe that trend growth in the UK probably has risen but only to perhaps 2.5-2.75% and even that rests on

the assumption that increased investment and the effect of running the economy at a consistently fast pace will bear fruit.

Tampering with the books

But before leaving this issue there is one final point to note. Much of the improvement in productivity in the US has become evident only because the statisticians have changed the way they take account of software spending. The effect of this has been to boost measured GDP. This also boosts measured productivity. Other governments are considering similar changes. So far the UK Office for National Statistics has maintained the view that this phenomenon is correctly measured in the UK. However, a cynic might suggest that a revision to the GDP figures towards the end of this year would allow the government to claim, in the run up to the next election, that their policies were beginning to boost productivity. Watch this space! ■

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¹ We use the term productivity to mean labour productivity. In fact economists distinguish between the productivity of labour, capital and the two combined which is called total factor productivity.

² Stephen D Oliner and Daniel E Sichel, February 2000. *The Resurgence of Growth in the late 1990s: Is information Technology the Story?* working paper, Federal Reserve Board.