

THE RETURN OF PRODUCTIVITY GROWTH

HIGHER INVESTMENT HOLDS THE KEY TO SUSTAINED IMPROVEMENT

Productivity matters. Living standards will double roughly every 35 years if productivity growth rises by an average of 2% per year. If productivity rises by 1% per year on average, it will take twice as long for living standards to double.

Productivity growth is the essential ingredient of economic progress. In the long run, material living standards cannot increase unless workers are able to increase the amount of output they produce relative to their labour input. Through innovation, saving and investment that raises the quality and quantity of an economy's capital stock, productivity can rise over time.

The high and rising living standards we enjoy today in the advanced world began with the first Industrial Revolution that started in Great Britain in the late 18th century. Within a few decades, the other major advanced economies of the time, including the US and Germany, also began to industrialise. Over the next 50 or so years, the rate of productivity growth coming from technological progress in Europe and North America outpaced anything that had happened before.

Since living conditions for the average person were more or less stagnant for most of human history, continued economic progress and rising productivity cannot be taken as a given. Although economists can describe the recipe for improved productivity, when it actually comes to accumulating these ingredients, well, that is a different matter altogether.

Typically, growth in advanced economies bounces back strongly after a severe downturn. Such is the experience of the post-war period. In a normal cyclical recovery, strong investment leads to rising capital per worker and rising productivity. In the post-Lehman upswing, only employment has recovered at its normal rate. Productivity growth has languished, rising at only around half the rate common for the late 20th century. Because of this shortfall in output-per-worker growth, GDP growth rates have been around a



Growth in advanced economies bounces back

third lower than the averages of the past. This has puzzled economists.

Since the financial crisis, cautious households and firms have held higher precautionary cash balances than usual. They have saved more while investing and spending less than in previous upturns. The necessary deleveraging and reallocation of capital away from unproductive real estate has further weighed on demand and risk-taking. Firms have hired workers to produce more to meet the rising demand rather than investing in new capacities. As a result, capital-to-labour ratios and rates of productivity growth have stagnated.

But after seven years of caution, 2017 marked the partial return to normal demand dynamics in the advanced world. Over time, stronger growth will put strains on available resources. Many advanced economies are close to, or at, full capacity. Firms now need to raise capacities in order to produce more. In the coming years, healthy demand growth should translate into higher investment and stronger gains in productivity.

This year has started auspiciously. With the improving global backdrop, rising profits and asset prices, fading memories of the crisis, and still low costs

of capital thanks to global central banks' accommodative policies, firms that are running into capacity constraints are well placed to invest more in the years ahead. By raising the quantity of capital per worker as employment gains slow, higher investment will help to lift productivity growth.

The current modest pick-up in wage growth on both sides of the Atlantic is consistent with the improved productivity trends. While financial markets might worry about the potential inflationary risks from higher wage growth and the prospect of a quicker-than-expected monetary tightening by central banks, stronger productivity growth will dampen the pass-through of wage inflation to price inflation. Central banks can continue to move slowly towards tighter monetary policies.

While the building global economic upswing may eventually gain so much momentum that the risk of overheating becomes more pronounced, we are not there yet. Faster productivity growth helps delay this process. For now, we can relax and enjoy a long-awaited return to normal. ♥



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