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Global economy battles decline in productivity growth

 By Chris Giles in London

Hopes for living standards in rich and poorer states may be dashed


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Christine Lagarde, managing director of the International Monetary Fund, echoed the World Bank on Wednesday in predicting gradually strengthening growth at the same time as cautioning against risks.

Predictable as these new year messages were, the world economy is far from boring. Behind the gradual improvement in the growth outlook lie immediate questions over policy, winners and losers in the global growth league tables and important trends affecting almost all countries.

Markets will inevitably focus on the latest twists and turns of monetary policy for the good reason that it has the capacity to make and break fortunes. Big questions for 2014 include whether the advanced world will move from witnessing falling rates of inflation towards deflation; will the Federal Reserve taper its asset purchases more quickly; and will US action destroy capital flows to emerging economies.

The bigger, although less immediate, question asks why the underlying health of the global economy has faltered. For behind the forecasts of small improvements in headline growth lies a significant decline in productivity growth in rich and poor countries alike.

As Paul Krugman, the economics Nobel laureate, noted in the mid 1990s: “Productivity isn’t everything, but in the long run it is almost everything”.
Countries’ economic fortunes can boom and bust, but it is only by improving the efficiency by which labour and capital are turned into goods and services that living standards are sustainably increased.

On Tuesday, the Conference Board think-tank produced its annual assessment of global productivity, showing that in 2013 total factor productivity, its broadest definition, declined for the first time in decades, indicating that the world made no improvements in the way it used and allocated labour and capital resources last year.
If overall productivity growth disappears in the years ahead, it will dash hopes that rich countries can improve their populations’ living standards and that emerging economies can catch up with the advanced world.

The story for both labour productivity – output per hour worked – and total factor productivity is the same. Declining growth rates are a result of a long history of falling productivity growth in advanced economies which is no longer more than offset by huge rises in the efficiency of emerging economies.

For the US, still the world’s largest and one of the world’s richest economies, the trend raises the question whether its productivity crisis is the product of its weak demand recovery or that its powers to innovate and push the possibilities of economic activity further have stalled. This huge debate was sparked by a paper by Professor Robert Gordon of Northwestern University asking whether big innovations of the 19th and 20th century such as efficient transport and labour-saving devices in the home were now all in the past.

In addition to this existential thought, almost every other country has to ask why it is not catching up with the US faster. This worry is convulsing France and led François Hollande, the French president, to call for “faster, further and deeper” reforms.

In emerging economies, while the productivity trends are still significantly better than in the 1970s and 1980s, the worrying signs are that sustained spending on capital goods is not producing the same improvements in efficiency as 10 years ago, suggesting capital is not being allocated to the best possible areas. The Conference Board estimated that total factor productivity stalled last year in China and declined in India, suggesting even the largest emerging economies are struggling to make the advances in efficiency previously so easily found.

Continued rapid rises in labour and capital inputs, however, still mean emerging economies are likely to grow much faster than the rich world in 2014, the World Bank forecasts, with some of the poorest parts of the world doing best although potentially vulnerable to a collapse in capital flows. A return to growth is also predicted in North Africa and the Middle East after two difficult years, even though lost ground is unlikely to be recovered.

The main improvement in the global outlook, however, comes from the advanced economies which are likely finally to emerge from the crisis years with some decent growth, according to the World Bank. If true, that would reduce some of the urgency of the longer-term productivity challenge, but catch-up growth can only continue for some time and, with rapidly falling unemployment in the US and UK, the bigger questions are becoming more urgent.