Britain needs a new approach to fix its shameful productivity record

JEREMY WARNER
VIEWPOINT

Virtually all chancellors aspire to improve Britain's shamefully poor productivity record. Few succeed. Can Philip Hammond, who at last week's Conservative Party conference identified productivity as one of the key challenges for his Chancellorship, hope to do any better?

For Britain to succeed and prosper in the post-Brexit world, it is vital that he does. Productivity growth – more output for less input – is the magic ingredient which delivers higher living standards. It's why real wages rise over time, and it's why, at least in the modern age, each generation has been significantly better off than the last one. Without it, living standards stagnate or decline and, as we are seeing, political and social tensions rise.

Poor productivity growth, or rather the absence of it, is therefore an urgent cause for concern.

The phenomenon is by no means confined to Britain. Since the financial crisis, it has been common to virtually all Western economies. Yet for Britain, there is at least the opportunity to play catch up, for we have a much longer-term issue with poor productivity than some of our main rivals. It's not just the US and Germany that the UK lags, but France, the Netherlands, Sweden and even Italy.

Even narrowing the margin just a little would pay big dividends. If Britain could raise its productivity rate of growth by just one percentage point a year, Hammond points out, we would, within a decade, add £250bn to the size of the economy, or £9,000 for every household in Britain.

At its best, the UK is as productive as anywhere, yet such examples of world-beating performance are patchy and highly concentrated geographically. Basically, London and the South East are fine. It's the rest of the country we need to worry about. If rates of productivity seen in London could be applied nationally, even the US would be left trailing.

Yet it is the wider, worldwide problem of poor productivity growth I want primarily to address here. By now, we are all able to list some of the bigger, macroeconomic causes of this sickness – from ageing populations, poor rates of labour force participation, inadequate investment, a broken banking system and a decline in the number of new company formations.

Yet at its heart is a paradox which has so far gone largely unexplained; on the one hand we see apparently transformational technological progress and, what with the prospect of driverless cars, breakthroughs in medical diagnostics and cures and even colonies on Mars, the promise of lots more to come. On all kinds of fronts, from LED light bulbs to factory automation, the world is becoming massively more efficient in its use of both resources and labour.

So much so, that the main worry among policymakers is not so much that of insufficient innovation but rather "technological unemployment" – the fear that automation will put us all out of a job. Yet if this is indeed what's happening, it's not yet apparent in the productivity figures.

Some of this seeming mystery can be explained by faulty statistics that fail adequately to capture the dynamics of the new economy. Measuring the transition from an economy based on tangible production to one centred more around ideas and knowhow is proving troublesome.

But these deficiencies cannot be the whole story. A new paper by economists at the OECD provides what I think may well be a large part of the remaining answer. The world, they suggest, is divided between a relatively small number of "frontier companies", where technological take-up is high, and a great hinterland of laggards which, despite its inefficiencies nevertheless manages to scrape by and survive.

Frontier companies are typically three to four times more productive than the laggards, tend to be big multi-nationals, and pay well. Their higher productivity also means they have significantly higher mark-ups. These differences apply in equal measure to service and manufacturing sectors.

It has obviously always been the case that some companies are swifter to adopt and exploit new technologies than others. What's changed is the process of diffusion by which new, productivity-enhancing technologies are more widely adopted throughout the economy. One way or another, it has become broken. Productivity growth is therefore becoming increasingly dispersed. New technologies are spreading rapidly across and between countries, but their diffusion to all firms within individual economies is slower and slower. It is small wonder that so many in the West find themselves left behind by globalisation. Many of its fruits are simply not being plucked.

CHARLOTTE GRAHAM - GUZELIAN

Britain needs more examples of high productivity, which Amazon, *pictured*, is known for

'Small wonder so many in the West find themselves left behind by globalisation. Many of its fruits are not being plucked'

Markets, it seems, are becoming ever more prone to "winner takes all" dynamics, with a small number of large firms able to manipulate standards and regulations to their own advantage. Today's new technologies tend to be costly and complex to introduce, and require high skills, which smaller players struggle to emulate. As a result, barriers to entry are getting higher, and markets less competitive. Virtually all advanced economies seem to have less competition in key sectors than they used to, with many industries becoming significantly more concentrated than they were.

Capital may also have become quite widely misallocated to asset rich but productivity poor companies during the financial crisis and the subsequent low interest rate environment. The process of "creative destruction", by which older, poorly performing companies are forced out of business by more innovative, competitive newcomers seems to have substantially ground to a halt. Productivity growth is becoming increasingly dispersed, there is less entrepreneurialism, and the laggards are not going out of business as they should.

Hammond is plainly right to focus on Britain's poor productivity record. And there is no doubt something to be said for the enhanced infrastructure spending and public investment in education and training he suggests as remedies. But the key takeaway from the OECD research is the urgent need for structural reform, including product and labour market deregulation, to get the broken diffusion machine going again.

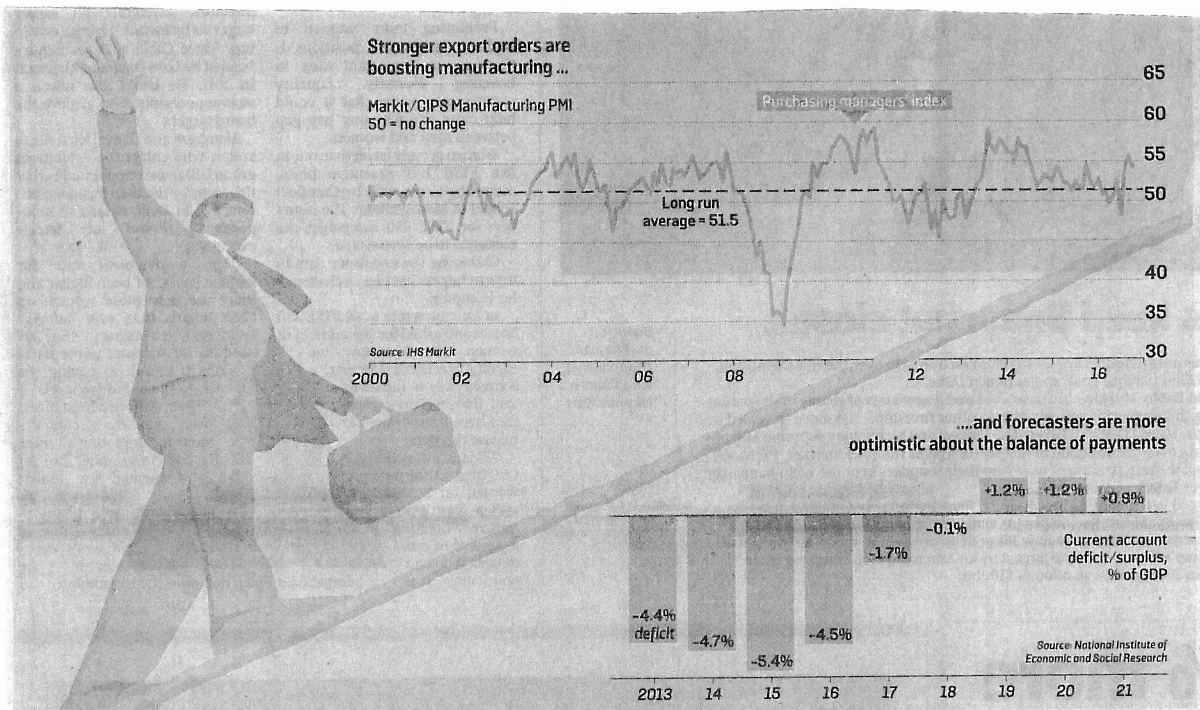
Central banks can do nothing more to save capitalism from itself. There is also a limit to the effectiveness of further fiscal interventions. A different approach is called for.

Business

has seen its share price climb from 95.5p to 142.6p.

Share price

180



Sterling's ill wind could blow us back to balance

DAVID SMITH
ECONOMIC OUTLOOK

You would have to say it has been a bracing few months, particularly for the pound. Blown in one direction — sharply down — by the referendum result and government indications that it will be pursuing a harder form of Brexit, then blown back up a little — to $1.25 — by the High Court ruling last Thursday that parliament must have a vote on the triggering of the formal article 50 process.

But the pound remains very substantially lower than it was, which will have consequences, notably higher inflation. It is an ill wind, however, that blows nobody some good.

Manufacturers are clearly benefiting from weaker sterling. The latest purchasing managers' survey for the sector from Markit showed export orders are driving a mini-revival in our factories. That is good news, but far more remarkable is the possibility of one of Britain's long-standing Achilles heels being eliminated in just a few years.

I am referring to the current account deficit, or gap in the balance of payments — the amount that this country is in the red in its transactions with the rest of the world. It used to be regarded as the one of the best measures of the nation's economic health.

The deficit, as regular readers will know, has been running at record levels. Last year it was no less than £100.2bn, 5.4% of gross domestic product. In the first half of this year it averaged 5.8% of GDP. It was this that led the Bank of England governor Mark Carney to say that Britain would be dependent on the kindness of strangers to fund all this red ink.

The remarkable news, then, is that Britain may not be dependent on this kindness for too much longer. The latest forecast from the National Institute of Economic and Social Research (NIESR) attracted a lot of attention a few days ago because of its prediction that inflation will rise to 4% next year, putting a big squeeze on real — after-inflation — household incomes and thus restraining spending.

Also in the forecast, however, was a remarkable set of numbers on the prospects for the current account deficit. The NIESR expects this year's figure to average out at 4.5% of GDP, a small improvement on last year. Next year it predicts a bigger drop in the deficit, to 1.7% of GDP. It is what might happen next that really caught my eye, though. The deficit is predicted to virtually disappear in 2018, dropping to a mere 0.1% of GDP, but then to be followed by three successive annual surpluses of 1.2%, 1.2% and 0.9%.

Before explaining how this is expected to come about, it is worth taking a moment to record how unusual a single current account surplus would be, let alone three in a row. Britain has not had a single annual surplus in the past three decades. The Office for National Statistics' dataset, going back to 1987, shows that the nearest we had to a surplus was a 0.2% of GDP deficit in 1997. Last year, as noted, it was a record 5.4% of GDP. So this would be a very big change.

How does it happen? There are three main things happening in the NIESR forecast. Though it notes Britain's exports often respond disappointingly to falls in the pound — in the jargon, the elasticities are low — it expects some impact on export growth. But, as far as trade is concerned, weaker domestic demand and higher import prices reduce growth in the goods and services we buy from abroad. Imports are the main channel through which the trade picture improves.

The result is that net trade (exports minus imports) having made a negative contribution to growth in recent years, despite post-crisis hopes of export-led growth, is forecast to make a significant positive contribution next year and beyond. The trade deficit in goods and services, £39bn last year, is predicted to disappear before the end of the decade.

The second big factor is investment income, which has been responsible for much of the lurch into record current account deficits in recent times. This was the phenomenon under which foreigners were earning larger returns on their investments in Britain than British people and institutions were doing on their investments overseas.

The lower pound affects this in two ways. It boosts the sterling value of foreign assets and thus improves Britain's net international investment position, while leaving the sterling value of foreign-owned assets here unchanged. It also boosts the value of foreign income. It is enough to return to surplus this component of the balance of payments, the so-called primary income account, perhaps even before the end of this year.

Finally, in what Simon Kirby at the NIESR admits might be a heroic assumption, another source of improvement is that Britain stops paying contributions to the EU in 2019-20. That assumes exit by March 2019, a date perhaps complicated by the High Court judgment, and assumes exit is not followed by the kind of arrangements Switzerland and Norway have with the EU, which involve contributions.

Anyway, the prospect of a return to surplus on Britain's current account, particularly from a position of record deficit, is encouraging. The Bank of England, by the way, also sees the deficit narrowing significantly but its forecast does not run as long as NIESR's.

Will it happen? Forecasts — good and bad — are forecasts, and subject to the usual health warnings. I had thought the big fall in the pound from the autumn of 2007 to early 2009 would lead to a significant improvement in the current account position but the outcome was disappointing, not least because of the weakness of Britain's export markets in the eurozone (one reason for the decline in the EU share of exports).

The NIESR assumes that the pound stays roughly where it was at the time of its forecast — $1.22 and €1.11 — which implies a prolonged period during which it is below both fair value and historical averages. Currencies move, as we saw last Thursday. Depending on what happens this Tuesday in America, the dollar could move quite a lot. Currency market indications in recent days are that it would fall a lot on a Donald Trump victory, pushing the pound higher.

There is also, of course, the elephant in the room of Britain's future trading arrangements. The NIESR expects the trade and current account positions to start deteriorating again in the first half of the 2020s. If Britain fails to secure good trade deals with the EU and the rest of the world, that deterioration could be very significant indeed. We should enjoy this return to surplus while it lasts.

PS Have we reached rock bottom for interest rates at 0.25%? Having said that it would consider a further cut before the end of the year when it reduced them to that level in August, the Bank predictably left well alone last Thursday in the light of stronger data than it had expected. Its stance now is determinedly neutral; it could cut again if economic weakness requires it. Equally — and this was a change — it will raise rates if it thinks higher inflation is becoming embedded.

Despite an upward revision to growth and inflation next year, the Bank's latest assessment is a gloomy one. Growth of 2% or so feels like proper growth, but the Bank does not expect that to occur in the three years 2017-19, with predictions of 1.4%, 1.5% and 1.6% respectively. Meanwhile, it says, inflation will move above the 2% target and stay there; 2.7%, 2.7% and 2.5% respectively.

The falling pound is one reason for the rise in inflation, but there are also what the Bank describes as supply developments, which will also bear down on growth. It takes the view that Brexit uncertainty will hit investment in capital equipment and in skills and training, hampering productivity growth. It is a sobering picture, in contrast to the better prospects for the balance of payments. Carney will be glad to get back home to Canada in 2019.

david.smith@sunday-times.co.uk