The contribution of weak investment to the productivity slowdown

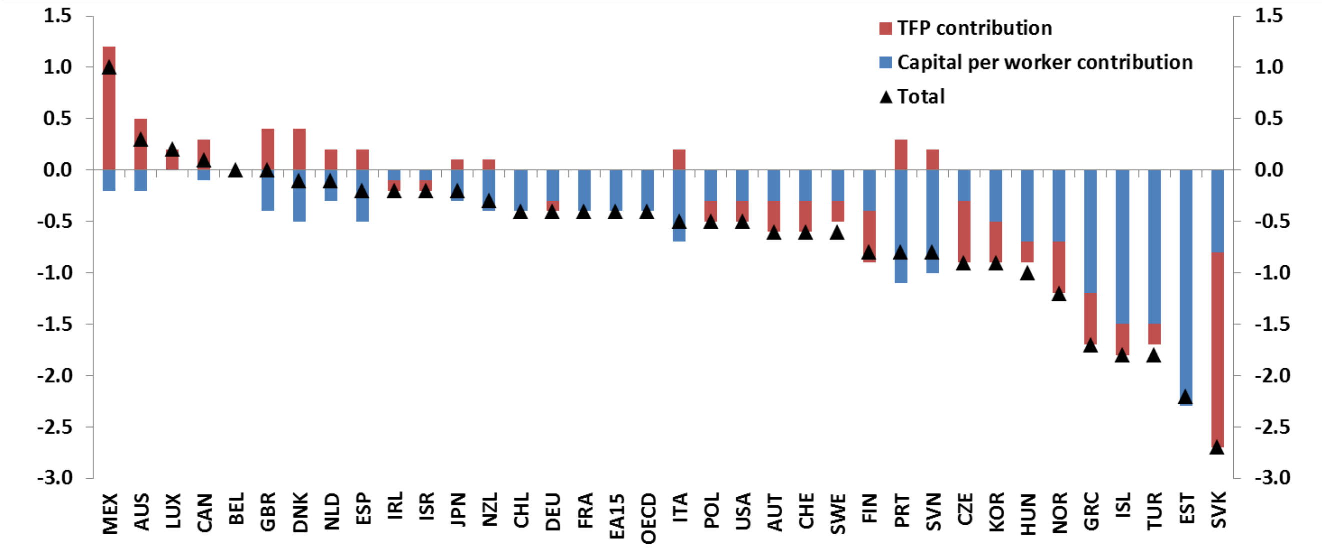
by Yvan Guillemette, OECD Economics Department

Concerns around weak productivity growth are everywhere these days. As the latest OECD Economic Outlook notes, since the mid-2000s, productivity growth has been markedly lower than at any other time since the 1950s. In response, the OECD has just launched the Global Forum on Productivity, an initiative to foster international co-operation between public bodies who promote productivity-enhancing policies. The goal is clear: to kick productivity growth out of the doldrums. In the long run, it drives all gains in living standards. Without it, many countries may not be able to keep the promises embedded in their social programs.

But if we are to boost productivity growth, it would help to understand why it has slowed. Recent OECD work disentangles two overlapping developments (Ollivaud, Guillemette and Turner, 2016). The first is a secular slowdown in total factor productivity growth (the efficiency with which labour and capital inputs are combined in production), which predates the crisis. This trend has continued since, but the reasons behind it are not yet well understood. The second is an abrupt slowdown in investment following the crisis. On average across the OECD and the euro area, trend productivity growth slowed by 0.4 pp per annum between 2007 and 2015, all of which is explained by slower growth in capital per worker. The same is true of most individual OECD countries (see figure).

Change in trend productivity growth between 2007 and 2015

Percentage points per year



Note: Because the decomposition uses an approximation, a small discrepancy sometimes occurs between the total and the sum of the two contributions.

Why has investment slowed down? A large part of the explanation is simply that weak demand and excess capacity give firms little incentive to invest. Falling investment reduces the amount of capital that workers have to work with, depressing their own productivity and the overall productive capacity of the economy, so-called potential output. The authors calculate that the demand shock associated with the financial crisis may have reduced the aggregate OECD capital stock by about 3¼ per cent and the level of potential output by more than 1% by 2015. The implied reduction in the average growth rate of the capital stock explains about half of the 0.4 pp decline in the contribution from capital deepening to trend productivity growth mentioned above for the OECD area.

Further to the demand effect, capital misallocation during the pre-crisis expansion explains why investment weakness is particularly acute in the countries that saw the biggest investment booms. In addition, many governments have cut public investment in response to deteriorating public finances. Uncertainty, lack of visibility and volatility have added to this unsavoury mix. And to cap it all, the pace of productivity-boosting structural reform has slowed.

High inertia in the capital stock means that the negative effects of the crisis on productivity could last for a while. This realisation adds to the urgency of using all available fiscal space to help stretched monetary policies boost demand, and to redouble efforts on structural reforms.

References:

Ollivaud, P., Y. Guillemette and D. Turner (2016), "Links between weak Investment and the slowdown in productivity and potential output growth across the OECD", *OECD Economics Department Working Papers*, No. 1304.

OECD Economic Outlook, June 2016.