Instability, not productivity, is the economic problem

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There is currently a big debate about productivity growth. Is it as slow as it has been measured or have changes in the economy led to growing measurement errors? If slow growth is real, what causes it?

I don't claim to know but it is noticeable that periods of slow productivity growth often follow large macroeconomic shocks. After the oil-price eruption and subsequent stagflation of 1973 a decade of slow productivity growth followed in many leading economies. Then, as now, "structural" explanations were offered. One was that rapid growth of the labour force meant more workers were young and inexperienced! Recently, it has been argued that slow growth of the labour force means more marginal workers are being employed – equally implausible. Quite possibly productivity will pick up again as the global economy settles down, just as it did before.

But there's the rub. The economy needs to avoid another shock. The real concern is that whether it is growing fast or slow the economy has become dangerously unstable and a succession of recessions is quite likely. To understand why we need to review some history.

For some 30 years after the second world war the global economy grew with only minor interruptions but with creeping inflation. In some countries, the creep tended to accelerate and when the oil shock of 1974/5 worsened the terms of trade inflation exploded in most developed countries. That period was characterised by either a stable share of wages and profits in GDP or, in some countries, a rising wage share.

Inflation, ascribed largely to "wage push", led to deflationary policies and, in some countries, reduction of unemployment benefit and curtailment of trades union prerogatives. There was also a general liberalisation of capital flows. The latter was shortly followed by two phenomena that changed the world. The first was the information revolution that facilitated the breaking down and dispersal of supply chains; the second was the collapse of communism that released millions of educated, literate workers onto the world market economy.

As a consequence, from the mid-1980s economic power swung decisively from labour to capital. Inflation died in all developed countries and in most the share of profits within GDP began to rise. Cyclically adjusted, the rise was to last for over 30 years. Within the labour market in Western countries jobs at the top of the hierarchy became better paid, those at the bottom worse paid while those in the middle dwindled in relative number.

This led to some agonising and indignation about the growth of inequality. Less remarked was the consequence for aggregate demand. If wages grow more slowly than output, who buys the output? For a while the answer was that, excited by higher profits and the possibilities offered by technical change, the capitalists increased investment spending. Gross fixed capital formation in the United States, for example, rose from some 9 percent of GDP to nearly 14 percent in the 1990s. But capitalists are not content to keep on increasing investment unless the additional output can be sold at a profit. Investment booms always end as they confront what Marx called the "realisation of capital" problem – how to get paid back.

Pay-back time

The world has found a solution of sorts: make credit cheap. After the dot.com crash and recession of the early 2000s easy money led to an inflation of property prices and massive equity withdrawal that allowed households to increase their spending despite static wages. This was particularly marked in the "Anglosphere" countries. But the property bubble led to a crash of the housing market eventually and a worse recession in 2008/9.

The banks were blamed for extending the easy credit but the remedy was repeated with quantitative easing. This has facilitated another recovery driven by consumer spending as households, after a pause, have increased their personal debt to pre-crisis levels. This time the corporate sector has not increased investment spending.

For those who believe the reduced productivity growth is real, the low business investment is to blame. In any case it is inevitable. First, many of the fastest growing businesses in the IT and digital economy have very low requirements for fixed capital. Apple's annual profits are bigger than its fixed capital. Second, other businesses prefer to buy back shares, inflating their price, rather than trust in consumer demand built on an unsustainable debt build-up. Growth, whether slow or under-recorded owing to unmeasured improvements in the quality of services, will last until consumers decide they are over-extended and can borrow no more. Or until their creditors make the same determination. Then the economy will fall into recession again.

Financial speculation and leverage could make that recession severe. Their absence would ensure the recession would be less pronounced, Recession is inevitable all the same and cannot be avoided so long as the growth of household income is below the growth of potential output so that aggregate demand can be maintained only by bursts of easy credit followed by retrenchment.

A traditional Keynesian solution would have been for the state to maintain demand by running a fiscal deficit and supporting demand either by its own expenditures or by transfer payments. In the present situation that would lead to state spending accounting for a larger and increasing share of GDP. That is widely considered politically unacceptable. In any case it leads to issues of international co-ordination that have hitherto proved insoluble.

The wages conundrum

In a world of deficient demand and shortage of "jobs", all countries want to run an export surplus. Easy money everywhere eliminates the possibility of competitive devaluation – everyone is trying it so no-one can do it. The country that expands its fiscal deficit quickly ends up with a current account deficit. Calls on surplus countries to take their share of the burden of raising demand fall on deaf ears. Indeed, Germany, for example, is congenitally deaf on this issue. Trade imbalances grow, so does international indebtedness and eventually creditors become alarmed. No one wants to be another Greece so stabilisation via fiscal deficit is unfashionable as long as international co-ordination of fiscal policies is impossible.

If GDP is under-measured, welfare is advancing faster than we think but that does not change the fact of global deficiency of aggregate demand with the precariousness and instability of employment it entails. Nor would an acceleration of measured productivity help if the proceeds were appropriated by capital and used for more share buy-backs and an inflation of asset prices that did not result in investment spending. Current technical developments that seem likely to reduce the demand for less-skilled labour further will simply exacerbate the distribution-demand problem. The system does not give out enough purchasing power to absorb its output. Incomes are too concentrated in profits and high-end wages for the economy to grow in a stable fashion.

Proposals like a citizens' income have been proposed to solve the problem but they would need to be financed by higher taxation of high earners and of capital. The problem with such redistribution is the taxation or appropriation that must precede it. That is difficult to achieve in a world of mobile capital where everyone is anxious to attract it.

It seems the real world resolution of these problems must be either a retreat into autarky, restrictions on capital and nationalistic policies or an increase in international co-operation and an understanding that international surpluses and deficits are a matter of common concern. The election of President Trump and the vote for Brexit demonstrate that the former is much more likely than the latter.