BOQ GROUP

15 September 2023

# ECONOMIC UPDATE

## The productivity puzzle – or is it?

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# Key Points

- **Recorded productivity growth has been very weak in recent quarters;**
- **Some of this reflects cyclical factors;**
- **But there are other reasons as to why the current data may understate productivity in the economy;**
- **Improving productivity growth should be a key focus over the next decade.**

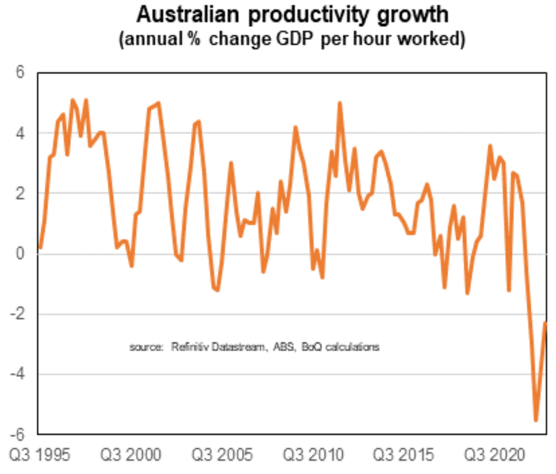
## Recorded productivity growth has been weak

The June quarter 2023 GDP numbers were recently released. Economic growth in the quarter was decent (0.4%) and would certainly have been higher if it was not for material and workers shortages. We also found out that the first half of the year was better than we thought with economic growth in Q1 revised up (by 0.2%).

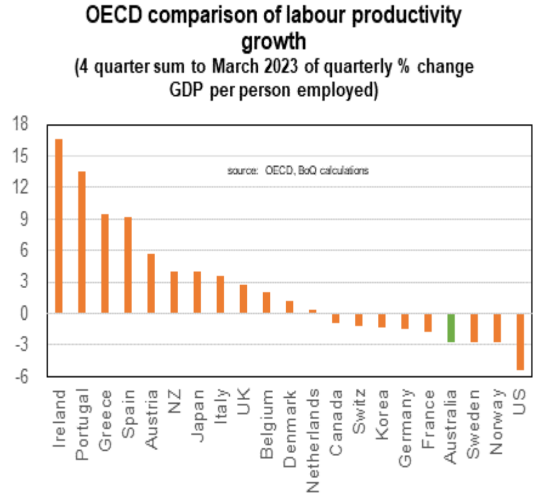
There was a fair bit of focus in the commentary on the GDP numbers about the very weak recorded productivity growth. Conceptually the best productivity measure is GDP per hour worked (productivity is not about working longer but smarter). By that measure Australian productivity growth has been low both by historical standards and compared with peer countries (albeit using GDP per worker as the productivity benchmark).

Strong productivity growth matters. It has been a notable bug-bear of the RBA recently that weak productivity growth could make it harder for inflation to return to 2-3%. Over the longer-term rising productivity growth funds after-inflation wages growth ('real' wages). Stronger productivity growth also would make it easier to pay for rising demands for higher government spending.

Recorded productivity growth in Australia has been very low over the past year.




And has been low by peer country standards.




A number of reasons have been put forward as to why productivity growth has been so weak. These include:

- Working From Home;
- Firms hoarding labour following their difficult experience of the past couple of years of trying to find skilled workers;
- The increasing importance of services-sector industries to the economy, sectors that have historically found it difficult to boost productivity growth;

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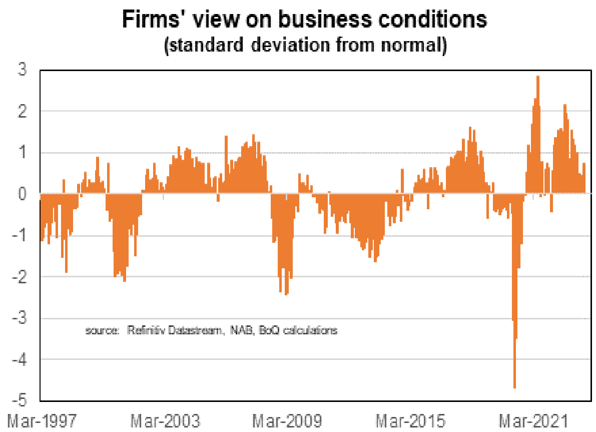
- The tight jobs market has meant there are more inexperienced (and therefore less productive) workers in the labour force.

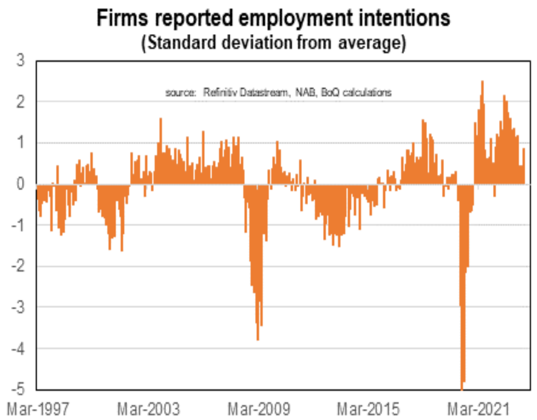
It is too early to determine whether the Working From Home phenomena has been a positive or negative influence on productivity growth (a note for another day). Improving productivity growth in the services sector will be a key economic challenge over the next couple of decades. But the increasing role of the services sector in the economy has been a trend for some time and the sharp drop in productivity growth has been a more recent phenomenon.

It would not surprise that after their recent trouble in finding workers firms would be reluctant to retrench people despite slowing demand in the economy. There are anecdotes that this is happening. But far from wanting to contract firms are still looking to expand. According to the NAB survey the feedback from firms was that business conditions in August were above their historical average. Their hiring intentions remain at a decent clip. The August labour market numbers pointed to a jobs market still doing well.

Firms report that business conditions are currently better than average.




As a result employment intentions are also above average.




I do think that one of the reasons that productivity growth has been lower in recent times has been the rising number of inexperienced workers in the workforce. The unemployment rate remains near fifty-year lows. Employment growth in Australia has been strong over the past year, both by historical standards and by international comparison. By RBA calculations the vacancy to unemployment ratio has been the highest amongst peer countries. Inevitably in such a tight jobs market a higher-than-usual proportion of less experienced workers will get a job.

Having such a low unemployment rate is unambiguously a good thing (providing it does not lead to higher inflation), not the least as it also helps to boost the long-run potential growth of the economy. Research suggests that the best way for people to gain new skills is 'learning by doing'. In this respect having a higher proportion of inexperienced employees in the workforce is similar to an investment in education, where the boost to worker skills may help boost labour productivity in future years.

In any event, a cyclical slowing in productivity often happens at this time in the economic cycle. The economy is performing strongly and leads to firms expanding their hiring, including for less experienced staff. Then the economy starts to slow. At first firms are unsure as to how permanent the slowing in economic growth will be and so keep their staff. The result is that output grows less but jobs growth doesn't and so recorded productivity growth slows. Some of the recent decline in productivity growth

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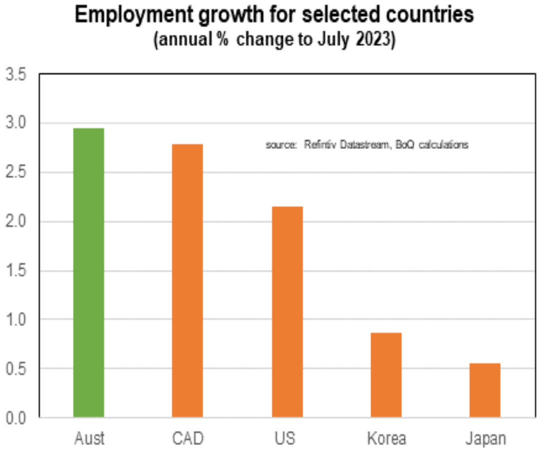
therefore says more about the cyclical state of the economy than the underlying productivity potential of the economy.

There has been an additional factor in this economic cycle. Firms' say that order books were growing at a record pace in 2022 (which led firms to go on a hiring binge). But the ability to meet those orders was constrained by the historically large degree of worker and material shortages. The result was that employment growth picked up more strongly than output growth. And so impacted productivity.

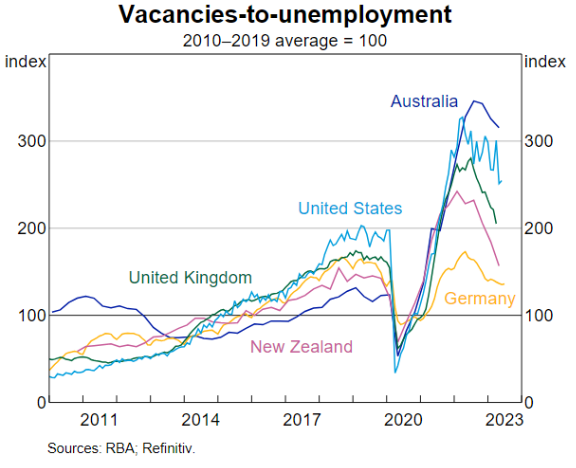
Concerns about material shortages have begun to decline, as has worries about the lack of skilled workers (albeit more slowly). So, this should be a reduced factor weighing on productivity growth in coming quarters.

Jobs growth in Australia has been very strong over the past year.

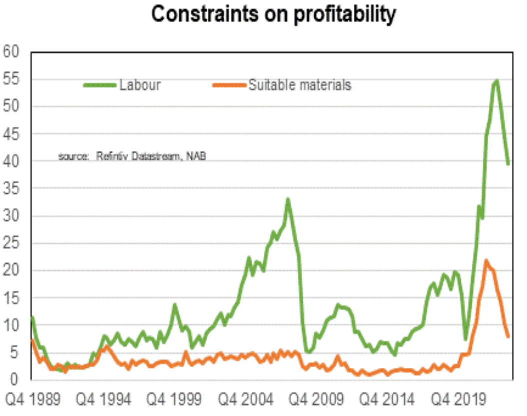

And it has been strong by peer country standards.




The vacancy-to-unemployment ratio rose the strongest in Australia.



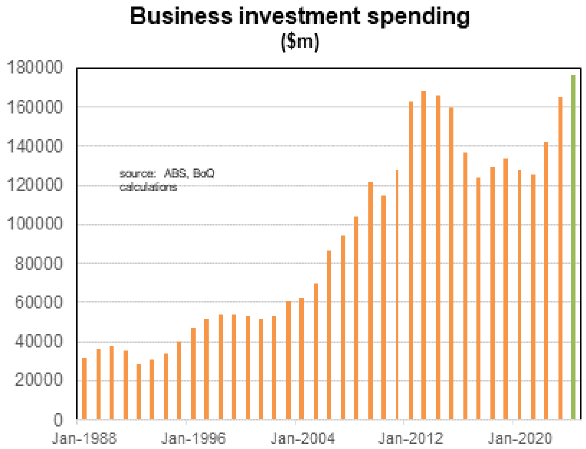

Supply constraints have been a more significant issue in this economic cycle.



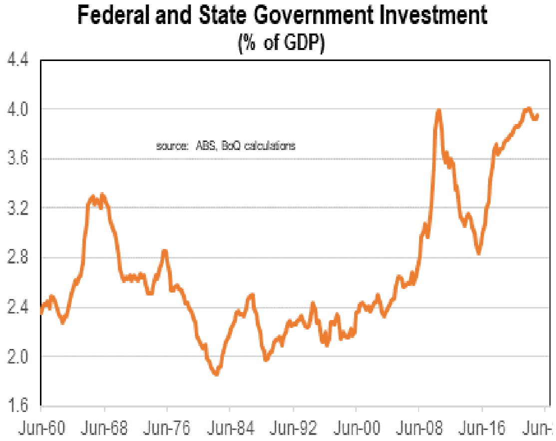

Another factor that is likely holding back productivity growth is that there is currently plenty of investment taking place in the Australian economy. Firms are increasing their capex spending (notably on plant and equipment and IT) due to high capacity utilisation, decent profit growth and the need to digitise. At the same time Governments' are doing a large amount of infrastructure work, including for large transport projects and for climate transition.

The last time that Australia had a period where there was a significant amount of investment spending in the 2000's (the mining boom) was also a period when productivity growth took a notable dip. There is a period when a large amount of work occurs on the investment without a boost to output growth. Productivity growth then jumps when the investment is completed and output is boosted from that investment.

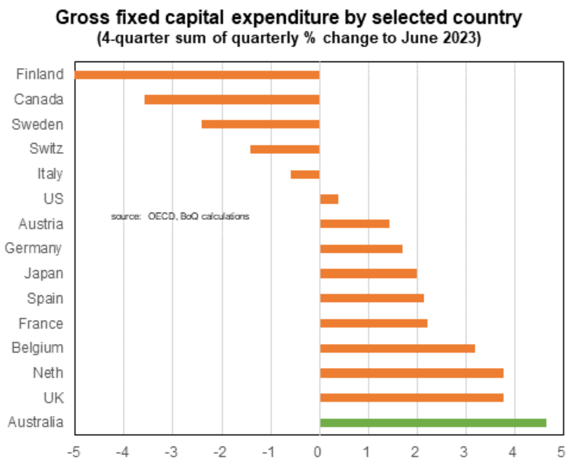
Business investment has picked up strongly over the past couple of years.




Government investment is also high.




Spending on investment has been strong in Australia by peer country standards.



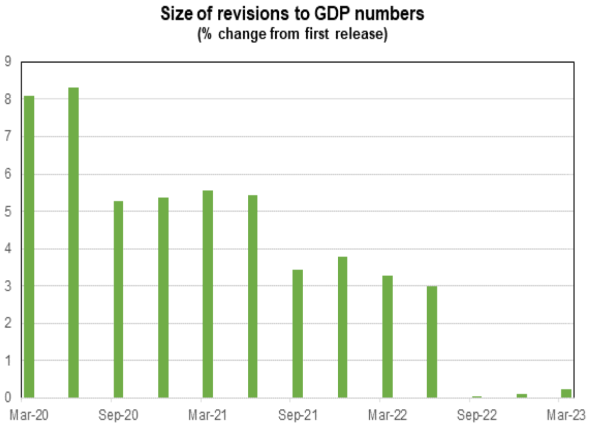

Productivity growth dipped in the 2000's when the mining investment was happening but rose the next decade when the mines were competed.


Maybe the other reason to think that productivity growth might be understated is that the economy may be stronger than what is currently suggested by the GDP numbers. Productivity growth is defined as GDP per hour worked (some use GDP per employed worker), and so stronger economic growth would mean higher recorded productivity growth (unless employment growth has also been underestimated).

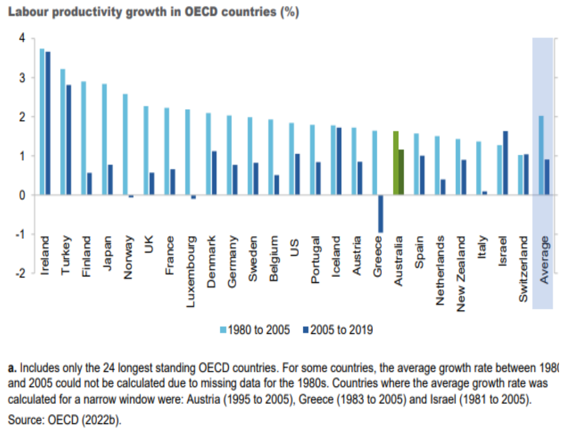
Stronger economic growth would be consistent with the current relatively upbeat view of the business sector (although at least some of that optimism might reflect the strength of population growth). So, it is possible that we could see upward revisions to the size of the Australian economy. The UK statistical agency recently found an additional 2% of GDP, much of it during COVID.

Indeed, that has also happened in Australia. The ABS has subsequently found that the Australian economy was 8% larger in the first half of 2020 from when the GDP numbers were first released, 5% larger in 2020-21 and 3% larger in 2021-22. As with the UK revisions, the biggest changes happened during the depths of COVID when understanding the amount of economic activity taking place was difficult. The GDP revisions to the most recent quarters has to date been more modest. Nonetheless, business confidence about their hiring intentions and potential capex spending does suggest that the economy is doing OK and that further upward revisions to the GDP numbers are possible.

The economy was bigger through COVID than previously thought.




Australian productivity growth has slowed in recent years. But it also has in most peer countries, and by more.




All of this highlights the problems about reading too much into short-term movements in the productivity numbers. That is always the case in any economic cycle. But it is particularly the case for the current cycle given the unusually large problems with supply-chain problems and worker shortages, as well as the substantial pickup of investment spending. It is why most of the analysis on productivity growth is done by taking the average outcome over a number of years.

That is not to downplay the need to boost productivity growth in the economy. Taking a longer lens, Productivity Commission work (see above chart) has highlighted that productivity growth has been structurally weaker over the past decade (as it has in many countries). How to improve productivity growth, particularly in the services sector, will be one of the key domestic economic challenges over the next couple of decades.

We really do live in interesting times.

Regards

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