

# Slowing economic growth: the challenge of lifting productivity

*This document is based on discussions at the CEDA Council on Economic Policy (CCEP) meeting held 17 July, 2015<sup>1</sup>. It does not necessarily reflect the views or opinions of any individual in attendance unless specifically cited. This summary does not reflect the unanimous views of all participants. Individual views may differ from the statements made in this summary.*

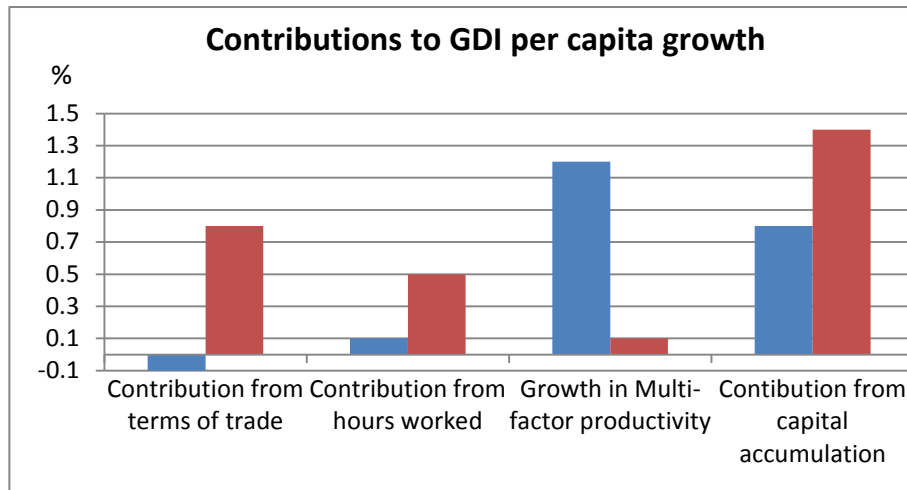
CEDA's Council on Economic Policy (CCEP) meeting in July involved a presentation and discussion on *Slowing economic growth: the challenge of lifting productivity*, delivered by Dr Philip Lowe, Deputy Governor of the Reserve Bank of Australia. The presentation touched on the challenges for Australia of maintaining robust economic growth. In particular, the presentation and following discussion focused on international debates about whether the current subdued level of economic growth across many developed economies represents a new normal.

During the presentation, members of the CCEP discussed the nature of the productivity challenge confronting Australia and debated potential remedies. In particular, different views were expressed about the causes of low levels of investment, subdued wage growth and what policy measures could be introduced to enable future productivity growth.

## **Reduced economic growth**

After reviewing recent economic conditions in Australia the presentation put the nation's level of economic growth in the international context. In particular, it outlined the current international policy debate about the causes of lower economic growth across developed economies and their implications for the future rate of economic growth. The challenge of lifting Australia's level of productivity was discussed in this context. Participants noted that significant improvements to productivity were required for Australia to maintain its record of economic growth. While business conditions seem to be in place for strong levels of investment, non-mining investment has remained subdued since the global financial crisis. In this regard, Australia's economic conditions are similar to many developed economies.

Participants discussed the interaction between the cycle in the terms of trade and trends in productivity growth in Australia. The extended terms of trade boost improved the incomes of Australians relative to the amount of goods and services the economy produced. During the 2000s the key driver of gross domestic income (GDI) per capita growth was capital accumulation, which accounted for about half of all the improvement to GDI per capita, while productivity growth added just 3.5 per cent to GDI per capita. In contrast, during the 1990s productivity growth accounted for 60 per cent of the total growth in GDI over the decade. With declining levels of mining investment, and falling terms of trade, Australia must improve productivity to experience ongoing income growth.



## Future of economic growth

There are currently two major perspectives on the future of economic growth. The pessimistic perspective suggests that the world has experienced an anomalous period of economic growth since the industrial revolution and it is reverting to a lower, more typical level of economic growth. In making a case for a low growth future, economist Professor Robert Gordon points out that many methods of production have not changed significantly in over a decade. This means that the way in which goods and services are produced and organised has been relatively static. For instance, it took only 66 years for technology to progress from the first ever human flight to putting a man on the moon. In the following 46 years there has been little progress in the speed of mass transportation, with automobiles and airplanes not becoming significantly faster. Many aspects of human activity replicate this experience.

Other potential headwinds against improving productivity are:

- During the last century the level of educational attainment in the population increased significantly. This resulted in boosting the productivity of the population. However, it is not possible to replicate this productivity increase with further education. In fact, participants discussed the need for the quality of education in Australia to improve to maintain the populations current levels of productivity;
- There is evidence to suggest political processes in the developed world are ossifying, reducing the ability to make difficult decisions. In particular, legal and regulatory changes have potentially increased the level of risk aversion in the economy;
- There are also significant equity issues in many developed economies as wealth is less evenly distributed now than it was last century; and
- While there was a demographic dividend underpinning productivity last century, now global populations are rapidly ageing. Ageing populations are less productive and may be more risk averse. While this issue is potentially influencing Australia, it is having less of an influence than in many other countries due to the nation's high migration rate. Almost half of Australia's population was either born overseas or their parents were. Furthermore, the level of migration into the country is very high compared to many other nations.

In contrast to the pessimistic forecasts of Professor Gordon, the optimistic perspective of Professor Joel Mokyr focuses on how the factors that underpinned the productivity improvements of last century are even

more pronounced. This perspective suggests that the following factors are creating the potential for further technologically driven economic growth:

- The level of diversity brought to social and economic challenges has increased significantly, with greater capacity for people with very different worldviews to grapple with social and commercial problems. This increases the likelihood that an innovative solution can be found;
- Nation-state competition encouraged the innovation that underpinned the first waves of the industrial revolution. Technological developments, such as the internet and the ubiquity of telecommunications, mean nation-state competition is more intense than ever; and
- The scientific method has been broadly accepted and used in a wide range of areas and, as a result, the capacity for progress is improved.

Participants noted that this is not the first time there have been periods of low productivity growth. For instance, productivity growth was low during the 1970s before improving with the introduction of computing. It may be that the current low levels of economic growth may be due to other factors.

During the discussion, it was noted that the global economy is going through a major structural adjustment due to the integration of the developing world. This has resulted in hundreds of millions of additional workers being added to the global labour market with pronounced consequences for job and wage growth. Another potential contributor to lower growth is the high level of indebtedness, to the extent that it has reduced the willingness of consumers to spend and of businesses to invest. High levels of indebtedness exist throughout the developed world, and may be a major contributor to relatively slow consumption and business investment growth.

The discussion also focused on whether low levels of business investment could be explained by society becoming risk adverse. It was pointed out that Australia is just as effective as ever in producing businesses that operate on the technological frontier. However, the rate in which other companies adopt these innovations has slowed down. The different culture at startup companies compared to established businesses was considered to be particularly relevant. It was also noted that the amount of time boards spend on risk related issues has grown significantly and may be reducing the amount of innovation taking place in the economy. Changing risk preferences, driven by either the wealth of society or its increasing age, may have contributed to the decline in small business ownership.

To improve Australia's productivity, it was suggested that the nation should focus on:

- Building an innovation culture both in terms of government policy settings but also cultural acceptance of innovation and entrepreneurship;
- Investing in physical infrastructure to improve productive capacity, particularly in the nation's capital cities;
- Encouraging new entrants – often the most productive – by implementing reforms to competition policy; and
- Improving Australia's educational outcomes by increasing the number of science, technology, engineering and mathematics (STEM) students.

While the majority of these recommendations were broadly accepted, there was considerable discussion about the need for more STEM students. In part, it was questioned whether Australia could or even should seek to compete in terms of the quantity of STEM students when the annual number of graduates from these courses numbers in the millions in countries such as China and India. Furthermore, it was also questioned as to whether STEM training provided a robust basis for entrepreneurial decision making. It was also noted that the earnings premia associated with social science degrees have been higher than those for hard sciences in Australia.

It should be noted that it was widely recognised that Australia's education system needs to teach fluency in STEM concepts. In fact, it was suggested that core aspects of STEM subjects should become prerequisite for the education curriculum.

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· Attending the CCEP were Professor Rodney Maddock (Chair), Professor the Hon. Stephen Martin, Professor Susan Thorp, Professor Percy Allen AM, Tim Harcourt, Su-Lin Ong, Professor Mardi Dungey, Dr Alexandra Heath, Dr Mark Cully, Professor Stephen King, Professor Paul Simshauser, Professor Warwick McKibbin, Professor Graeme Samuel AC, Professor Greg Smith, Nathan Taylor, Sarah-Jane Derby; and Dr Philip Lowe (Guest).

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