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US capital productivity decline must be reversed

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The debate about the current recovery centres on whether a secular change is taking place in the US economy. If it is not, then we should all be optimistic because peak-to- trough declines in real gross domestic product of 4 per cent are usually followed by gains of 6-8 per cent. But the consensus view is that growth will be sluggish (2-3 per cent) and few jobs will be created.

There will be revenue growth to be sure. The weak dollar has clearly helped exports and the 90 per cent of the working population with jobs are spending again now that their house prices have stabilised and the stock market has come back from its lows of last March. The unemployment rate remains stubbornly close to 10 per cent, however, and operating rates for US manufacturers are at 70 per cent so there isn't much of an incentive for capital spending beyond technology.

Moreover, the working week remains about 33 hours, so even those who are working aren't getting their pre-recession paychecks. To get the goods out of the door and provide the services demanded by customers, companies are hiring temporary workers in record numbers to maintain maximum flexibility. They are worried that a healthcare bill, if one passes, will add onerously to the cost of full-time employees and they don't want to be hit with more termination pay if the economy suffers a double-dip.

The result of this is that productivity is soaring. The reading of better than 8 per cent growth is the highest in decades. Rather than applaud the efficiency of the American worker one should wonder if the numbers are too good. Are workers being driven to the point of exhaustion? There's no sign that anyone's complaining. Wage rates are barely increasing. Most of us with jobs are glad to have them and aren't willing to make any waves.

How much longer can this go on? Not much longer in my opinion. The unemployment rate usually starts moving lower about nine months after the economy troughs and that happened in the second quarter of 2009, so we could see jobs created as soon as the February report which will come out March 5. I also believe real GDP will be stronger than the consensus expects as inventories continue to be built and the remaining part of the government's stimulus programme flows through the economy.

Longer-term, I doubt that the US or Europe will grow faster than 3 per cent a year any time in the next five years. The developing world, however, will grow in excess of 5 per cent a year. The result of this is that the mature industrial economies are losing about a percentage point a year in share of world GDP to the emerging markets and they are losing a similar amount in share of world stock market capitalisation.

The biggest problem the US is facing is the productivity of capital. After the end of the second world war it took less than $2 of investment by government, corporations and individuals to produce $1 of GDP growth. The productivity of capital continued to be impressive until 1980 when Europe had recovered and Japan was producing cars and consumer electronics products that found wide acceptance in world markets.

In the single decade of the 1980s, the productivity of capital declined from a level where it took less than $2 of investment to produce $1 of growth to one where about $3 was needed. If you assign a 30 per cent gross margin to that revenue growth, the return on investment declined from 15 per cent to 10 per cent.

That level of return proved to be satisfactory, but in the first decade of the current century capital productivity declined seriously in the US. Because of profligate spending on over-priced housing and other assets that declined seriously, as well as deficit spending by the government, by the end of the decade it took $6 of capital to produce $1 of growth. The return on that would only be 5 per cent and few would put money at risk for that reward.

When you look abroad to assess our competitive position, the results are not encouraging. It is hard to put together comparable information but, based on the data I could gather, Europe was still getting $1 of growth for $2 of investment and China was getting at least $1 of growth for each dollar of investment.

If the US is to stop losing ground against other mature and developing economies, it is going to have to put money to work more effectively. We are still the leaders in technology and scientific research and we must continue to take advantage of the commercial possibilities of innovation. If we do not reverse the current trends, growth in the US beyond this year will be disappointing and our standard of living will decline.

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