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Productivity and the allocation of resources – speech by Ben Broadbent

In a speech at Durham Business School, Ben Broadbent – External Member of the Monetary Policy Committee – considers the reasons for the apparent slowdown in productivity growth in the UK. He argues that it may be due to the failure of the financial sector to reallocate resources to sectors where they are most productive. He then considers the implications of this for monetary policymaking.

Ben Broadbent highlights the striking divergence between employment and output growth in recent years: "In more normal times, the 3% drop in output since mid-2007 would have been associated with an 8% decline in the number of jobs. Instead, and despite a contraction in the public sector, aggregate employment has risen slightly over the last five years. The likelihood that the past relationship could explain more recent trends is 0.2%, a one in five hundred chance." One explanation for this is weak demand and firms hoarding labour, but he notes that firms have increased hiring, which is inconsistent with labour hoarding.

Ben Broadbent argues that the evidence suggests: "...it is [hard] to believe that there hasn't also been a genuine hit to the economy's effective supply capacity." Importantly, he adds, "There needn't have been any "technical regress" for this to have occurred. A combination of uneven demand (across sectors) and an impaired financial system, one that is unable to reallocates capital resources sufficiently quickly to respond to such shocks, is enough to reduce aggregate output per employee." Uneven demand could result from a number of sources, including the rise in commodity prices and the impact of the credit crunch on the demand for purely domestic-facing sectors.

Ben Broadbent presents evidence, in the form of a marked increase in the divergence of output, prices and profits across sectors, to support his argument that capital has been misallocated. In addition, while employment appears to have been able to migrate across sectors, that appears less true of capital. "This suggests that there may still be unexploited opportunities from capital reallocation, and an equivalent cost to the productive potential of the economy." He adds that: "Some firms, it seems, are kept in business (and retain employees) despite making relatively low returns. Others, able to expand but unable to obtain the finance to do so, are forced to substitute labour for capital." Together, that can help explain the weakness of output and the relative strength of employment. He notes that this "capital mismatch" may be the result of an exceptional degree of cross-sectoral volatility. But: "...the spread of profits across the economy, especially when compared with the relative stability of wage spreads, is suggestive of problems in the allocation of capital specifically."

Importantly, he thinks that: "It's hard to imagine this dispersion in returns can persist indefinitely. Assuming the underlying shifts in relative demand are permanent, the economy must in the end adapt to them. Indeed, at some point, once the financial system returns to health, one could imagine exactly the reverse process: a long period of above-trend productivity growth."

Ben Broadbent turns to the implications for monetary policy: "First, we should set policy not just on its ability to affect demand but its capacity to improve the flow of finance in the economy as well...If, as the MPC expects, the Funding for Lending Scheme helps to promote the supply of finance across the economy it's likely it will also improve its allocation."

Second, he thinks that policymakers "...should probably pay less attention (than we normally do) to movements in output and relatively more to changes in employment", noting that "...the relationship between employment and inflation has proved more stable through the crisis than those between either of those variables and output."

Key Resources

http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech599.pdf
Full speech by Ben Broadbent