IN BRIEF

SOLVING THE PRODUCTIVITY PUZZLE: THE ROLE OF DEMAND AND THE PROMISE OF DIGITIZATION

Labor productivity growth is near historic lows in the United States and much of Western Europe. While growth in labor productivity has been slowing since the 1960s in many of these countries, the sharp drop to an average of 0.5 percent in 2010–14 from 2.4 percent a decade earlier has been particularly concerning. We attempt to shed light on this puzzle with economy-wide analyses, industry case studies, and corporate surveys, and draw implications for the future.

- We find there has been a job-rich but productivity-weak recovery, with low value added but high hours worked growth, and a broad-based decline with a distinct lack of productivity-accelerating sectors. While there are many schools of thought, we find three waves explain those patterns and the decline.

- **Wave 1:** The waning of a productivity boom that began in the 1990s dragged down productivity growth by about one percentage point. Around 2005, a decade-long productivity boom from a PC, software, and database system ICT revolution and the restructuring of domestic operations and global supply chains was ending. By then, retail supply chain management tools were broadly implemented and manufacturing offshoring momentum slowed.

- **Wave 2:** Financial crisis aftereffects, including weak demand and uncertainty, caused another percentage point drag. After the crisis hit, sectors such as financial services went from boom to bust, and companies reacted to weak demand and uncertainty by holding back investment, driving capital intensity growth down to the lowest rates since World War II. Weak demand further depressed productivity growth through negative economy of scale effects and downshifts in product and service mix. For example, in finance, growth in loan volumes dropped by about 10 percentage points or more across many countries.

- **Wave 3:** Digitization, often involving a transformation of operating and business models, promises significant productivity-boosting opportunities but the benefits have not yet materialized at scale. This is due to adoption barriers and lag effects as well as transition costs; the net effect on productivity in the short term is unclear. For example, in retail, online sales are two times more productive than store sales yet remain on average about 10 percent of total sales volume and come with transition costs like declining footfall in stores. Our surveys and sector analysis show that transition costs can include an initial duplication of structures and investment, cannibalization of incumbent business, and the diversion of management attention.

The waves had different effects on countries. Sweden and the United States had a particularly strong ICT boom that waned, while the United Kingdom had experienced a financial services boom that ended with the crisis. Germany and France started from more moderate productivity-growth rates and experienced smaller declines mostly related to capital intensity. Italy and Spain started with zero productivity growth at the turn of the century and did not decline further.

We expect productivity growth to recover and see the potential for at least 2 percent growth a year over the next ten years, with 60 percent coming from digital opportunities. However, while crisis-related aftereffects are diminishing, long-term drags on demand for goods and services may persist and hold back productivity from changing demographics, declining labor shares, rising income inequality, polarization of labor markets, and declining investment rates. Digital may amplify these demand leakages while potentially creating other barriers to productivity growth, such as winner-take-most effects on industry structure. Capturing the productivity potential of advanced economies will require a dual focus that promotes sustained demand growth and digital diffusion.
Capturing the labor productivity potential of advanced economies

PRODUCTIVITY GROWTH MATTERS FOR MATERIAL LIVING STANDARDS BUT HAS DROPPED TO HISTORIC LOWS

WHAT IS BEHIND EXCEPTIONALLY WEAK PRODUCTIVITY GROWTH?

Two waves dragged down productivity growth on average close to one percentage point each. A third wave contains the promise of significant productivity-boosting opportunities, but the benefits have not yet materialized at scale. This is due to adoption barriers, lags, and transitions costs.

WE EXAMINE SUPPLY AND DEMAND FACTORS ACROSS SEVEN COUNTRIES AND SIX SECTORS

PERCENTAGE POINTS IMPACT ON PRODUCTIVITY GROWTH

WAVE 1
THE WANING OF A MID-1990S PRODUCTIVITY BOOM

2.4

AVERAGE PRODUCTIVITY GROWTH
2000–04

WAVE 2
FINANCIAL CRISIS AFTEREFFECTS, INCLUDING WEAK DEMAND AND UNCERTAINTY

0.8

AVERAGE PRODUCTIVITY GROWTH
2010–14 (including a -0.2% residual)

WAVE 3
DIGITIZATION

0.9

0.5

This could unlock productivity growth of 2%+ a year over the next ten years.

BEYOND TRADITIONAL SUPPLY-SIDE APPROACHES, POLICY MAKERS NEED TO FOCUS ON PROMOTING DEMAND AND DIGITAL DIFFUSION

McKinsey Global Institute