CURRENT ANALYSIS

July 2013

Is the Current Canadian Economic Recovery Really Substandard?

A complaint about the current recovery/expansion period is the sluggish pace of growth compared to earlier post-recession periods. A common graph used to illustrate the point is to plot real GDP indexed to its pre-recession peak and compare it to the average path of the economy for all other recessions back to the 1950s. This is illustrated in Chart 1. This graph implies that the current recovery is not only well below the average path followed by the Canadian economy coming out of recessions since the 1950s but it hugs close to the lower bound of the dispersion of growth through all of these historical periods.

An objection to this comparison is that these earlier recovery/expansion periods reflect much higher trend or "potential" growth rates of the Canadian economy. Potential growth is essentially an economy's speed limit though it is generally exceeded during recovery periods because of slack built up during recessions. It can be approximated by summing trend growth in labour input (e.g. hours worked) and trend labour productivity. In the current environment of weak productivity and sluggish labour force growth, potential growth is estimated at a historically low rate of around 2%.

As shown in Chart 2, there has been a steady downward trend in potential growth from the 4½% to 5% realized in the 1950s and 1960s. Much of the slowing reflects a sharp and persistent long-term decline in productivity growth. Partial offset was provided, particularly in the 1960s and 1970s, by stronger growth in the labour input reflecting a combination of the entrance of the baby boom generation into the work force and sharply rising female participation rates. The baby boom generation is now beginning to reach retirement age, however, and female participation rates have flattened out after closing much of the gap with the male population by the turn of the century. This has resulted in further slowing in potential GDP growth relative to past recessionary periods in Canada.

To try and control for this factor, we have lowered the average growth rate derived from all past recovery/expansion periods used in Chart 1 by the difference between potential growth currently (about 2%) and actual potential GDP growth during the historical periods (average of about 3.7% across all recession recoveries since 1951.) As shown in Chart 3, this modification suggests that the current recovery, though still very sluggish, is actually not markedly different from past recovery/expansion periods once the underlying lower potential growth numbers are taken into account. A lion's share of the underperformance implied in Graph 1 can be explained by the lowering of potential

Chart 1

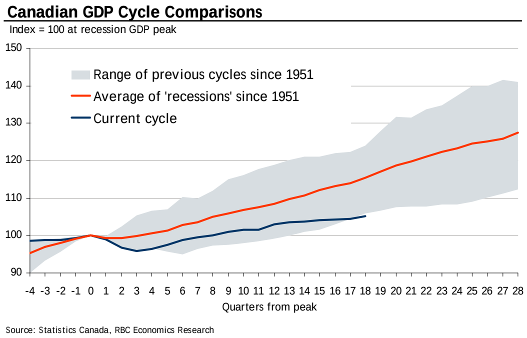

Chart 2

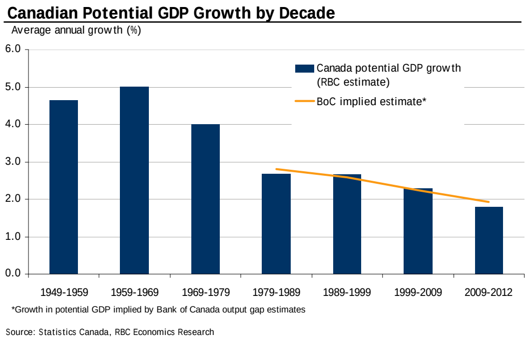

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Chart 3

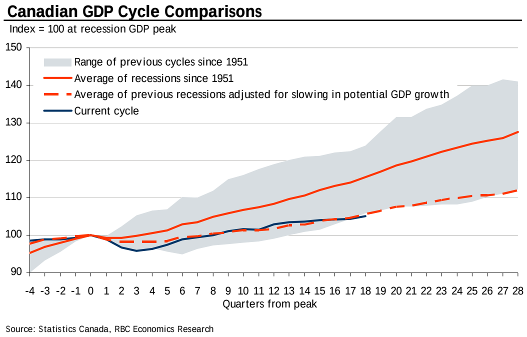
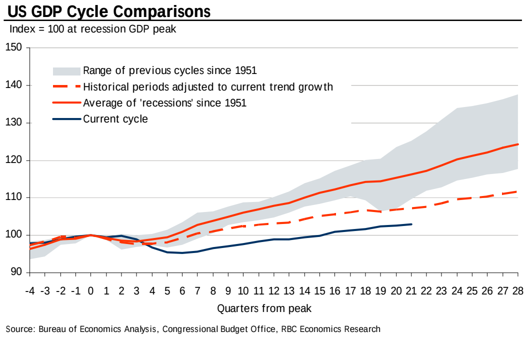


Chart 4



growth. In other words the sluggish growth in the current recovery/expansion phase of the business cycle is more due to weak trend or potential growth, which in turn is related to historically low gains in productivity and the impact of pre-existing demographic trends on labour force growth, rather than cyclical weakness associated with the 2008/09 recession.

Importantly, the slowing in potential GDP growth, resulting from longer-term demographic trends and slowing productivity growth, is not just a Canadian phenomenon. The economic recovery has lagged past performance in the US even more than in Canada. In part, this has reflected fiscal restraint as well as the fact that disruptions to US housing and credit markets were much more severe in the recession than in Canada; however, slower potential growth has also been a factor in the underperformance of the US recovery. Accounting for stronger potential GDP growth in prior cycles, in the same way as described above for Canada, suggests that about 70% of the underperformance of the US economy during the economic recovery can be accounted for by slower potential GDP growth (Chart 4). This is similar to the conclusion reached by the Congressional Budget Office (CBO) in a November 2012[1] study that "about two-thirds" of the underperformance of the US economy in the current recovery/expansion period reflects lower U.S. potential GDP growth rather than cyclical weakness. Similarly, Stock and Watson (2012)[2] found that, while cyclical factors have played a role, "most of the slow recovery in employment, and nearly all of the slow recovery in output, is due to a secular slowdown in trend labor force growth."

Canada's current recovery/expansion does look substandard relative to growth in earlier periods of post-recession growth; however, this is more the result of the overall potential growth in the economy ratcheting lower steadily from the 1950s. This in turn reflects the more fundamental problem of slowing productivity growth and more recently slowing in labour inputs rather than transitory fallout from the 2008/09 recession.

1. CBO (2012). *What Accounts for the Slow Growth of the Economy After the Recession?* http://www.cbo.gov/sites/default/files/cbofiles/attachments/43707-SlowRecovery.pdf

2. Stock and Watson (2012). *Disentangling the Channels of the 2007-2009 Recession.* NBER Working Paper No. 18094.