Economic Viewpoint

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The Canadian economy's growth potential enters a new era

Canada's economy has advanced at a fairly modest pace in the last few years, raising some questions about real GDP's long-term growth potential. A breakdown of the annual real GDP change, starting with the increase in total hours worked and evolution of labour productivity will allow us to pinpoint the major trends influencing the Canadian economy. Output growth potential will remain rather limited over the coming decades, due to slower growth by the working age population. This will have consequences for several facets of the economy, including job creation, interest rates and the stock market.

After rebounding considerably in the quarters following the last recession, Canada's economy has since maintained a fairly modest pace. Real GDP only rose an average 1.7% in 2012 and 2.0% in 2013. For 2014, everything suggests that the year will end with another limited gain of 2.2%. What is behind the Canadian economy's more moderate rise? And, more importantly, can we expect growth to accelerate in the coming years?

DETERMINANTS FOR ECONOMIC GROWTH

To find our answers, it is helpful to look at real GDP growth historically, dividing its growth into two components: labour productivity and total hours worked.

In theory, annual real GDP growth equals the sum of the change in total hours worked in the economy and fluctuations in labour productivity[1]. For example, if labour productivity remains unchanged, real production growth will be determined entirely by the increase in total hours worked. On the other hand, if labour productivity rises, the efficiency gains made by workers will boost output for the same number of hours worked.

As table 1 shows, Canada's economy has seen fairly different growth rates over the decades. From 1962 to 1970, average real GDP growth in the business sector[2] was 5.6%, very rapid progress by today's standards. Much of this gain is due to the 3.8% average increase in labour productivity, inflated by substantial investments in public infrastructure as well as by reforms to the educational system.

Table 1 – Annual change in real GDP broken down into annual change in hours worked and labour productivity

Averages for different periods (%)	*Δ Real GDP for the business sector*	=	*Δ Total hours worked*	+	*Δ Labour productivity*
1962–1970	5.6	=	1.8	+	3.8
1971–1980	4.4	=	2.2	+	2.2
1981–1990	2.0	=	0.8	+	1.2
1991–2000	3.4	=	1.4	+	2.0
2001–2010	1.6	=	0.7	+	0.8
2011–2013	2.2	=	1.6	+	0.6

Note: The sum may not match real GDP due to component rounding.
Sources: Statistics Canada and Desjardins, Economic Studies

From 1971 to 1980, average real GDP growth was at 4.4%, a bit slower than the previous decade. This more limited growth is due to a smaller rise in labour productivity. However, this weaker contribution was partially offset by the accelerating growth in total hours worked, as the majority of the baby-boomers had entered the labour market.

Starting in the 1980s, annual real GDP growth slowed again. Unlike the previous decades, Canada's economy began to experience longer and more severe periods of recession. For example, real GDP in the business sector contracted 4.5% in 1982 and 4.1% in 1991.

[1] Note that labour productivity is the ratio between the output of goods and services and the number of hours worked to achieve that output.

[2] The historical figures on production, hours worked and productivity only involve the business sector, as public administration is excluded from these statistics.

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The slower growth recorded from the early 1980s onwards can be seen in both total hours worked and labour productivity. That being said, the end of the 1990s was marked by a sharp acceleration by economic growth. The average annual real GDP change rose to 5.7% between 1997 and 2000. The number of hours worked rose an average 2.6%, while labour productivity advanced 2.9%[3], thanks to the plethora of investments made during these years, particularly in the tech sector, with the Y2K problem.

The decade from 2001 to 2010 saw serious disruptions. First, it began with a marked slowdown by Canada's economic growth, due to the tech sector's plunge, which among other things triggered a recession in the United States, a large slide by Canadian exports and appreciation by the loonie. Then, the major world recession from 2008–2009 resulted in Canada's real GDP in the business sector growing just 0.3% in 2008, then contracting 4.7% in 2009. All in all, the decade from 2001–2010 saw average annual real GDP growth of just 1.6%, which divides almost equally into a modest rise by hours worked and limited growth by productivity. If we exclude the disappointing results seen in 2001, 2008 and 2009, average real GDP growth during this decade is obviously much higher, at 2.7%. The average increase in hours worked during the good years of 2000 was 1.6%, while productivity advanced 1.0%.

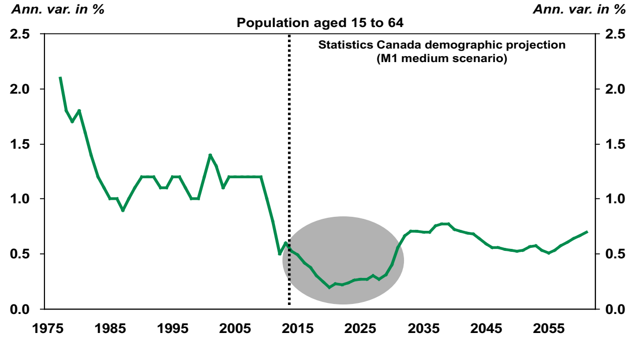
As for the new decade that began in 2011, the results to date are rather disappointing. Average annual real GDP growth for businesses was only 2.2% between 2011 and 2013. The average change in hours worked was 1.6%, while productivity growth was a weak 0.6%. Can we expect economic growth to accelerate in the coming years? In order to answer this question, we must analyze future developments in hours worked and productivity.

DEMOGRAPHICS: THE TREND CAN'T BE DENIED

Canada's ageing population has been the subject of many comments and studies in recent years. In short, the problem stems from baby-boomers gradually retiring. As we can see in graph 1, growth by Canadians in the labour market is expected to slow considerably in the coming years. In fact, this phenomenon began to have an impact in 2010. According to Statistics Canada's projections[4], the slowdown should peak in 2020, when the annual change in the population aged 15–64 will hit a low of 0.2%.

Since labour pool growth will continue to slow in the coming years, causing some labour shortages, it will be increasingly difficult to fill job vacancies, especially those requiring specialized qualifications. This will inevitably lead to a slower rise in the number of jobs in Canada's economy. Assuming the average hours each worker does a week remains more or less steady, weaker job creation will lead to more modest growth by total hours worked in the Canadian economy. To offset the slower growth by hours worked and maintain the same rate of real GDP growth, labour productivity will need to accelerate significantly over the coming years.

Graph 1 – Growth by the working age population will be weaker in the coming years

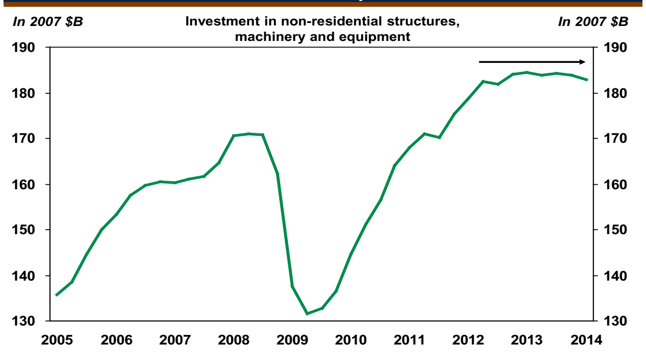


Sources: Statistics Canada and Desjardins, Economic Studies

HEADING TOWARD LARGER PRODUCTIVITY GAINS?

Unfortunately, the opposite has occurred, with average annual growth by labour productivity at just 0.6% since 2011. Note that non-residential investment by business has barely risen in the last two years, due to the many uncertainties about demand strength (graph 2), among other things.

Graph 2 – Non-residential investment has stopped increasing in the last few quarters



Sources: Statistics Canada and Desjardins, Economic Studies

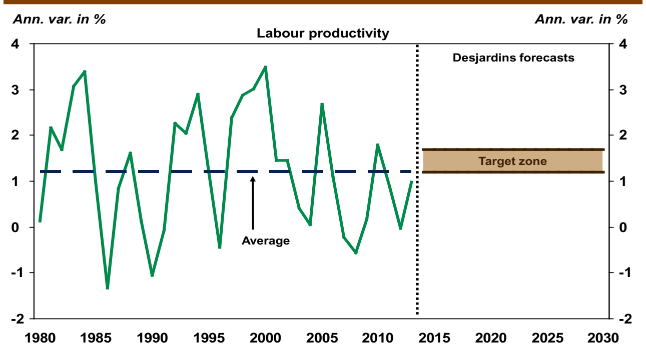
However, expected improvements to global economic conditions in the coming quarters should have a positive effect on Canadian entrepreneur confidence. Non-residential business investment is therefore likely to accelerate, a situation that should pave the way for higher

[3] The total change in the components does not always exactly equal real GDP growth, due to rounding.

[4] According to Statistics Canada's medium projection (M1).

productivity gains. Under these conditions, we can expect annual growth by labour productivity to accelerate soon. The latest results have also been encouraging in this respect. However, given the historical data for productivity, it is difficult to believe that labour productivity growth will be able to average better than 1.7% over the next several years (graph 3). Labour productivity has gained an average of just 1.2% since 1980. Of course, some major innovation could always take place, causing productivity to skyrocket, but there's little chance of that happening. Accordingly, a realistic projection for average annual productivity growth in the coming decades would be between 1.2% and 1.7%.

Graph 3 – Average productivity growth will be hard pressed to beat 1.7% for a long time



Sources: Statistics Canada and Desjardins, Economic Studies

WEAKER GROWTH POTENTIAL

The combination of very soft growth by total hours worked, at around 0.3% on average between 2014 and 2030, and annual labour productivity growth between 1.2% and 1.7% implies that Canada's potential for economic growth will remain between 1.5% and 2.0% from now until 2030. This is quite different from its potential at the start of the 2000s, which was nearly 3%. This difference clearly shows that Canada's economy is in a new age, characterized by weaker average growth rates.

Note the growth potential measure is an estimate of the annual average increase that we expect for real GDP in the long term. In reality, real GDP will move around this measure in tandem with the different economic cycles. However, we must conclude that, henceforth, annual real GDP growth well above 2% will be the exception rather than the rule.

According to our estimates, real GDP growth will however be just above the 2% mark over the coming years. This projection is above potential because Canada's economy has not yet recovered from the harmful effects of the great recession. There is also still excess production capacities.

However, the Canadian economy should return to full production capacity in late 2015 or early 2016. The change in real GDP should therefore slow starting in 2017, returning to a pace closer to its long-term potential. On average, annual real GDP growth should rise to 2.0% between 2014 and 2020 (table 2).

Table 2 – Growth assumptions for real GDP, hours worked and productivity

In %	*Δ Real GDP for the business sector*	=	*Δ Total hours worked*	+	*Δ Labour productivity*
2014	2.2	=	1.0	+	1.2
2015	2.5	=	1.0	+	1.5
2016	2.2	=	0.8	+	1.4
2017	2.0	=	0.8	+	1.2
2018	1.8	=	0.7	+	1.1
2019	1.7	=	0.5	+	1.2
2020	1.7	=	0.5	+	1.2
Average from 2014–2020	*2.0*	=	*0.8*	+	*1.3*
Average from 2021–2030	*1.7*	=	*0.5*	+	*1.2*

Note: The sum may not match real GDP due to component rounding.
Sources: Statistics Canada and Desjardins, Economic Studies

For the 2021–2030 decade, annual real GDP growth should stand at an average 1.7%, assuming that growth by hours worked remains fairly low, at around 0.5%, and that labour productivity holds close to its historic average (1.2%). According to projections by Statistics Canada, though, growth by hours worked should accelerate somewhat starting in 2030; this will open the door to slightly higher growth potential for real GDP.

The Canadian economy's weaker growth potential in the coming decades will have widespread consequences, especially for the financial markets. On one hand, interest rate equilibrium levels will be lower than in the past. The neutral rate for key interest rates is often tied to the sum of real GDP growth potential and inflation. On the other hand, weaker growth by real output will lead to softer growth by business profits, which could result in lower stock market gains. All in all, several standards for the Canadian economy will have to be lowered in the coming years: output growth, monthly job creation, interest rates and the evolution of the stock market.

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