Stephen S Poloz: Redefining the limits to growth

Remarks by Mr Stephen S Poloz, Governor of the Bank of Canada, to the Halifax Chamber of Commerce, Halifax, Nova Scotia, 18 March 2014.

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Introduction

Happy belated St. Patrick's Day. I hope everyone's feeling fine.

I want to speak today about a different kind of headache: the prolonged lacklustre economic growth we are experiencing, here in Canada, but also globally.

Canada's economy has been in recovery since 2009 – for four years – yet economic growth still pales compared to the pre-crisis years. Likewise, the global economy has been growing, on average, at only about two-thirds the pace of growth in the four years prior to the crisis.

You're right if you think it's unusual to have such weak growth in a recovery. It is *also* unusual to have weak growth for such a prolonged period of time. You might well be asking: So, what are we in for? What can we plan on?

There are different ways of looking at this. Some suggest it is the tail end of the crisis that is still limiting growth, while others propose that we are facing a slower long-term trend. In short, there are two responses: on the one hand, the cheque is in the mail; and, on the other, this is as good as it gets.

The real answer is: It's complicated. Both views are part of the story. In the time I have with you today, I'd like to talk about the forces that are holding back economic growth in Canada and the world. My hope is that you will take away some insights into the Bank's analysis of what we are experiencing – so that you can make reasonable, informed financial decisions for yourselves and your families, your businesses, and your futures.

The global financial crisis

Let's start with the financial crisis. As a global event, it has drawn a lot of attention, rightly so. In very short order, global GDP fell by more than 3 per cent and millions of jobs were lost. Here in Canada, almost a half million jobs were lost and GDP fell by more than 4 per cent.

The policy response around the world was rapid and extraordinary. Policy interest rates were slashed to near-zero in many advanced countries; the economies at the centre of the crisis further eased monetary conditions through quantitative easing. The G-20 countries also undertook an unprecedented and concerted fiscal expansion.

These policies worked well, no doubt about that. No matter how you feel about the final outcome, we all recognize that it could have been far worse – indeed, that coordinated policy response may have averted a full-blown global depression.

Nevertheless, given the passage of time, it is reasonable to ask why growth has not yet returned to pre-crisis trends. One widely accepted explanation is that, historically, a recovery following a financial crisis has always taken longer than a recovery in a more normal business cycle. According to this view, a period of subdued growth after a financial crisis can still be regarded as *cyclical*, in the sense that it will eventually prove to be temporary. Once balance sheets have been repaired, growth should return to its historical trend – bearing in mind that growth in the United States, and much of the rest of world, leading up to the crisis was extraordinary, so the true historical trend precedes that period. Still, given the uncertain timing, this approach reminds me of that old excuse, "Sorry, but the cheque is in the mail."

More than a hangover

But the global economy may not be just suffering through a hangover from the financial crisis. There are other, longer-term forces at work as well. Some analysts are suggesting we may be facing a long period of secular stagnation. On this alternative view, the economy could perform well below normal, leaving many out of work or underemployed for a long time to come. As business people, you need to understand that possibility, and how much weight to put on it. As a central banker, I need to understand it as well.

Let's dive in. Long-term economic growth is driven by two factors: 1) growth in the supply of labour, which is connected to population growth and changes in its composition, or what we call "demographics;" and 2) productivity growth, which is economists' shorthand for how efficiently we produce goods and services. For illustration, if we had 2 per cent trend growth in the supply of labour and 1 per cent trend growth in productivity, trend growth for the economy would be about 3 per cent.

Now, productivity is fodder for a speech all on its own, which I won't impose on you. Let me quickly summarize how it fits in before expanding on the demographic forces at work.

Productivity growth fluctuates around a long-term trend, tending to be weak during recessions and the early stages of a recovery, and stronger in periods of economic expansion. It follows then that the weakness in productivity growth since the financial crisis may be a symptom of a post-crisis hangover. Indeed, in Canada, the latest data show a pickup in productivity in the second half of 2013, to around 2 per cent, which is very promising. The Bank's outlook for the next couple of years is that uncertainty will continue to dissipate, boosting investment and new firm creation, and then productivity growth is expected to outpace its 30-year average.

A demographics story

The other ingredient of Canada's potential economic growth is the labour force. So let's turn to demographics and start with one immovable fact and one quick reminder. First, we are all getting older each day; and second, the baby-boom generation – yes, I am among them – is Canada's largest population cohort.

The demographics story is often told as one about the labour force: as the boomer generation retires and exits from the workforce, labour's contribution to the potential growth of the economy declines. This is already under way. In 2011, the growth rate of the population of working-age Canadians crossed below that of the overall population, reversing an almost 50-year trend. The Bank expects that next year, labour's contribution to the potential growth of the economy will be half what it was in 2007. That's the labour story, in a nutshell, and it is slowing us down.

There's another dimension to the demographics story – one that gets less attention, but that merits careful consideration to fully understand what the future holds.

As people move through different stages of life, their spending and savings habits change. Think of the students out there who are amassing university or college loans. A bit later on, people enter a family-building stage, which normally involves some heavy borrowing up front for a family home. As we get older, we tend to take a breather on the accumulation of debt; we work at paying it back and start to put aside savings. As we get closer to retirement, people save more and build up wealth. Typically, in the 15 or 20 or so years before they retire, people are in serious nest-building mode.

As the facts show it, Canadian households are indeed getting wealthier, which is a good thing. Data released last month show that, despite the financial crisis and Great Recession, net worth rose noticeably across all age groups from 1999 through 2012.

Now, let's bring the boomers into the picture. They're called the boomers for a reason. The huge wave of that generation simply overwhelms the charts. Born between 1946 and 1964, the youngest boomers are turning 50 this year. And so, right now, we are seeing a very predictable demographic bulge of *more* people, putting away *more* savings. This is Mother Nature at work, and it's where things get interesting.

Why does a central banker care? First, the financial decisions made by individuals are of course important to those individuals. But when a large swath of the population is making similar decisions, the impact on the broader economy can be significant. Second, *where* individuals decide to store their wealth also matters a great deal.

Allocation matters

Canadians, it won't surprise you, love their houses. We hold a lot of our wealth in real estate. This practice preceded the crisis, and it was reinforced by it. You may recall – it even may have been your experience – in the 1990s, the share of household wealth in financial assets, such as equities, was increasing faster than that in real estate.

But since then, real estate has become more attractive and has grown as a share of total household assets. With the "dot-com" bust and Enron and other corporate scandals in the rear-view mirror, with low interest rates helping keep mortgage payments manageable, and with cocooning taking hold, housing was increasingly seen as a safe and attractive investment. For the sector as a whole, real estate assets accounted for 40 per cent of total wealth in 2012, up quite a bit from 32 per cent in 1999.

Economists have their own way of interpreting these trends. We see some forms of assets primarily as "stores of value," while others work through the system to fund investments and add to the productive potential of the economy. Savings that fund infrastructure and business investment are "being put to work," which can help improve productivity, while savings that go into housing are seen as contributing less to productive potential.

This shift toward housing was also evident in many developed countries before the crisis hit and could have contributed to a slower growth rate for productivity.

Layering on the crisis

Importantly, the fallout from the financial crisis has worked to magnify some of these effects. It's only logical to expect that secular trends and cyclical fluctuations interact with each other – and this is certainly true of the demographics-savings trend and the crisis.

As I mentioned, the crisis walloped global demand. It opened up a huge and persistent uncertainty wedge that has held down global demand for business fixed investment. In many countries, the crisis also triggered household and bank deleveraging, not to mention fiscal consolidation.

As a result, there has been a crisis-induced increase in savings at a global level. There already was a demographics-driven desire for higher savings in advanced economies and there were massive savings inflows from emerging markets. Then, through widespread deleveraging, the crisis added an extra boost to the world's aggregate savings. Naturally, this translates into weak aggregate demand.

As a trade-dependent economy, Canada feels these effects directly. Weak global demand is limiting the growth of our exports, and the associated uncertainty is holding back business investment in structures, equipment and software.

In other words, demographic forces and the lingering hangover from the financial crisis are pulling in the same direction, putting limits on our growth possibilities.

Policy response and the outlook for growth

I've slowly come around to answering my own question about why this matters to a central banker. It's not just because we care – which, let me assure you, we do. But in order for us to do our job properly, we need to understand all the dynamics that feed into the Canadian economy – and, importantly, how our own policy measures affect the outcomes.

In Canada, low policy rates motivated Canadians to invest even more in real estate. You could say the Canadian recovery was due to the reinforcing of activity that was already under way, thanks to underlying demographic forces.

But we know that we cannot sustain economic growth in Canada based on housing alone. Our belief is that the post-crisis hangover in the United States is dissipating, and momentum is building. This will inevitably lead to more growth in Canadian exports and, with the reduction in uncertainty that comes with that, more investment in Canada's economic capacity, including creating more companies – and the much-anticipated rotation in growth.

This won't necessarily happen in a linear fashion. Although we continue to expect above-trend growth in Canada this year and next, the recent data suggest that the first quarter will be on the soft side. This mostly seems to be attributable to unusual weather, but it bears deeper analysis. Similarly, on the inflation front, while we have had a couple of months of slightly stronger core inflation, which is reassuring, most analysts are expecting softer inflation data later this week because of a sharp movement in February last year. Looking through the short-term volatility, inflation still seems to be running at around 1.2 per cent, give or take a tenth or two.

While we expect growth to approach 2.5 per cent over the next couple of years, we also see the economy's potential capacity growing at around an average of 2 per cent. This is why we say that it will take a couple of years for us to close our excess capacity gap and get inflation back to near our 2 per cent target. Looking beyond that, one would normally expect our economy to grow at its potential, which, as I said, is around 2 per cent, and which is made up of about 1 to 1.5 per cent growth in productivity and a gradually declining contribution from labour force growth, driven by the demographics story I outlined earlier.

Accordingly, were it not for our demographic outlook, our growth would converge on a higher trend line. This is the sense in which demographic forces help define our limits to growth.

In the broader global economy, however, the possibility of secular stagnation needs to be taken seriously. The combination of low demand, low investment and high savings could be having an impact on what economists refer to as the Wicksellian rate, or the equilibrium real rate of interest. There is rigorous theory behind this notion, which I will spare you, but it suggests that interest rates may remain lower than we have experienced in the past for a longer period, until some of these long-term forces dissipate. One specific consequence would be that even extraordinarily low policy interest rates could prove to be less stimulative than in normal circumstances.

Cause for optimism

In the G-20 meetings held recently in Sydney, Australia, we recognized that the global economy has not yet returned to strong, sustainable and balanced growth, and that there is limited scope for further stimulus from conventional policies. It was in this context that we underscored the importance of structural reforms to future growth.

To make this notion concrete, the G-20 set out an aspiration to collectively boost global GDP by 2 per cent over the next five years, or about 0.4 per cent per year in growth terms, on average. Maybe this does not sound like much, but it would add up to US$2 trillion for the world. That's a lot of income, especially when it would arrive more or less for free – it would come from countries removing structural impediments to growth.

Such impediments include trade barriers, labour market rigidities and other factors that make economies inefficient. If your car has an issue that is preventing it from running at top speed or top efficiency, you either arrive late or waste a lot of fuel getting there. Economies are the same – structural impediments impose limits to growth, and removing them can redefine our limits to growth.

The goal of raising global GDP by an extra 2 per cent over the next five years is a reasonable aspiration, and Canada certainly shares it. As a small open economy, we have the opportunity to garner more growth from abroad by building our international businesses. There are lots of economies growing faster than ours, and we can position ourselves to catch those tailwinds, which will help us overcome some of the domestic demographic constraints on demand. We can do this now, but as our various free trade agreements fall into place, we will be able to do so even more effectively.

As our exports strengthen and confidence improves, increased business investment and the creation of brand new companies will help raise our productivity and counterbalance some of the demographic constraints on labour supply. Other structural changes can also contribute in this way, including improving competitiveness; removing barriers to interprovincial trade and the migration of workers; and increasing investments in education, training and infrastructure, to name a few.

The effect of any of these structural changes is win-win-win: companies win, because they can plan better and grow their business; consumers win, in the form of employment growth and reduced uncertainty; and governments win, as higher growth automatically makes fiscal planning easier. Raising our trend growth rate by only 0.1 or 0.2 percentage points per year through such structural reforms would mean an income boost of $25,000 to $50,000 over a typical 30-year career – certainly worth having.

Conclusion

Let me wrap up.

Over 40 years ago, the Club of Rome published a book entitled, *The Limits to Growth*. To the global think tank, those limits were about finite natural resources and the environment. Although the timing remains uncertain, its arguments remain relevant today.

But within that envelope, we have the ability to define our own limits to growth. The financial crisis was nearly calamitous, and we are still working to overcome its after-effects with both macroeconomic policies and a new global financial architecture.

We continue to believe that the world economy is healing, and that Canada will benefit in the form of stronger exports. From there, we expect to see more investment and new firm creation. This will permit the emergence of a natural, sustained growth trajectory for Canada, and a return of inflation to our 2 per cent target.

But the demographic forces that are in play suggest that the growth trajectory that we converge on after the recovery period will be slower than our historical trend, and it will also be associated with lower equilibrium rates of interest than we are used to. Fortunately, global policy-makers have the ability to redefine the limits to growth by removing growth impediments, but as business people and investors, we must keep those efforts in perspective.

The world remains a complicated place, and there may be implications for your businesses and your personal savings and investment plans. I hope I have been able to add to your understanding today.