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True North in
Canadian public policy

Commentary

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Unprecedented Stimulus has Failed to Spur Long-Term Growth

Slow growth has persisted for the past decade despite the monetary and fiscal stimulus following the Great Recession.

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Overview

The economy rebounded in the second quarter from its near-stall over the winter months. However, growth was largely confined to exports, as business investment continued to falter and consumer spending levelled-off. The apparent contradiction of large job gains and slow output growth over the past year is reconciled by a sharp drop in hours worked.

The outlook is for moderate growth at best in the second half of the year, according to the Macdonald-Laurier Institute leading economic indicator (LEI). More broadly, slow growth has persisted for the past decade despite unprecedented doses of monetary and fiscal stimulus. Comparing the slow recovery from the Great Recession of 2008-2009 to the Great Depression of the 1930s leads to the sobering conclusion that government actions in recent years did not materially increase long-term growth, belying the promise that stimulus would not just cushion the downturn but also speed up the recovery.

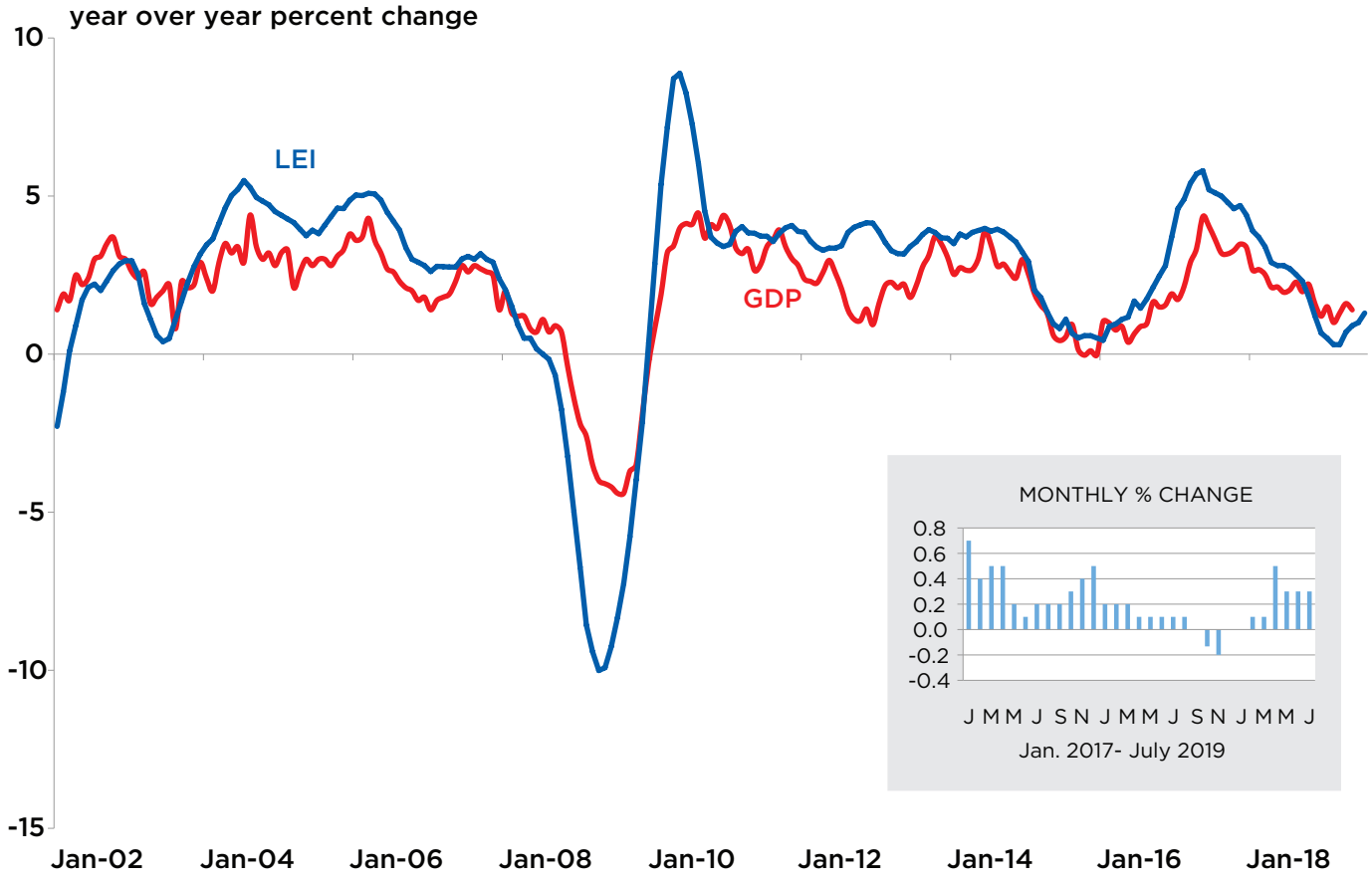
Introduction

Real GDP rose by 0.9 percent in the second quarter, after increases of 0.1 percent in each of the previous two quarters. The 1.4 percent gain in real GDP over the past four quarters is a good barometer of the underlying trend of growth. Most of the second-quarter increase in GDP originated in exports, which benefited from

an easing of the production cuts imposed by the Alberta government that buttressed oil prices. However, domestic demand edged down due to a sharp decline in business investment while consumer spending was little changed. Housing posted its first increase after five consecutive quarterly declines.

The second quarter increase in GDP signals that growth has resumed. However, growth is likely to return to more a more subdued pace in the second half of the year, according to the Macdonald-Laurier leading economic indicator (chart 1). The LEI posted a modest 0.3 percent gain in July for the third straight month. The increase was led by housing. Several of the components related to exports remained weak as global economic growth slowed. In particular, growth in China was the lowest in seven years, while the German economy contracted in the second quarter. The US economy posted steady growth, as weakness in its agricultural and industrial sectors brought on by its trade dispute with China was offset by steady gains in consumer spending.

CHART 1: MLI'S LEADING ECONOMIC INDICATOR (LEI)



Business investment fell 1.6 percent in the second quarter. Aircraft led the decline, after a sharp increase in deliveries in the first quarter was followed by the suspension of deliveries of Boeing's new 737 Max. However, the decrease was widespread outside of aircraft as well, with declines in seven of the 10 components of spending on structures and equipment.

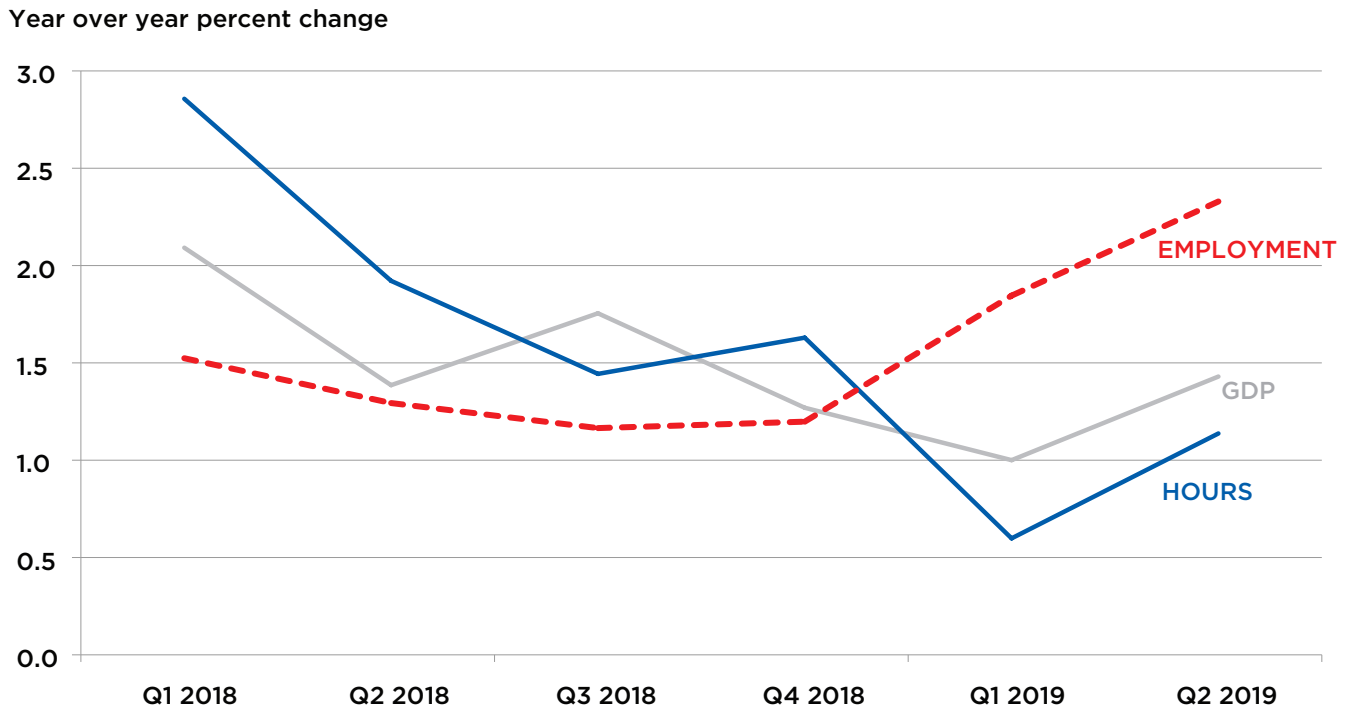
The stall in consumer spending occurred despite higher disposable incomes. As a result, the household savings rate rose to 1.7 percent, its highest level in over a year but still well below its 5 percent average in the years before the 2015 crash in oil prices led the Bank of Canada to lower interest rates. By comparison, the US savings rate has been above 7 percent over this period.

Prices of exported crude oil and bitumen rose 15 percent after a 32 percent jump in the first quarter when Alberta's mandatory production cuts took effect and as prices on world markets rallied after a swoon late in 2018.

Job growth outstrips output and hours worked

One of the puzzles in the recent data on the Canadian economy was the acceleration of employment to year-over-year growth of 2.3 percent at a time when GDP growth languished between 1.0 percent and 1.4 percent (chart 2). This suggests that the labour market is substantially outperforming output and that productivity is falling sharply. However, chart 2 shows that labour inputs as properly measured by hours worked remained closely aligned with business sector GDP over the past year. In fact, despite the slowdown in GDP growth, hours worked in the Canadian economy slowed even more, implying a small gain in labour productivity. The contradiction is not between the data on GDP and labour markets but within the labour market data on employment and hours worked. The conundrum is not why GDP growth is so weak when employment is growing, but why employment continues to rise when the demand for hours worked has slowed.

CHART 2: GROSS DOMESTIC PRODUCT, EMPLOYMENT AND HOURS



Source: Statistics Canada CANSIM Table 36-10-0206-01 and 14-10-0287-01

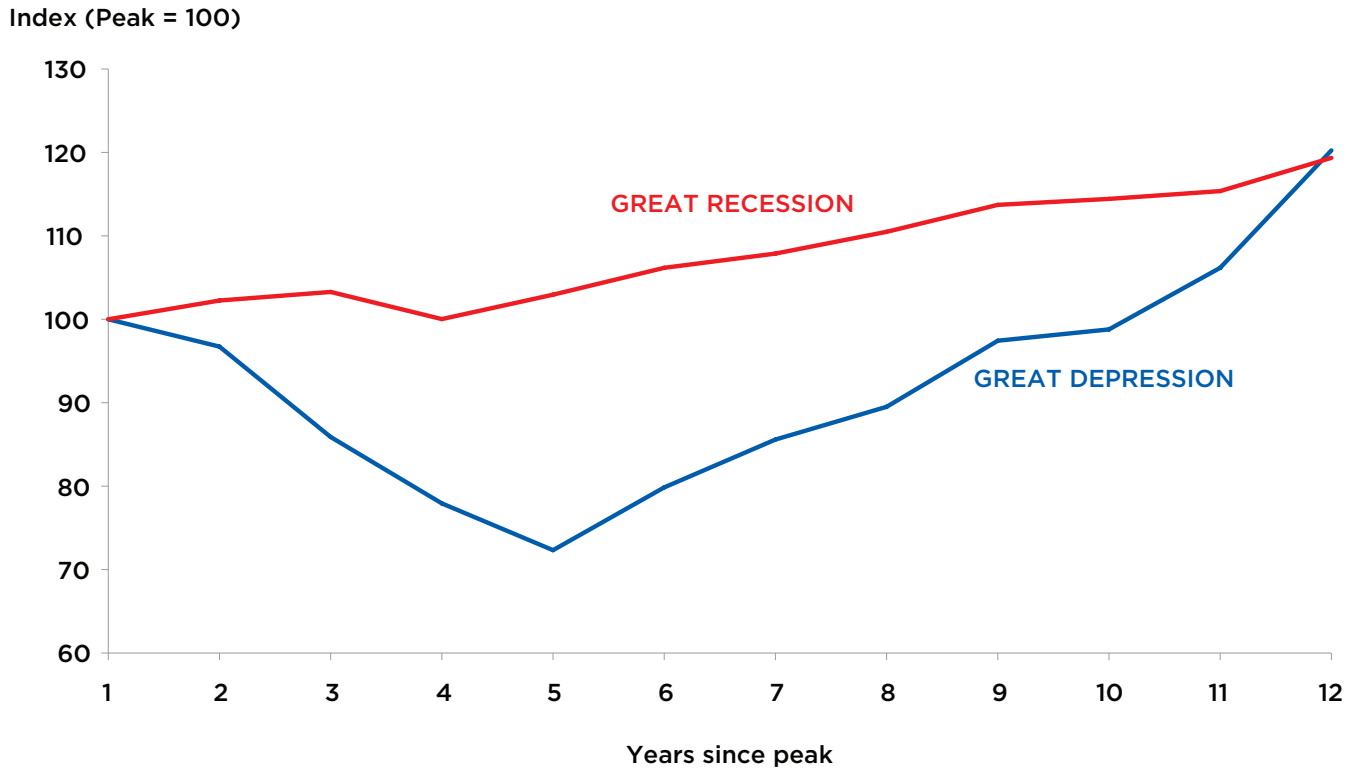
Most of the divergence between employment and hours worked reflects a sharp drop in hours worked over the past year. This reflects both a shift from full-time to part-time jobs as well as a decline in the number of people working long workweeks of 50 hours or more, especially in Ontario and Quebec (Cross 2019). Employment in the public sector, which is included in the employment data but not in hours worked in the productivity numbers, is not an explanatory factor since it has grown slightly less than GDP.

Recovery from Great Recession exactly matches recovery from Depression: What this tells us about stimulus

Real GDP growth year-over-year remains stuck in the range of 1.0 to 2.0 percent where it has been mired for most of the past decade. The persistence of mediocre growth for over a decade is a sobering reminder of the failure of extraordinary monetary and fiscal stimulus to boost faster growth.

Comparing real GDP during the Great Depression of the 1930s with the Great Recession and its aftermath over the past 10 years vividly shows the limitations of macroeconomic stimulus in recent years (see chart 3, adapted from a graph by former US Treasury Secretary Lawrence Summers to Canada's experience) (Summers 2017, 558). It is remarkable that 11 years after the peak of economic activity (1929 for the Great Depression and 2008 for the Great Recession), real GDP has arrived at exactly the same point with a net gain of 20 percent over the 11 years of recession and recovery in both cycles. As Summers concluded, the failure of extraordinary monetary and fiscal stimulus to produce a better outcome over the past decade "should be a (if not *the*) principal pre-occupation of contemporary macroeconomics" (italics in the original) (Summers 2017, 558).

CHART 3: GROSS DOMESTIC PRODUCT (CONSTANT DOLLARS)



Source : CANSIM tables 36-10-0202-01 and Table 36-10-0369-01

Arguments can be made for and against the usefulness of the extraordinary policies adopted after the recession began in 2008. On the one hand, unprecedented monetary and fiscal stimulus averted a repeat of the 25 percent loss of GDP during the worst of the Great Depression between 1929 and 1933, when fiscal stimulus was non-existent and monetary policy arguably aggravated the downturn (notably in the US where thousands of banks failed). On the other hand, the recovery in the 1930s proceeded much faster than in the aftermath of the 2008-2009 downturn despite substantially less monetary and fiscal stimulus.

The very success in averting a sharp, sudden downturn in the economy after 2008 itself was a major factor in the lethargy of the recovery. For example, much of the stimulus from low interest rates reflected shifting purchases of big-ticket items such as houses and autos from the future into the present. This stimulated aggregate demand in the short-term but at the expense of fewer purchases in the longer-term. More broadly, shifting spending to sectors such as housing and government inevitably lowered long-term productivity growth, notably as business investment has lagged.[1] This reduction in productivity growth ensured slower growth as the recovery proceeded.

> "Because GDP measures the flow of income generated by the economy in each year, there is no clear-cut answer to whether the experience of the Great Depression or the Great Recession was better."

The implications of the different evolution of growth during and after the Great Depression compared with the Great Recession are nuanced by the fact that GDP is a measure of the flow of income generated by the economy in each year, not the cumulative stock of wealth in a society. If chart 3 showed that the stock of wealth ended up at the same place after 11 years in both cycles, it would be unambiguously correct to conclude that there was no net difference between the two episodes. However, because GDP measures the flow of income generated by the economy in each year, there is no clear-cut answer to whether the experience of the Great Depression or the Great Recession was better. It depends on whether society prefers a steep loss of income followed by a quick recovery or a milder loss of income followed by years of slow growth. This is not a value judgement that either statisticians or economists can make.

Severe contractions such as occurred between 1929 and 1933 or 1981 and 1982 can create widespread unemployment and social problems from losing hope of finding a job or rising foreclosures on homes. However, protracted periods of slow growth also leave an unwanted legacy, including hampering the reallocation of resources that a sharp decline during the 'bust' phase of the cycle encourages and which lays the basis for higher productivity growth. As David Simpson put it:

> The recession phase of the cycle is a remedial one, in the sense that those investments made during the boom that are subsequently revealed to have been unwarranted are liquidated. In market parlance, just as a rising tide lifts all boats so the falling tide reveals who has been swimming naked. In other words, the recession helps to identify and eliminate unsuccessful projects and businesses. Note the adjective 'remedial': it is the recession, however painful, which is the recovery phase of the business cycle. It is only in the recession that earlier wrong investments are exposed and corrected. (Simpson 2013, 137)

Society can rationally choose to influence the amplitude of the business cycle it prefers, such as favouring a milder recession provided it is informed that this entails a more gradual recovery than the 'V-shaped' cycles of severe recessions followed by rapid recoveries seen in the 1930s or the early 1980s. However, policy-makers in central banks and Finance departments never presented this choice during the recent recession and recovery. As Adair Turner has pointed out, economists failed first "to foresee the crisis coming at all" and then failed "to foresee how difficult and slow the recovery would be" (Turner 2014, 165).

Instead, they promised that the extraordinary stimulus applied during the worst of the downturn in 2008-2009 would both cushion the downturn and fuel a robust recovery—a checkmark-shaped recovery in which output soon surpasses its previous peak not the V-shaped cycle seen in the 1930s when output barely returned to its earlier peak. As Summers concluded, "The Keynesian aspiration was not to merely reduce the amplitude of cyclical fluctuations, but also to increase overall growth" (Summers 2013, 559). Policymakers certainly did not warn the public that the price of short-term stimulus was lower growth over the longer-term. It was only after years of slow recovery from the Great Recession that economists began to theorize that sluggish growth (or 'secular stagnation' as Summers called it) may have become the 'New Normal.'

The US experience over the last 11 years closely tracks that of Canada. In both countries, real GDP fell much faster during the Great Depression than during the Great Recession but growth rebounded quicker in the 1930s, leaving total GDP at about the same point after 11 years. Summers observes that "If these comparisons were made on a global basis, the current episode would appear even worse compared to the Great Depression" (Summers 2013, 559). For most of Europe and Japan, the Great Depression was less severe than in North America, while the recovery of growth in recent years has been slower than in North America. This is an even more damning critique of macroeconomic policymaking than North America's recent experience, since policy cannot take credit for either the less severe Depression in the 1930s outside of North America nor boast that it lifted growth over the past decade.

About the Author

Philip Cross is a Munk Senior Fellow at the Macdonald-Laurier Institute. Prior to joining MLI, Mr. Cross spent 36 years at Statistics Canada specializing in macroeconomics. He was appointed Chief Economic Analyst in 2008 and was responsible for ensuring quality and coherency of all major economic statistics. During his career, he also wrote the "Current Economic Conditions" section of the Canadian Economic Observer, which provides Statistics Canada's view of the economy. He is a frequent commentator on the economy and interpreter of Statistics Canada reports for the media and general public. He is also a member of the CD Howe Business Cycle Dating Committee

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Endnotes

1 For a broader assessment of monetary and fiscal stimulus in recent years, see Cross, Philip. 2016. *The Limits of Economic "Stimulus": How monetary and fiscal policy have sown the seeds of the next crisis*. Macdonald-Laurier Institute, November.

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