Economic Viewpoint

Desjardins Economic Studies
www.desjardins.com/economics

December 9, 2014

The possible consequences of weaker economic growth potential in Canada

It was previously established that the Canadian economy's growth potential would be lower in the coming decades. While difficult to evaluate, this *Economic Viewpoint* offers an overview of the many effects such a slowdown could have on the country's economic agents. In addition to a higher risk of recession, we can expect slower growth in consumption and residential investment, as well as weaker budgetary revenue growth, which will force governments to make some tough choices. Financial markets will also feel it, as interest rates will tend to be lower and stock prices will have less potential to rise. Returns on savings and pension plans will therefore be weaker.

In our August 20 *Economic Viewpoint*,[1] we showed that the Canadian economy's growth potential will be weaker by 2030. This observation was generally based on demographic projections, which reveal that working age population growth will slow considerably in the coming years. Growth in total hours worked in the Canadian economy should therefore wane considerably. That being said, the effect could be slightly offset by an increase in labour productivity.

As a supplement to August's statements, this *Economic Viewpoint* provides a more detailed overview of the possible consequences of weaker growth potential in Canada's economy.

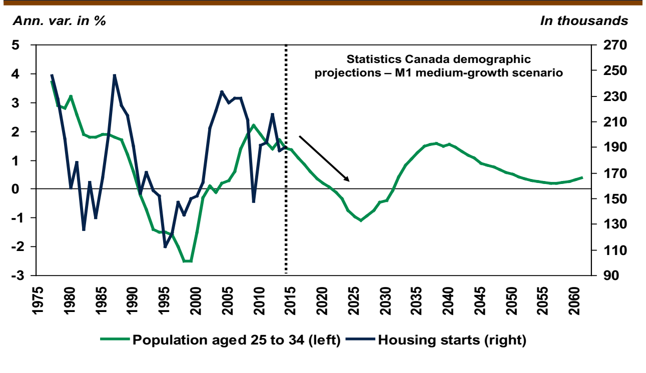
HIGHER RISK OF RECESSION

Due to the weaker potential for growth, Canada's average real GDP growth will be lower in the next few decades. Under these circumstances, there is a bigger chance that quarterly real GDP change will drop below zero. An economy is considered to be in recession when it posts two consecutive pullbacks in its real GDP. The probability of a recession occurring will therefore be greater in the coming years. Clearly, provinces with growth potential below the national average, such as Quebec and the Maritime provinces, will be more exposed to this phenomenon. Japan's current economic situation is a good example, as the Japanese economy's growth potential is extremely low, slightly below 1%, which opens the door to multiple episodes of recession.

SLOWER GROWTH IN SPENDING AND RESIDENTIAL INVESTMENT

The considerable deceleration in total hours worked points to softer working income growth for Canadians as a whole. This will probably lead to slower growth in spending and residential investment (graph 1).

Graph 1 – Demographic factors should slow homebuilding in the coming years



Sources: Statistics Canada and Desjardins, Economic Studies

[1] Desjardins, Economic Studies, *Economic Viewpoint*, "The Canadian economy's growth potential enters a new era," August 20, 2014, www.desjardins.com/ressources/pdf/pv140820-e.pdf?resVer=1408541429000.

François Dupuis
Vice-President and Chief Economist

Benoit P. Durocher
Senior Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.
Important: This document is based on public information and may under no circumstances be used or construed as a commitment by Desjardins Group. While the information provided has been determined on the basis of data obtained from sources that are deemed to be reliable, Desjardins Group in no way warrants that the information is accurate or complete. The document is provided solely for information purposes and does not constitute an offer or solicitation for purchase or sale. Desjardins Group takes no responsibility for the consequences of any decision whatsoever made on the basis of the data contained herein and does not hereby undertake to provide any advice, notably in the area of investment services. The data on prices or margins are provided for information purposes and may be modified at any time, based on such factors as market conditions. The past performances and projections expressed herein are no guarantee of future performance. The opinions and forecasts contained herein are, unless otherwise indicated, those of the document's authors and do not represent the opinions of any other person or the official position of Desjardins Group. **Copyright © 2014, Desjardins Group. All rights reserved.**

While growth in total household spending will undoubtedly feel some downside pressure, the demographic changes underway will also modify consumers' behaviour, altering the composition of their consumption basket and investments. An older population will favour faster growth in demand for goods and services for older consumers. Conversely, goods and services consumed mainly by young people will face softer demand. For example, consumers over 60 tend to spend less on furnishings and appliances, food and clothing (table 1). In contrast, they spend more on health care and housing (rents are especially high for retirement homes).

Table 1
Spending habits change with age

	Yearly spending by age	
In $	Late forties	Late sixties
Shelter	4,900	6,900*
Other accommodation	500	400
Household operations	1,400	1,400
Furnishings and equipment	1,400	900*
Purchased automobiles	1,500	2,000*
Automobile operation	2,400	2,200
Public transportation	500	400
Food	5,500	4,100*
Clothing	2,400	1,200*
Personal care	700	500*
Health	700	1,200*
Recreation	1,800	1,800
Reading and printed materials	200	200
Tobacco and alcohol	1,300	800*
Other	1,500	800*

* Substantially different from the group in their late forties.
Source: A. Lafrance and S. LaRochelle-Côté, "Consumption Patterns Among Aging Canadians: A Synthetic Cohort Approach," Economics Analysis Division, Statistics Canada, Catalogue no. 11F0027M — No. 067, March 2011, p. 24, www.statcan.gc.ca/pub/11f0027m/11f0027m2011067-eng.pdf.

We will also see a substitution phenomenon in the housing market, where growth in demand for multi-unit housing (including condos and housing for seniors) could continue to outstrip demand for single-family dwellings.

WEAKER GROWTH POTENTIAL FOR CORPORATE PROFITS

Slower growth in consumer spending and residential investment will translate into softer growth in corporate income, both directly (retailers, wholesalers, homebuilders, housing services, etc.) and indirectly (companies with business ties to those industries). Unless corporate profit margins unexpectedly spike, the slowdown in revenue will then lead to slower growth in corporate profits. We could hope that businesses will manage to offset some of this shortfall by increasing their trade abroad. However, international competition is fierce and everything suggests that Canadian businesses will continue to struggle to win global market share.

MIXED EFFECT ON NON-RESIDENTIAL INVESTMENT

The effect that weaker Canadian economic growth potential will have on movement in non-residential investment is less obvious. On one hand, the shift to softer growth in the next few years will foster some surplus production capacity, putting downside pressure on investment in non-residential construction, as well as machinery and equipment. On the other hand, the drop in total hours worked will probably be accompanied by a slight acceleration in labour productivity. To achieve that, some companies will modernize their production capacity, which will in turn put upside pressure on non-residential investment. The net effect on total corporate investment is therefore hard to gauge, and it will depend largely on the scope of the corporate modernization process.

FASTER WAGE GROWTH

Historically speaking, the correlation between worker earnings and their productivity is quite high. That means that the slight acceleration in labour productivity expected in the coming years could lead to slightly higher wage growth. This is clearly good news for Canadian workers, taken individually. However, as the forecast rise in productivity is fairly small, the additional wage growth resulting from efficiency gains will not be enough to entirely offset the overall slowdown in Canadian earnings due to slower growth in hours worked.

SMALLER RISE IN BUDGETARY REVENUE

Budgetary revenue growth for the federal and provincial governments is closely tied to nominal GDP growth. In consequence, weaker GDP growth potential will translate into a lower rise in personal income taxes, given the smaller increase in hours worked. As mentioned above, corporate profit growth could also be slower, which will drag down corporate tax gains. Weaker growth in consumer spending and non-residential investment will also curb government revenue from indirect taxes, such as the federal goods and services tax (GST) and the various provincial sales taxes.

DECELERATION IN PUBLIC SPENDING GROWTH AND/OR INCREASED PUBLIC DEBT

Slower growth in budgetary revenue will force governments to make some tough choices. Among others, they could decide to slow public spending. Budget spending will be under considerable upside pressure over the coming years, as population ageing will affect health care spending. Under these conditions, budget cuts in other types of spending could be quite substantial. Governments will clearly have to prioritize some expenses while others will have to be called into question.

That being said, a slowdown in total government spending is not inevitable. Governments could choose to offset slower budget revenue growth by enlarging the public debt or increasing taxation rates. However, these two solutions have rather limited potential. On one hand, some provinces already carry heavy debt loads. The federal government certainly has more leeway in this respect, but a substantial increase in federal debt could rapidly reverse the progress on cleaning up the public finances—progress painfully acquired in the last few decades. If the debt loads increase, the risk is clearly that public debt interest costs will rise significantly, which could put additional pressure on budget spending. On the other hand, governments could opt for a tax hike on household and corporate income, or raise indirect tax rates to increase their budgetary revenue. While the federal government does have some leeway, given the tax cuts ordered in recent years, most provinces already have a fairly high level of taxation, and maintaining some fiscal competitiveness on the North American and international markets limits the potential for increases.

LOWER INTEREST RATES

The advent of weaker growth potential in Canada's economy will also have repercussions for interest rates, which will tend to be lower. Carolyn Wilkins, Senior Deputy Governor of the Bank of Canada, recently defined the neutral key rate as "the real risk-free rate of interest that enables the economy to operate at full capacity with stable inflation after cyclical forces have dissipated." The nominal neutral interest rate can therefore be easily estimated by combining the annual inflation rate and real GDP growth potential. Assuming stable price growth, weaker growth in potential implies a lower neutral interest rate.

The Bank of Canada's Senior Deputy Governor also mentioned that the nominal neutral key rate is currently between 3% and 4%. This is lower than it was before the Great Recession of 2008–2009, when the neutral rate was assessed at 4.5% to 5.5%. This gap primarily corresponds to the drop in growth potential that occurred in recent years.

The downtrend for the neutral key interest rate will have consequences for all interest rates in Canada's economy. For example, short-term Treasury bill yields track movement by the overnight rate very closely. Bond yields for longer maturities are in turn influenced by short-term yields, as well as the trend for U.S. bond yields and a premium that factors in the length of the term. These downside pressures will eventually ripple into retail rates, such as rates on mortgages, consumer loans, credit cards and term savings. With lower interest rates, some households are likely to take on more debt. However, as older people are generally less likely to resort to debt, population ageing will mean that the total amount of household debt will not rise considerably. In fact, some contraction is even likely.

WEAKER GROWTH POTENTIAL FOR STOCK MARKETS

As mentioned earlier, slower growth in consumer spending and residential investment will lead to a smaller rise in corporate profits. That being said, the slowdown in corporate profit growth could be lessened in the years to come if another up cycle for commodity prices materializes. As profits are a key factor in stock price movement, slower profit growth could lead to weaker growth potential for stock markets in the coming decades.

LOWER RETURNS ON SAVINGS AND PENSION PLANS

The combination of lower interest rates and softer growth potential for stock markets means that returns on savings and pension plans will be smaller in the coming decades. If they hope to be able to maintain a similar standard of living upon retirement, workers could be forced to increase their savings rate, cutting into the proportion of their income allotted to personal spending and residential investment. This could intensify the current downside pressure on these components.

Another option would be to keep the same savings rate, which would allow workers to maintain the pace of spending while they are working. However, the funds available in savings and pension plans upon retirement would be smaller, as returns would be lower, which would force retirees to curb their spending. In both cases, consumer spending during a household's lifecycle would be reduced.

Under these conditions, there will be considerable social and financial pressure to push back the age of retirement, a solution that would not only lessen the harmful effects of lower returns, but also partially offset the impact of slower growth in the working age population.

ALL AGENTS WILL BE AFFECTED

In the end, all economic agents—households, businesses, governments—will be hurt by the slowdown in economic growth potential. However, the exact scope of these effects is difficult to pinpoint. One might think the phenomenon could be lessened by relying more on foreign demand

and increasing international trade to support Canada's economic growth. Unfortunately, the demographic problem isn't unique to Canada, and most countries will also see their growth potential reduced to some extent (table 2). It therefore seems rather unlikely that the shortfall can be offset by export gains. The many consequences of decreased output potential therefore seem hard to avoid.

Table 2 – Most countries will see their output potential slow in the coming years

In %	*Annual growth in the population aged 15 to 64*	
	Ave. 2000–2010	Ave. 2015–2025
Advanced nations	**0.41**	**-0.31**
United States	1.05	0.21
Japan	-0.54	-0.74
Europe (excl. Eastern Europe)	0.36	-0.22
Canada	1.23	0.14
Quebec	0.75	-0.16
Developing nations	**1.95**	**1.13**
China	1.46	-0.12
India	2.01	1.23
Latin America	1.71	1.01
Africa	2.68	2.63
World	**1.65**	**0.90**

Sources: United Nations and Desjardins, Economic Studies

Benoit P. Durocher
Senior Economist