Intelligence MEMOS

From: Glen Hodgson

To: Canadian Economy Watchers

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Re: **How Badly Damaged is the Canadian Economy?**

Along with much of the world, Canada's economy has suffered from the pandemic and other events in 2020, notably the shock to global oil markets. How bad? An examination of the immediate data and longer trends indicates significant damage, with a lengthy recovery period ahead.

Let's start with labour markets, where there are signs of recovery but also growing evidence of damage. The unemployment rate exploded from 6 percent to nearly 14 percent during the March to May shutdown. It has steadily dropped since as many displaced workers have been re-engaged, but it was still 8.6 percent in December, almost 50 percent higher than before the pandemic.

There are many other worrying signs. Long-term unemployment, i.e. of 27 weeks or longer, has increased sharply and is now more than one quarter of those unemployed, with a growing risk of many discouraged workers dropping out of the workforce. Much of the Canadian workforce is under-utilized; the latest StatsCan data show that one in six people in the potential labour force are employed but working less than half of their usual hours, are unemployed, or want a job but are not looking for one.

Women, youth, Indigenous people and new Canadians continue to be particularly affected by pandemic-driven unemployment and under-employment. To help minimize long-term scarring, active labour market policy is called for, including enhanced retraining and skills development, facilitating school-to-work transitions for recent graduates, supporting labour market participation by parents and under-represented groups, and fully recognizing and utilizing the skills of new Canadians.

Economic output has been steadily rebuilding after the deep contraction during the shutdown period. The consensus among private forecasters is for 2020 GDP to shrink by 5.8 percent, with real growth of 4.8 percent projected in 2021. Despite this rebound, the survival of many businesses remains uncertain. Even with a successful vaccine rollout and a steady return to more normal operating conditions in many sectors, Canadian GDP by the end of 2021 is projected to be around 3 percent below the level of GDP at the end of 2019.

Perhaps the most serious indicator of damage is the estimated drop in long-term growth performance for the Canadian economy, which economists call "potential". The recent federal economic statement provided a revised estimate of Canada's growth potential, taking into account the pandemic shutdown and uneven recovery. Long-term growth potential has declined by roughly half a percentage point from estimates prior to the pandemic, to only 1.4 percent real growth annually.

Long-term growth potential matters. Long-term annual growth that is half a percentage point lower than before the pandemic increases the odds of an eventual tax increase to fund policy priorities and manage public debt.

Canada's long-term annual growth potential can be raised back toward 2 percent, but it will require a reversal in this year's labour market and investment trends. As noted earlier, some healing is taking place in Canadian labour markets, but there are also still many individuals at risk. The consensus forecast in the economic statement indicated it will be 2024 before the unemployment rate declines to pre-pandemic levels.

A sustained boost to the level of investment would make a valuable contribution to growth, fostering capital formation and faster productivity growth. Increased public sector investment in infrastructure can partly address the investment gap, but higher sustained private investment will be key to maintaining and building the economy's productive capacity and the ability to innovate. While investment in maintenance of the existing capital base will recover somewhat as the economy slowly heals, new capital formation is bound to be more difficult. The scale of investment in energy production, distribution and use with low or no GHG emissions, along with addressing the transition challenges facing the oil and gas sector, will be critical to the long-term Canadian growth puzzle.

Policy can help guide us through the uneven recovery with minimizing labour market scarring as a top priority. Creating the best possible investment climate with an eye on the transition to an economy with low or no GHG emissions also deserves attention. Maintaining international business tax competitiveness has always been a challenge, but one we cannot ignore. Improving the overall competitive and regulatory environment is another option that is fully within our control; more efficient regulatory processes could be adopted without sacrificing health, safety and other standards.

There is no single silver bullet for lifting private investment, but these actions together will go a long way.

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