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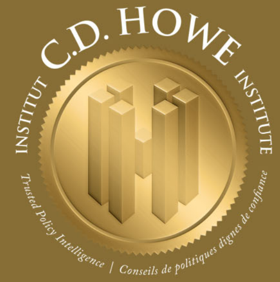

From: Glen Hodgson

To: Concerned Canadians

Date: October 19, 2021

Re: **COMPLICATIONS ABOUND IN THE PANDEMIC RECOVERY**

The Canadian economy is on the rebound from the pandemic shutdown and most economic forecasters are projecting positive growth into the medium term.

This good news story conceals deeper factors that will complicate the recovery and longer-term outlook.

The potential for further pandemic waves is a significant immediate risk factor, and a wildcard. Most forecasters have already pulled back their 2021 forecasts from 6 percent to around 5 percent, largely due to an uptick in Covid cases in the second quarter and a resulting tightening of business opening conditions. The latest case surge in Alberta and Saskatchewan may put additional downward pressure on overall Canadian growth performance.

Managing the ongoing pandemic risk effectively would require moving quickly toward complete vaccination, combined with clear and sustained rules on masking and social contacts. However, many governments have been timid, late and/or in flux with their Covid policy statements – limiting effectiveness – and have been reluctant to use sticks (not just carrots) to improve compliance.

Another immediate factor is the rise in monthly inflation, now up to 4.1 percent. The Bank of Canada had initially suggested that rising 2021 inflation reflected exceptional transitional price conditions in the pandemic recovery that are unlikely to be sustained or repeated, although the pressure on global supply chains could make higher inflation more deeply embedded. It would be foolish to ignore inflation's rise. Canadian monetary conditions may need to tighten faster than currently projected, particularly if the US Federal Reserve moves quickly to reduce bond purchases.

Looking ahead, an annual growth rate below 2 percent is generally accepted as "potential," or the sustainable long-term growth rate, for the Canadian economy. Annual growth is projected to continue above potential at around 4.5 percent in 2022 and 3 percent in 2023, fueled in part by continuing fiscal and monetary stimulus. However, we need to remember that this positive outlook is really just the economy catching up with its potential growth path after 2020 pandemic trough. The level of Canadian GDP has more or less returned to its pre-pandemic level, but it will take three to four years of growth above potential to fully recover the lost ground.

Two structural factors weigh on future growth.

The first is demographics, the key factor behind the steady decline in growth potential over the past two decades. An aging Canadian society and a fertility rate well below replacement have combined to reduce labour-force growth. The resulting workforce and skills shortages are driving down the growth potential of the economy. It is striking that even with output and employment still in recovery, employers still cannot fill many jobs.

Immigration can help mitigate the impact of demographics, but immigration alone – even if increased as planned to 400,000 people annually – will only partially offset the negative growth impact of an aging population.

The second structural factor is climate change and climate policy.

More frequent severe weather-related events like floods and forest fires are increasing the risk of disruption to sustained economic activity and growth, especially in affected regions. It has become broadly recognized that comprehensive climate policy, domestically and internationally, will be needed to address these risks and reduce GHG emissions.

Available economic modelling suggests well-designed climate policy would limit the negative impact on growth in the foreseeable future. Smart policy choices would include investing today in climate mitigation and adaptation, and using price signals (i.e. rising carbon prices) to strengthen incentives to reduce GHG emissions, as is the federal plan.

The flip side of climate policy is the transition in the energy sector and other sectors with high emissions intensity. Production of oil, gas and coal typically represents around 6 percent of Canadian GDP, with a well-paid work force. But conventional energy is a major source of rising GHG emissions that will need to plateau and then decline if Canada is to meet its emissions targets.

Figuring out how to foster the energy transition while addressing the consequences for output, employment, and firm survival is a massive multi-year policy challenge facing Canadian businesses and governments. An orderly transition with minimal negative GDP impacts would mean pursuing multiple transition pathways, utilizing wide-scale innovation to shift toward low-emission energy production, unlocking a wave of private and public transition investment financing, and supporting affected workers.

In contrast, a messy transition would see wide-scale disruption, with deep and prolonged negative GDP and employment impacts.

The ongoing recovery from the pandemic is good news. Solid growth in output and employment should continue into the medium term, gradually slowing to a more sustainable rate below 2 percent annually as the output gap is steadily closed. However, there are many complicating factors both immediate and longer term that could throw the recovery path off course. Without a series of smart decisions on many fronts, sustained Canadian growth will remain under pressure.

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