IS SLOW GROWTH THE NEW NORMAL FOR CANADA?

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Contents

Summary

The idea that the western world is trapped in a "New Normal" of slow economic growth has gained currency with many economists and financial market analysts. Proponents list a number of factors allegedly restraining the trend of growth, including the lingering impact of the 2008 financial crisis, an aging population, and even a slowdown in the underlying rate of innovation and technological change. Some argue that governments have exhausted their ability to stimulate the economy; others cite the uncertainty created by the unprecedented monetary and fiscal stimulus in the United States in response to the financial crisis and recession as a major drag on the recovery itself.

This paper argues that slow growth early in a recovery is not unprecedented and does not augur weak growth will continue. There is reason to believe that pessimism about growth will prove to be an over-reaction to the current environment, just as happened in the 1930s and 1970s. These past periods of prolonged slow growth ended when governments adopted better and more predictable policies. The lingering effect of the financial crisis is dissipating in the United States, which seems poised to return to above-trend rates of growth. An aging labour force is much more of a problem for Europe and Japan than North America, which has a younger population that is not projected to contract in the future because of a higher birth rate and more immigration. The possibilities for innovative technological change remain encouraging for growth, although this variable is the most difficult to project.

In Canada, growth since the recession has not been unusually weak compared with the previous two decades, reflected in the adult unemployment rate that is already at historically low levels. Canada is particularly well positioned to take advantage of an upturn in the US economy since the lasting impact of the recession upon its financial sector and labour markets has been much less pronounced than in the United States. This will help Canada overcome the recent slump in commodity prices. A further boost to growth would come from a better policy framework, especially in central Canada where provincial government debt continues to increase. More policy stimulus is not needed in North America at this time; more predictable policies would serve better.

Introduction

As the world emerged from the 2007–2009 financial and economic crisis, Bill Gross, until recently Pimco's legendary head of the world's largest bond fund, coined the phrase that subdued growth for an extended period would become the "New Normal" for the US economy.[1] This prediction was rooted in the belief that the cyclical hangover from the financial crisis, notably deleveraging that inhibited capital formation, would reinforce structural trends—deglobalization and reregulation—he believed would take root and dampen growth.

The idea that the major developed countries are trapped in a prolonged period of slow growth subsequently proliferated, labelled by some as "Secular Stagnation"[2] or a "New Mediocre".[3] Economists refined the definition of secular stagnation to mean that negative interest rates are needed to equate saving and investment with full employment.[4] Tyler Cowen wrote a best-selling book called *The Great Stagnation* in 2011.[5] Professor Robert Gordon forecast that per-capita real GDP growth over the next few decades will average less than 1% a year.[6] McGill Professor Christopher Ragan articulated a Canadian version of the New Normal, with growth constrained by demographics and impediments to more policy stimulus to the economy.[7] Pessimism about long-term growth was the driving force behind Thomas Piketty's gloomy prediction in his best-selling *Capital in the Twenty-First Century* that weak income growth relative to capital accumulation would drive income and wealth inequality to extreme levels.[8] In turn, rising inequality itself is thought by some to depress economic growth.[9]

1. Bill Gross (2009). On the "Course" to a New Normal. *Pimco Investment Outlook* (September).
2. Most notably the term was used by Larry Summers. See: Larry Summers (2004). U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound. *Business Economics* 49, 2.
3. Christine Lagarde (2014). The Challenge Facing the Global Economy: New Momentum to Overcome a New Mediocre. Remarks to Georgetown University, October 2.
4. Coen Teulings and Richard Baldwin (2014). Introduction. In *Secular Stagnation: Facts, Causes and Cures* (VoxEU.org eBook): 2.
5. Tyler Cowen (2010). *The Great Stagnation*. Dutton.
6. R.J. Gordon (2014). *The Demise of U.S. Economic Growth: Restatement, Rebuttal and Reflections*. NBER Working Paper No. 19895 (February).
7. Christopher Ragan (2014). *What Now? Addressing the Burden of Canada's Slow-Growth Recovery*. C.D. Howe Institute Commentary No. 413 (July).
8. Thomas Piketty (2014) *Capital in the Twenty-First Century*. Belknap/Harvard University Press. For a critical review, see: P. Cross (2014). *Review of* Capital in the Twenty-First Century. Fraser Institute (August).
9. Interestingly, a scarcity of natural resources and high commodity prices, particularly for oil, were rarely mentioned as a cause of future slow growth, outside of Jeff Rubin's *The End of Growth* (Random House Canada, 2012). But pessimism is not limited to economic growth: concerns about a disappearing middle class or how employment could be decimated by technological change also proliferated in the aftermath of the crisis.

Many economists believe that low GDP growth of 1.5% to 2.0% is the New Normal. This paper argues that the notion of a New Normal of slow economic growth is an idea that follows the pattern of extrapolating growth patterns during slowdowns too far into the future, at least for North America. The arguments for a New Normal are plausible, but so is a different interpretation of the reasons for the recent slowdown and a return to higher rates of growth in the future. Moreover, some of the recent record of sub-par growth can be attributed to poor policies that can be more easily corrected than structural forces such as an aging population. The case for optimism about long-term growth has always been correct in the past, reflecting the secular increase in our know-how and ability to innovate. As Paul Romer observed, "The historical pattern has been one of accelerating growth—not just sustained growth but accelerating growth".[10] There are few reasons to think the recent crisis has damaged the key ingredients propelling long-term growth in most of the world.

Extended periods of depressed growth in the past also were accompanied by despondency about the future. Kevin Kelly observed that "economists, like cultists awaiting the apocalypse, had long looked to the day growth would end".[11] The term "Secular Stagnation" was originally coined by Alvin Hansen in his Presidential Address to the American Economic Association in 1938 to describe how slow economic and population growth reinforced each other in the 1930s (just as the economy was strengthening and a decade before the baby boom).[12] Keynes remarked on the "bad attack of economic pessimism" that accompanied the onset of the Great Depression in 1930: "It is common to hear people say that the epoch of enormous economic progress which characterized the nineteenth century is over; that the rapid improvement in the standard of living is now going to slow down".[13] Keynes maintained the economy's potential was not hampered by the Depression; his optimism was vindicated in the decades after World War II, even as others maintained their faith in secular stagnation into the 1960s.[14]

10. Quoted, p. 91, in: George Gilder (2013). *Knowledge and Power*. Regnery Publishing.

11. Quoted, p. 90, in Gilder (2013). *Knowledge and Power*.

12. His speech, Economic Progress and Declining Population Growth, was published in *The American Economic Review* 29, 1 (March 1939). Hansen claimed that as incomes rose, the propensity to save increased while investment opportunities were exhausted.

13. John Maynard Keynes (1931). Economic Possibilities for Our Grandchildren. Published in John Maynard Keynes (1963). *Essays in Persuasion*. W.W. Norton: 358. Keynes did predict that, when the standard of living reached the level achieved today, the combination of consumption satiation and the exhaustion of technological innovation would limit the need for economic growth.

14. Peter Bernstein (2008). Introduction: The Great Contraction, Seen from the Perspective of 2007. In Milton Friedman and Anna Schwartz, eds., *The Great Contraction 1929–1933* (Princeton University Press): xix.

A similar wave of pessimism followed the sudden slowdown in economic growth in the mid-1970s. The alarmist forecasts of the Club of Rome that the post-war boom was over coincided with angst in the western world over rising commodity prices and lower growth. These predictions proved unfounded after the Reagan and Thatcher revolutions re-ignited growth in the 1980s. As Robert Lucas observed, real GDP growth in the United States has been remarkably stable over the twentieth century at about 3% for any sizeable sub-period, concluding "[t]he growth rate of an entire economy is not an easy thing to move around".[15]

Today's gloominess is the mirror image of the excessive optimism voiced by some economists before the recession. In his Presidential Address to the American Economic Association in 2003, Lucas said that the "central problem of depression prevention [has] been solved, for all practical purposes".[16] Just before being appointed Chair of the Federal Reserve Board, Ben Bernanke spoke of "the Great Moderation" in which taming the business cycle was no longer the primary concern of policymakers, thanks to financial stability, low inflation, steady growth, and low unemployment.[17] This optimism about economic stability proved unfounded with the onset of the worst global financial and economic crisis since the 1930s.

There are earlier examples of economists becoming overly optimistic during previous bouts of prosperity. The Harvard Economic Society in 1929 stated that "[a] severe depression is outside the range of probability", just before the onset of the Great Depression.[18] The unbroken prosperity of the 1960s drove many economists to think the business cycle had been eradicated, leading Paul Samuelson (the pre-eminent economist of the age) to say that "the NBER has worked itself out of a job" since recession dates would no longer be needed.[19]

So, sentiment in the economics profession tends to follow the business cycle, becoming overly optimistic during expansions and excessively pessimistic during contractions or periods of weak growth.[20] During boom times, "[w]e project that

15. Robert Lucas Jr. (1988). On The Mechanics of Economic Development. *Journal of Monetary Economics* 22: 13.

16. Robert Lucas Jr. (2003). Macroeconomic Priorities: AEA Presidential Address 2003. *American Economic Review* 93, 1 (March): 1.

17. Ben Bernanke (2004). The Great Moderation. Remarks to the Eastern Economic Association (February 20).

18. Quoted, p. 188, in: Lakshman Achuthan and Anirvan Banerji (2004). *Beating the Business Cycle*. Currency Doubleday.

19. Quoted, p. 33, in Achuthan and Banerji (2004). *Beating the Business Cycle*.

20. Robert Fogel notes that historically "the normal expectation was that things would never change" when there was no growth for centuries at a time. Robert Fogel (2000). *The Fourth Great Awakening and the Future of Egalitarianism*. University of Chicago Press: 80.

today's (temporarily) high growth will continue to be miraculous forever".[21] In the depth of a recession, we see no hope of a resumption of the rapid rates of long-term growth the western world has demonstrated since the Industrial Revolution.

Financial Crises and Hysteresis

Severe recessions can having a lasting impact ("hysteresis") in reducing economic growth through lower capital investment, scarring workers who lose their jobs and either drop out of the labour force or see their skills erode, and reducing the birth of new firms. As noted economist Larry Summers put it, there is doubt "whether the cycle actually cycles" in the sense of a complete bounce back from the recession's drop in economic activity.[22] The Congressional Budget Office has trimmed its estimate of potential output by 5% because of the recession.[23]

There is a substantial body of evidence that financial crises in particular are usually followed by an extended period of slow growth. Reinhart and Rogoff pioneered this finding in *This Time Is Different*.[24] They concluded that crises spawned by high levels of debt are followed by weak recoveries as economies deleverage and governments use financial repression to reduce the burden of debt.[25] Financial repression includes direct lending by captive domestic sources of funds (such as the Canada Pension Plan being obligated to buy provincial government debt before the 1997 overhaul of its operations), low interest rates, and regulation of international capital movements. Reinhart calls financial repression a form of default and debt restructuring. Financial repression is distinct from debt monetization, where debt is inflated away by printing money.

Further research found that "not only are financial recessions deeper and slower to recover than typical recessions, they also have slower recovery the greater

21. William Easterly (2013). *The Tyranny of Experts*. Basic Books: 314.

22. Summers (2004). U.S. Economic Prospects: 65.

23. Cited, p. 66, in Summers (2004). U.S. Economic Prospects.

24. Carmen Reinhart and Kenneth Rogoff (2009). *This Time Is Different: Eight Centuries of Financial Folly*. Princeton University Press.

25. It is noteworthy that Reinhart and Rogoff's conclusion that slow growth follows financial crises was based on a database that covered many countries over centuries. One study found that the US experience was different, with above-average growth in recoveries after a financial crisis, although these results are more pronounced for the nineteenth century. See: Michael Bordo and Joseph Haubrich (2012). *Deep Recessions, Fast Recoveries, and Financial Crises: Evidence from the American Record*. Working Paper 12-14 (June). Federal Reserve Bank of Cleveland.

the credit-to-GDP ratio is."[26] Stiglitz points to the lingering effect of a balance-sheet recession being reinforced by structural changes associated with moving from a manufacturing to a services economy and changing global trade patterns.[27]

Analysts vary widely in their assessment of the fall-out from the latest financial crisis. The Organisation for Economic Co-operation and Development (OECD) (2009)[28] found that the crisis reduced potential GDP for various countries by between 1.5% and 2.4%, but that this did not necessarily mean a permanently lower growth rate. Robert Hall of the National Bureau of Economic Research (NBER) estimated output in the United States was 13% below its trend path as a result of the financial crisis. The reasons for this shortfall were the depletion of the stock of plant and equipment (which accounted for 3.9 percentage points), lower total factor productivity (3.5 points), falling labour force participation (2.4 points), and lingering slack in the labour market (2.2 points).[29] Others, such as the Congressional Budget Office, put the shortfall of real GDP from its potential at less than half of Hall's estimate.[30]

Hysteresis in Canada from the last recession has been much less severe, since our banking system emerged basically unscathed from the crisis that ravaged the financial systems of the United States and Europe. There is corroborating evidence that hysteresis in Canada's labour market was much less pronounced than in the recessions that began in 1981 and 1990, notably much smaller rises in the share of long-term unemployment and part-time jobs. The lingering effect of the US recession originated in its devastating impact on the housing and financial sectors, where jobs did not recover for years, which had no counterpart in Canada. The Bank of Canada maintains that there was hysteresis in Canada's export sector after 2000, due to the implosion of the Information and Communications Technologies (ICT) sector, the rising exchange rate, and then the 2008 recession, forcing some firms to abandon export markets or go bankrupt.[31] It blamed these factors for the unexpected stall of exports in 2012 and 2013, although it is unclear

26. George Akerlof (2014). The Cat in the Tree and Further Observations: Rethinking Macroeconomic Policy II. In G. Akerlof, O. Blanchard, D. Romer and J. Stiglitz, eds., *What Have We Learned? Macroeconomic Policy after the Crisis* (MIT Press): 318.

27. Joseph Stiglitz (2014). The Lessons of the North Atlantic Crisis for Economic Theory and Policy. In In Akerlof, Blanchard, Romer and Stiglitz, eds., *What Have We Learned?*: 338.

28. Organisation for Economic Co-operation and Development (2009), *OECD Economic Outlook 85*: 216.

29. Robert Hall (2014). *Quantifying the Lasting Harm to the U.S. Economy from the Financial Crisis*. NBER Working Paper No. 20183 (May).

30. Congressional Budget Office (2014). *An Update to the Budget and Economic Outlook: 2014 to 2024*. August 27.

31. Stephen Poloz (2014). *Integrating Uncertainty and Monetary Policy-Making: A Practitioner's Perspective*. Bank of Canada Discussion Paper 2014-6: 5.

why events over a decade earlier would affect exports so many years later. In any event, Bank of Canada Governor Steve Poloz acknowledged that "these destructive effects should be reversible over time".[32]

It is also worth emphasizing that Reinhart and Rogoff found that the fall-out from financial crises dissipated within a decade. The financial crisis erupted in 2007; we have just turned the page on 2015. So, based on historical patterns, it would be reasonable to expect the lingering effect of the recession to pass soon. This is already evident in the US housing market, where a decade of extremely low construction and a resurgence of household formation and pent-up demand have boosted housing starts back to the one million mark, twice their low plumbed during the worst of the recession.[33] A similar upturn due to pent-up demand is evident in the market for new vehicles.

Financial panics are inevitable. There is always some event that will cause savers in our society to worry about the safety of their assets, and withdraw funds from the financial system. It would be counterproductive to create a financial system with the sole goal of averting the risk of a crisis. For example, Gorton presents evidence that countries that undergo financial crises grow much faster than countries that do not.[34] Thailand, for example, has grown twice as fast as India for decades. South Korea also recovered quickly from the 1997 financial crisis in Asia. The occasional financial crisis may be the price paid for living in a society that rewards risk-taking and innovation.

Policy Uncertainty Continued to Rise after the Crisis

It is not just the financial crisis that changed the economic landscape in 2008. With it came a broad range of new and often unprecedented policies and regulations. These included quantitative easing and the use of forward guidance by central banks, record government deficits and debts, threats to the very existence of the Eurozone, radically new health care and financial regulations in the United

32. Stephen Poloz (2014). The Legacy of the Financial Crisis: What We Know, and What We Don't. Remarks to The Canadian Council for Public-Private Partnerships (November 3): 4.

33. Bordo and Haubrich blame the exceptionally slow recovery after 2009 on the weakness in residential construction. See: Bordo and Haubrich (2012). *Deep Recessions, Fast Recoveries, and Financial Crises*.

34. Gary Gorton (2012). *Misunderstanding Financial Crises: Why We Don't See Them Coming*. Oxford University Press: 177–181.

States, and new heads of all the major central banks in Europe and North America. While not the cause of the crisis, all this uncertainty about policy and regulation clearly deterred some spending, notably business investment. A study by the Dallas Federal Reserve found that "there is a strong negative correlation between macroeconomic uncertainty and real GDP growth since the Great Recession. Prior to that even the correlation was weak".[35]

Some critics, notably Stanford's John Taylor, blame slow US growth on the very government interventions implemented to revive growth.[36] There were few signs of secular stagnation before the 2007 crisis began. On the contrary, the economy boomed, driving unemployment down to 4.4% and causing enough inflation for the Federal Reserve Board to hike interest rates as recently as 2007. In Taylor's words, "government actions and interventions caused, prolonged, and worsened the financial crisis".[37] From this point of view, acquiescing to the notion of a New Normal of slow growth excuses government from responsibility for policies that stunt growth; governments are not just responding to extraordinary conditions, they are driving them. The clear implication is that a change in these policies would see a return to the growth rates seen in the previous 20 years.

The Economic Policy Uncertainty Index

The cumulative impact of uncertainty created by government policy is summarized in the new Economic Policy Uncertainty Index. Three professors created this index based on references in the media to uncertainty caused by public policies, scheduled changes to the tax code, and the dispersion of forecasts by economists.[38] It is noteworthy that the index for the United States reached its peak during 2011, not in 2008 or 2009, reflecting the threat of a default on its debt by the US government as Congress and the Obama administration grappled with whether to reduce the deficit primarily with tax increases or spending cuts (**figure 1**). It is encouraging for the prospect of stronger growth that the index recently has returned to pre-crisis levels. Another positive policy development was the lack of higher barriers to trade as a result of the recession, one of the threats Gross pointed to in his original formulation of a New Normal. Last year,

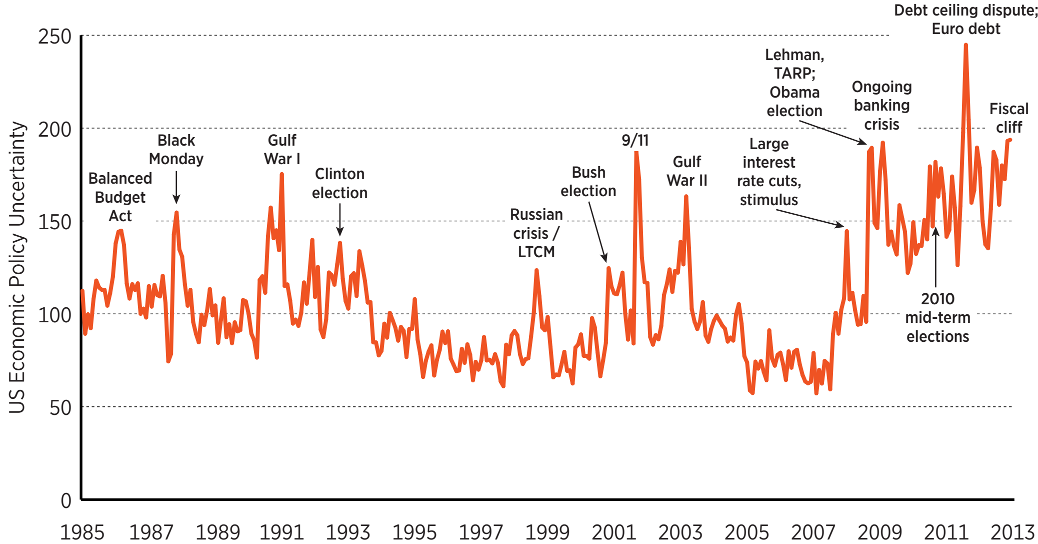
35. Michael Plante, Alexander Richter and Nathaniel Throckmorton (2014). *The Zero Lower Bound and Endogenous Uncertainty*. Working Paper 1405 (December). Federal Reserve Bank of Dallas, Research Department: 1.

36. John Taylor (2014). The Economic Hokum of "Secular Stagnation". *Wall Street Journal* (January 2).

37. John Taylor (2009). *Getting Off Track*. Hoover Institution Press, Stanford University: 61. See also John Taylor (2012). *First Principles*. W.W. Norton.

38. For more on this index, see: Nicholas Bloom (2013) *Killing the Economic Engine: Is Policy Uncertainty Stalling US and Canadian Economic Growth?* Fraser Alert (February).

Figure 1: Index of US Economic Policy Uncertainty, January 1985 to December 2012



Sources: Figure adapted from figure 1 in: Nicholas Bloom (2013). *Killing the Economic Engine: Is Policy Uncertainty Stalling US and Canadian Economic Growth?* Fraser Alert (February). Original from S. Baker, N. Bloom, and S. Davis (2013). *Measuring Economic Policy Uncertainty*. Stanford mimeo. Economic Policy Uncertainty. <www.policyuncertainty.com/media/BakerBloomDavis.pdf>, as of January 7, 2013.

the DHL Global Connectedness Index, which measures the depth and breadth of cross-border flows of trade, capital, people, and information, returned to its pre-recession high.[39]

For Canada, the largest source of policy uncertainty has been the United States. Besides the policies noted above that destabilized the US economy, Canada also was affected by the dithering of the Obama administration over the Keystone pipeline. Within Canada, several provinces also have created uncertainty, notably around the expansion of our own internal pipeline network. Ontario has unsettled its investment climate with plans to increase taxes and introduce a new pension plan.

Nor is Taylor the first to blame government policies for aggravating and prolonging a crisis. Policies of more regulation and fiscal stimulus after 2007 drew on the experience of what is presumed to have worked from the Great Depression. However, not everyone agrees these policies helped end the Depression: Amity Shales wrote in *The Forgotten Man* that "from Hoover to Roosevelt, government intervention helped to make the Depression Great".[40] More famously, Milton Friedman blamed the actions of the Federal Reserve Board for allowing the money supply to shrink along with recurring banking crises during the 1930s, turning

39. The DHL Global Connectedness Index is available at <http://www.dhl.com/en/about_us/logistics_insights/studies_research/global_connectedness_index/global_connectedness_index.html>.
40. Amity Shales (2007). *The Forgotten Man*. HarperCollins: 9.

"what might have been a garden-variety recession ... into a major catastrophe".[41] Years late, speaking for the Federal Reserve Board, Ben Bernanke famously declared to Friedman "You're right, we did it. We're sorry. But thanks to you, we won't do it again".[42]

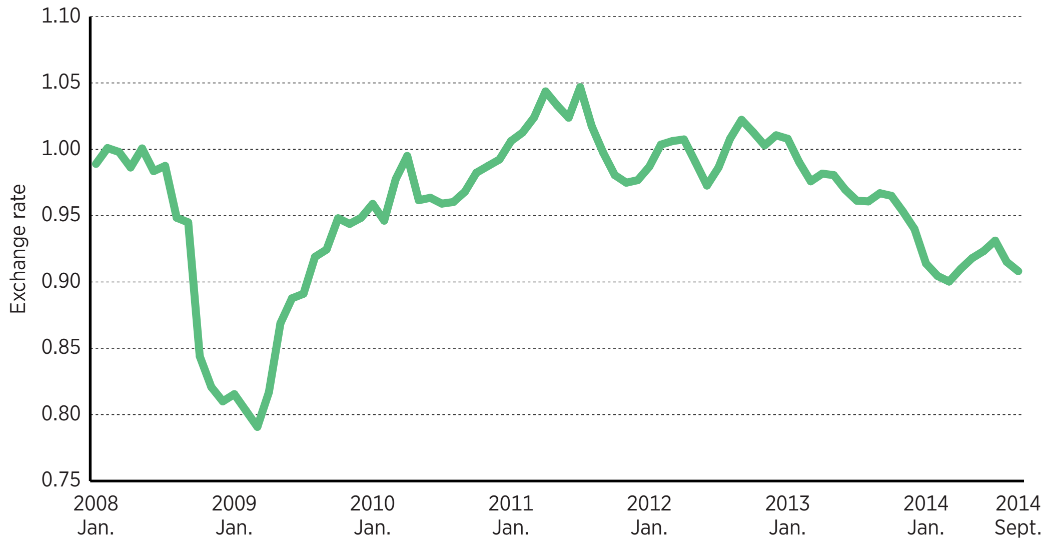
Is Policy Stimulus Exhausted?

Another reason some people despair about escaping the current extended period of low growth is the belief that the maximum possible or desirable stimulus from either monetary or fiscal policy has been reached. Ragan argues that "monetary policy has little ability to further stimulate Canadian growth".[43] At the same time, he warns fiscal restraint is needed because of the high level of accumulated debt and the looming demands of an aging population on government spending.

The belief that monetary policy is providing its maximum possible stimulus may be misplaced. One tool is quantitative easing, which has been implemented by all the G7 central banks in response to the crisis. However, while the Bank of Canada's extraordinary expansion of its balance sheet in 2008 was quickly unwound, it could be expanded again if circumstances warrant (all the other central banks adopted quantitative easing in stages). Another monetary tool available is the exchange rate. While there is some controversy over the role played by the Bank of Canada, the Canadian dollar has depreciated by over 10% since early 2013 (**figure 2**). Most economic models calculate this will help stimulate growth in Canada (although this may reflect a flaw in these models; while exports have increased markedly, there has been little change in the trajectory of output and employment). The relevant point here is that monetary policy has levers besides lower interest rates. And, late in January 2015, the Bank of Canada surprised markets with a drop in its Bank Rate, which accelerated the decline in the Canadian dollar. Some analysts argue, however, that record low interest rates are no longer a stimulus to the economy. Against a backdrop of weak demand and excess capacity, low interest rates have encouraged firms to buy back their own shares rather than investing in new plant and equipment.[44]

41. Milton Friedman and Anna Schwartz (1963). *A Monetary History of the United States, 1867–1960*. Princeton University Press. The quotation is from Milton and Rose Friedman (1998). *Two Lucky People Memoirs*. University of Chicago Press: 233.
42. Remarks by Governor Ben Bernanke (2002). On Milton Friedman's Ninetieth Birthday. University of Chicago (November 8).
43. Ragan (2014). *What Now?*: 1.
44. Andrew Smithers (2013). *The Road to Recovery*. Wiley: 213.

Figure 2: Canada-US Exchange Rate, Jan. 2008 to Sept. 2014



Source: Statistics Canada (2014). *Foreign Exchange Rates in Canadian Dollars*. Table 176-0064.

Nor is fiscal policy necessarily out of ammunition. With the federal government's deficit poised to be eliminated within a year (**figure 3**), some have advocated that a deficit be reinstated, with more spending on infrastructure or the long-term unemployed.

The proper fiscal policy response to slow growth depends crucially on whether it is driven by cyclical or structural factors, since expanding deficits to address secular stagnation is a recipe for chronic debt problems as seen recently in much of southern Europe. Ragan argues that, while fiscal policy is useful in stabilizing the economy in the short-term against recession, it is less useful during prolonged periods of slow growth.[45] Advocates of increased government spending and deficits usually assume a New Normal that is driven by cyclical factors, to avoid these structural problems.

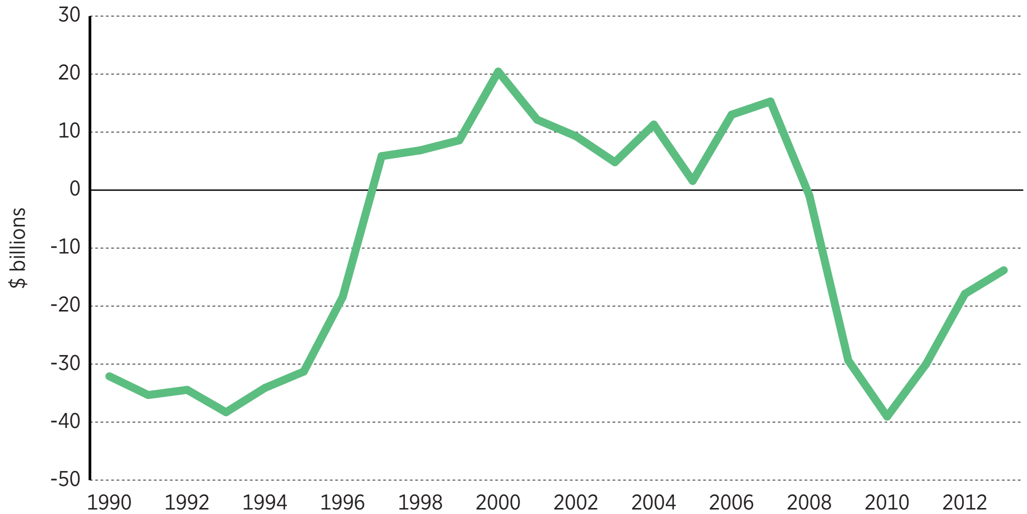
Deficit spending is meant to help cushion the economy against a sudden drop in spending. The classic metaphor is "pump priming". What is often forgotten, however, is how pump priming actually works in practice: to get a pump going, a little water is added, causing the pump to then produce more water on its own. It would be wasteful and counterproductive to add lots of water just to produce more water.[46] Similarly, a dose of government spending during a recession is meant to ignite private-sector activity, not to replace it.

"Pump-priming" is how the US government stimulus program (called *The Recovery Act of 2008*) was supposed to act. The Obama Administration predicted

45. Ragan (2014). *What Now?*: 7.

46. Thomas Sowell (2010). *Dismantling America*. Basic Books: 157.

Figure 3: Deficit ($ billions) of Canada's Federal Government, 1990–2013



Source: Statistics Canada (2014). *Revenue, Expenditure and Budgetary Balance—General Governments*.

that the stimulus from a higher deficit would cap the unemployment rate at 8%, rather than rising to 9%. Instead, unemployment hit 10%, and did not return to 8% until 2011. Either the theory of fiscal stimulus was wrong, or the models used to predict their impact are so erroneous as to be useless and therefore not a useful basis for formulating policy.[47]

Advocates of increased government spending and deficits also implicitly assume that the current level of federal debt relative to GDP is acceptable and can withstand some increase. Not everyone shares this complacency. In a collection of research by Canadian experts on whether the "war on debt" was over in 2004, Ragan and Watson concluded that the federal debt should be reduced to between 20% and 25% of GDP (it is currently about 35%).[48] Some experts even said the debt should be eliminated in the short run, freeing up money spent on interest payments to prepare for the inevitable increase in age-related expenditures.

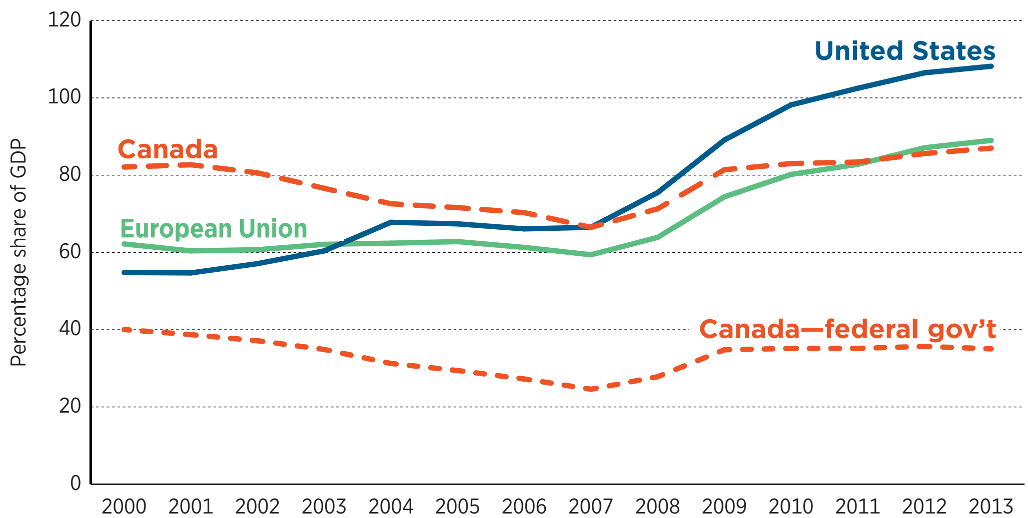
A complicating matter for evaluating Canada's fiscal situation is whether federal debt can be studied in isolation from the provincial debt. It is widely assumed Canada has a better fiscal position than the United States or the European Union. This is only true for the federal government. Canada's ratio of total government debt to GDP is similar to that of Europe and the United States, both of which are

47. Today, more Americans believe Elvis is alive than that *The Recovery Act* created jobs. Michael Grunwald (2014). The Long Road Back. *Time Magazine* (March 3).

48. Christopher Ragan and William Watson, eds. (2004). *Is the Debt War Over?* Institute for Research on Public Policy: 43.

often regarded as perilously close to the debt load that starts to inhibit economic growth (**figure 4**). The difference is that most of this government debt in Canada was issued by the provinces, notably Ontario and Quebec. It has been established that, if provinces ever have problems servicing their debt, the federal government would assume responsibility for their debt.[49] So the federal government's potential liability for debt is not as low as the 35% of GDP accounted for by its own debt.

Figure 4: Gross Debt as a Share of GDP (%) for Canada, the United States, and the European Union, 2000–2013



Sources: Statistics Canada. *National Balance Sheet Account*. Cansim table 378-0121. Organisation for Economic Co-operation and Development. *StatExtracts, Public Sector Debt, consolidated*.

Ragan articulated a Canadian version of the New Normal based on the process of elimination.[50] He argued that further policy stimulus is either unlikely (in the case of monetary policy) or unwise (for fiscal policy, given the looming budgetary squeeze from population aging). A revival of private-sector demand is deemed improbable, because of high household debt, weak business confidence, and sluggish export demand abroad. His conclusion is that, since low growth will likely continue, policy should adapt to its consequences of longer spells of unemployment and more part-time jobs. While this sectoral analysis of demand is appropriate for measuring GDP, it is a poor guide to analysis and forecasting.

The Bank of Canada shares some of this pessimism about the next couple of years. One Deputy Governor of the Bank of Canada said that "potential output growth in Canada and the other industrialized economies will be lower than it

49. Philip Cross (2014). *You're Not as Rich as You Think*. Macdonald-Laurier Institute (September).
50. Ragan (2014). *What Now?*

was in the years leading up to the crisis", pegging potential growth at less than 2% over the next two years.[51] However, the Bank made it clear: "We aren't buying the pessimistic view held by proponents of secular stagnation".[52]

Demographic Change—the Aging Workforce and Retirement

In his original formulation of the New Normal, Gross cited deglobalization and reregulation as factors contributing to slower growth. Most analysts downplay or ignore these concerns,[53] instead substituting other factors that dampen long-term growth. One is low productivity growth. Another favourite of many is demographic change. Most proponents of the New Normal scenario of slow growth cite the aging labour force as contributing to lower potential growth. The Bank of Canada cited entering "the retirement window for the post-war baby boomers" as one reason growth will not return to pre-2007 rates, even after the cyclical headwinds of "deleveraging, fiscal normalization, and lingering uncertainty" dissipate.[54]

The assumption is that the growth of the labour force will slow as people retire. (The original fear that the labour force would shrink outright has been removed from Statistics Canada's scenarios for future long-term trends, a victim of the unforeseen increase in the labour force participation rate for older workers).[55] Some of this impact would be offset by the higher productivity of older workers (at least of those not engaged in strenuous physical labour). As well, increased spending on health care and pensions diverts government spending from presumably more productive uses.

However, there are several problems with extrapolating from demographic changes to economic growth. First, the track record of the accuracy of forecasts of demographic changes in the labour force is not encouraging.[56] Second, the

51. Carolyn Wilkins (2014). Monetary Policy and the Underwhelming Recovery. Remarks to the CFA Society Toronto (September 22). Wilkins states some of this loss is due to cyclical factors, and potential growth will improve eventually.

52. Wilkins (2014). Monetary Policy: 8.

53. One reason is that most governments have resisted the temptation to adopt policies that dampen international trade. See: World Trade Organization (2014). *World Trade Report 2014*.

54. Poloz (2014). The Legacy of the Financial Crisis. Poloz also cited the boost that pre-crisis growth received from unsustainable leverage as another reason for a slowdown.

55. For more on Statistics Canada's revisions to population projections, see: Philip Cross (2014). *The Reality of Retirement Income in Canada*. Fraser Institute (April).

56. Cross (2014). The Reality of Retirement Income in Canada.

aging of the population varies widely between Japan and the European Union (where the population is already falling outright in countries like Germany and Russia) and North America. The populations of Canada and the United States are younger because of a higher birth rate and more immigration than in Japan and the European Union, and so the potential drag from demographics is lower in North America.[57] Aging is a much more daunting challenge to societies in Japan and Europe. In North America, some regard aging "as an opportunity disguised as a problem" based on the skills and experience older workers can bring to the labour force.[58] Third, economic forecasts built on predictions of major population shifts often miss the mark, because they ignore how "productivity trumps Malthusian demographics".[59]

Is the New Normal Already Here?

The New Normal blends together concerns that the weak recovery often seen after a financial crisis would reinforce a structural slowdown in growth. The distinction between cyclical and structural forces dampening growth is important for several reasons. A New Normal of slow growth mostly driven by the lingering effect of a financial crisis can be expected to largely dissipate within a decade, as Reinhart and Rogoff found in their history of financial crises. However, if the New Normal is driven by structural factors like aging and low productivity growth, society will need to implement fundamental reforms to combat their effect. The distinction between cyclical and structural forces dampening growth also has implications for government fiscal policy. Weak growth due to cyclical and therefore transitory factors might well be addressed by higher government deficits; slow growth due to structural factors makes running a fiscal deficit a disastrous policy choice.

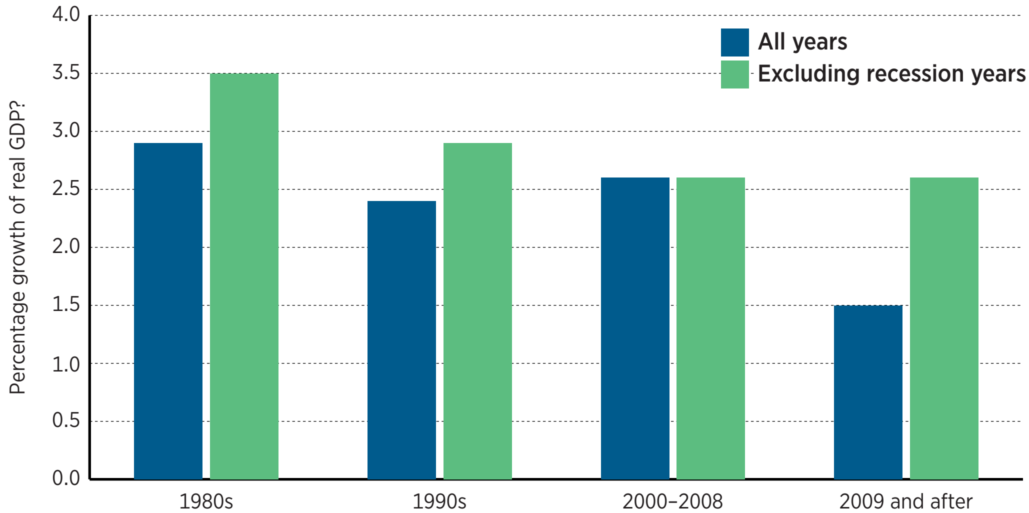
Has the economy already entered an era of slower growth due to the lingering effects of the recession and the onset of demographic change? The data on economic growth clearly say no, at least for Canada. Real GDP growth since 2009 has averaged 2.6%, virtually the same as non-recessionary periods in the previous two decades (**figure 5**). Using the broader measure of real GNI, which captures both the

57. In 2010, for example, 14.1% of Canada's population was 65 years and older, compared with 12.9% in the United States and 22.7% in Japan, 20.4% in Germany and just over 16% in France and the United Kingdom, according to: Anne Milan (2011). *Report on the Demographic Situation in Canada—Age and Sex Structure: Canada, Provinces and Territories, 2010*. Statistics Canada Catalogue no. 91-209-X: 6.

58. Chris Farrell (2014). *Unretirement*. Bloomsbury Press: 34.

59. Farrell (2014). *Unretirement*: 56.

Figure 5: Growth of Real GDP (%) in Canada, by Decade



Source: Statistics Canada. *Gross domestic product, expenditure-based; Canada; Chained (2007) dollars; Seasonally adjusted at annual rates; Gross domestic product at market prices (x 1,000,000)*. Table 380-0064.

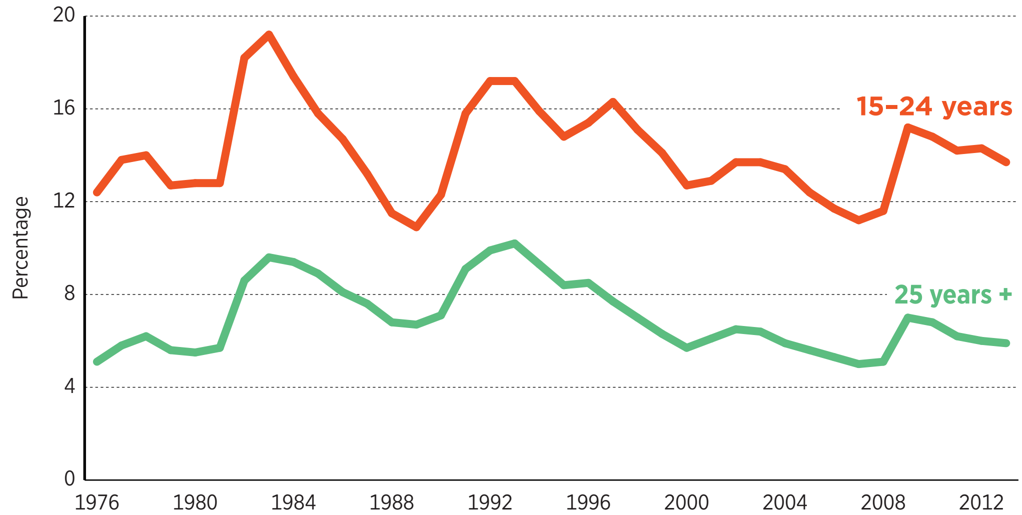
effect of improving terms of trade for Canada and its falling foreign debt, shows growth in recent years has actually been slightly better than before the crisis. If the New Normal means the days of 5% growth are over, then the era began in the mid-1970s (briefly interrupted by the ICT bubble in the late 1990s), making it anything but "New".

These improving macroeconomic outcomes are reflected in the adult unemployment rate, which at 5.8% is already at historically low levels (its all-time low was 5.0% in 2007). Overall unemployment is kept high by near-record youth unemployment (**figure 6**). The reasons for high youth unemployment are unclear, but do not seem to originate in aggregate demand.[60] The important point is that adult unemployment is near a record low and less than any year in the 1980s and 1990s despite what has been a relatively weak recovery.

Looking at the pattern of US economic growth shows a similar pattern of growth quickly returning to its long-term trend after the shock of the recession. Between 2009 and 2013, real GDP growth averaged 2.4% a year, compared with 2.7% from 2002 to 2007 after the 2001 recession. By this measure, the crisis produced no pronounced reduction of the economy's ability to grow (although US labour markets show a lasting impact of the recession on unemployment duration and part-time employment rates). The early stages of the recovery from the 1991 recession were not much better than now, with growth averaging 3.3% from 1992

60. For more on youth unemployment, see: Philip Cross (2014). *Skills Shortages*. Fraser Institute (June).

Figure 6: Unemployment Rates by Age for Canada, 1976–2013



Sources: Statistics Canada. *Labour force survey estimates (LFS), by sex and detailed age group; Canada; Unemployment rate (rate); Both sexes; 15 to 24 years* and *25 years and over*. Table 282-0002.

to 1995. There are a number of ways to interpret the Congressional Budget Office's estimated 5.6% gap between actual and potential GDP. It may be that potential is over-estimated; as Poloz stated, growth before the crisis was exaggerated by excessive borrowing that should be subtracted from the trend line.[61] As well, revisions to actual GDP may narrow the gap.

Some would argue that growth in the recovery should have been stronger, given the unusually severe decline during the recession. However, brisk recoveries do not always follow recessions, as was evident in the initially slow recovery starting in 1992 (as well as 2002, in the United States). A recovery that does not achieve trend rates of growth by itself is not proof of a New Normal. Some analysts assert that there is little evidence that this recovery has been unusually weak. James Stock found that "this recovery has in fact been typical of the post-1960 experience" after adjusting for the impact of demographic changes on potential growth of the labour force.[62]

One conclusion is that concerns about a New Normal are projections of what will occur in the future, which immediately adds considerable uncertainty given

61. Poloz (2014). The Legacy of the Financial Crisis: 3. If growth borrowing gave an exaggerated boost to US growth before 2008, this raises the interesting possibility that long-term potential growth in the United States had begun to slow in the middle of the decade but was masked by excessive leverage and the growing bubble in the housing and financial markets.

62. James Stock (2014). The Economic Recovery Five Years after the Financial Crisis. *Business Economics* 49, 1: 21.

the track record of forecasts of demographic and economic change. The lack of evidence that recent growth is unusually low by historical standards suggests that one of the basic assumptions of the New Normal—that the crisis is having a lingering effect on growth that cannot be addressed by policy makers—is suspect.

More recent data point to growth increasing to rates above what proponents of the New Normal say is possible. In particular, business investment and labour markets in the United States are improving, and these two sectors are typically the last to heal from recessions. Allen Sinai, who has made a career studying the US economy, recently stated: "We're finally in a normal business cycle", citing a 30% drop of the long-term unemployed in the past year.[63] Sinai is far from alone: Wells Fargo says that five years after the recession, US business "conditions finally appear to be returning to something closer to normal".[64]

Real GDP growth in the United States has exceeded an annual rate of 3.5% in four of the five quarters ending in the third quarter of 2014. The improving tone of the US economy is reflected in the unexpectedly rapid decline of the unemployment rate; in mid-2013, the Federal Reserve Board forecast that unemployment in the summer of 2014 would be 7%, nearly a point above the rate it actually achieved. As noted by James Bullard, head of the Federal Reserve of St Louis, "the US economy is approaching normal conditions" in terms of the Fed's main goals of price stability and maximum employment, but "monetary policy ... has not begun to normalize".[65] Summers, a year after advancing the prospect of secular stagnation, now worries that "the economy would be held back not by lack of demand but lack of supply potential" as the US unemployment rate is on a trajectory to hit 4% by the end of 2016.[66]

The strengthening of growth in the United States encouraged some organizations to forecast improved growth in Canada. This is not surprising since the conjecture of a New Normal has not changed Canada's dependence on the United States for growth (**figure 7**). One would expect growth to increase quickly in Canada when the US economy improves, since Canada was spared many of the impacts of blocked credit channels and high sovereign debt that have plagued growth in the other major industrial nations. What has been missing from Canada's recovery

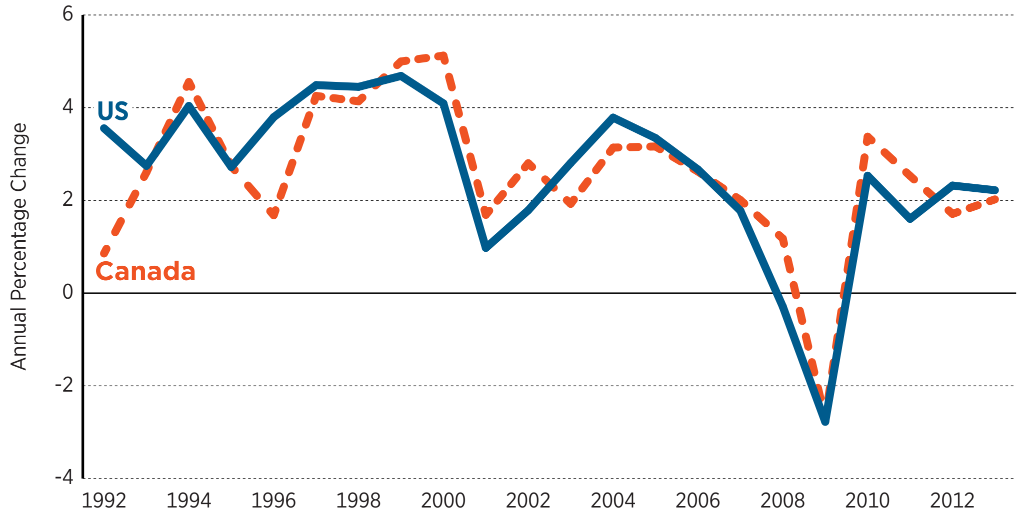
63. Allen Sinai (2014). *The Economy and a Sustainable Rebound—Normalizing if Not Already Normalized*. Decision Economics (website require subscription). <http://decisioneconomicsinc.com/the-economy-and-a-sustainable-rebound-normalizing-if-not-already-normalized>.

64. Wells Fargo Securities Economics Group (2014). *Monthly Outlook* (September 10).

65. James Bullard (2014). A Mismatch: Close to Macroeconomic Goals, Far from Normal Monetary Policy. *The Regional Economist* (October 2014). St Louis Federal Reserve Board.

66. Tomas Hirst (2014). Larry Summers Admits He May Have Been Wrong on Secular Stagnation. *Business Insider* (September 8).

Figure 7: Annual Change (%) in Real Gross Domestic Product, Canada and the United States, 1992–2013



Sources: Statistics Canada. *Gross domestic product, expenditure-based; Canada; Chained (2007) dollars; Seasonally adjusted at annual rates; Gross domestic product at market prices (x 1,000,000)*. Table 380-0064. Bureau of Economic Analysis, US Dep't of Commerce. Current-Dollar and "Real" Gross Domestic Product. *National Economic Accounts*. <http://www.bea.gov/national/index.htm#gdp>.

was strong export demand and sustained business investment.[67] However, exports have surged by 11.5% in the past year, contradicting Ragan's pessimism that "exports will likely disappoint".[68] This upturn in exports was driven by higher shipments to the United States, and a near doubling of exports to the United Kingdom (the destination of half Canada's shipments to the European Union, leaving us well-positioned to take advantage of the fastest-growing economy in Europe).[69] A pick-up in growth in the United States to more than 3% would help pull Canada along with it, despite the recent slump in commodity prices (which will affect nominal incomes more than the volume of output). This very scenario played out in 1997 and 1998: the world economy and commodity prices were stricken by the financial crisis in Asia and Russia, but strong growth in the United States boosted Canada's real GDP by over 8% over that period.

Fundamental to the New Normal scenario is the assumption that policies do not change. As outlined by Christine Lagarde, head of the International Monetary Fund, societies have a say in whether their future will be characterized by a New Mediocre of slow growth or a New Momentum of faster growth, depending on whether they make policy choices that remove structural impediments to growth. While Lagarde's

67. See: Bank of Canada (2014). *Monetary Policy Report* (October): 20.
68. Ragan (2014). *What Now?*: 15.
69. Export data from Statistics Canada, Cansim table 228-0069.

report was largely addressed to Europe, which is most at risk of being trapped in prolonged slow growth, it is easy to think of policies that would enhance growth in Canada. These include lower taxes, removing incentives to retire early, dismantling barriers to inter-provincial trade and mobility, and curtailing regulation. George Osborne, the UK Chancellor of the Exchequer, credited policies based on activist central banks, fiscal consolidation, and structural reform with boosting growth in the United Kingdom and North America above those of Europe and Japan.[70]

Some people question how current conditions can be characterized as normal, given the truly extraordinary expansion of the balance sheets of many central banks around the world and the large increase in government deficits in Canada and the United States. James Bullard, head of the St Louis Federal Reserve Board, observed that the mismatch between near normal macroeconomic conditions and a very abnormal monetary policy (including record low interest rates and a Fed balance sheet that is equal to 25% of US GDP) pose risks to the economy in terms of a return of inflation or financial market bubbles.[71]

Innovation and Long-term Growth

It is notoriously hard to forecast long-term patterns in industry growth. The high-tech boom in the late 1990s was widely hailed as the wave of the future, with no one foreseeing that Canada's growth in the next decade would be driven by natural resources and construction. The inability to predict trends in innovation reflects the focus of neoclassical economics on allocative efficiency. The neoclassical model of economic growth pioneered by Robert Solow treated innovation as the residual that cannot be explained after accounting for changes in labour and capital. This accounting approach to economic growth is limited and incomplete; it cannot explain growth that comes from innovation and unexpected leaps of knowledge, which we as humans are unable to imagine. Not being able to specify which sectors or processes will generate growth does not mean they will not occur. Knowledge, in the words of Gregory Mankiw, "is an unmeasurable variable" and so economics has been largely silent on how it translates into innovation, technology, and entrepreneurship.[72]

70. George Osborne (2014). Speech to the Economic Club of New York (December 15). Available at <https://www.gov.uk/government/organisations/hm-treasury>.

71. Bullard (2014). A Mismatch.

72. Gregory Mankiw, quoted in: R. Atkinson and S. Ezell (2012). *Innovation Economics: The Race for Global Advantage*. Yale University Press: 295.

In the work by Keynes cited earlier in this paper, he concluded that the western world's economy was suffering "not from the rheumatics of old age, but from the growing-pains of over-rapid changes".[73] This followed the introduction and diffusion of many technological improvements in the 1920s, including electricity, radio, motion pictures, and the automobile (all areas where investment in the stock market reached bubble proportions by 1929). Many argue we are at the threshold of what some call the Third Industrial Revolution based on harnessing the Internet. The First Industrial Revolution in the late eighteenth century was triggered by the steam engine, followed by the Second Revolution of urbanization, electrification, and the assembly line of standardization and mass production at the turn of the twentieth century.[74] As detailed by Richard Lipsey, it may take years or even decades for society to adopt and adapt new General Purpose Technologies, but once fully absorbed they will give a secular boost to productivity growth.[75] One example of the lag in adapting new technologies is the revolution underway in "fracking" for oil and gas; the technology of hydraulic fracking was first developed in 1947, but was not widely used until after 2004, when its potential was fully revealed by developments in 3-D seismic mapping and horizontal drilling.[76] In the past year, industrial capacity in the United States grew by 3.1%, the most since the 1990s, led by gains in high tech and mining.

Given the inherent difficulty of predicting the future, one can conceive of scenarios in which some sectors experience the rapid growth that helps drive overall growth. One is monetizing the Internet. The Federal Reserve Board recently said that "valuation metrics in some sectors appear substantially stretched—particularly those for smaller firms in the social media and biotechnology industries".[77] It may be, however, that markets are confident that firms are learning how to make money on the internet.

However, IT does not even begin to capture the breadth of changes taking place. Molecular genetics, nanotechnology, 3D manufacturing (including bioprinting of human body parts), drones for commercial purposes, driverless cars, and new materials like graphene[78] each has the potential for transformative change. However, the real transformative power of the internet is the reimagining of how products are delivered. Some examples are suggested by the rapid growth of Airbnb and the Uber taxi service; both use the internet as a platform to fundamentally

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73. Keynes (1931/1963). Economic Possibilities for Our Grandchildren: 358.
74. S. Heck and M. Rogers (2014). *Resource Revolution*. Melcher Media: 40.
75. R. Lipsey, K. Carlaw and C. Bekar (2005). *Economic Transformations: General Purpose Technologies and Long-Term Economic Growth*. Oxford University Press.
76. Daniel Yergin (2011). *The Quest*. Penguin Press: 17.
77. Federal Reserve Board (2014). *Monetary Policy Report to Congress* (July 15).
78. Graphene is pure carbon, one atom thick yet 100 times stronger than steel.

reshape the relationship between the consumer and the producer, even if the basic services being provided (a room to stay or a taxi ride) are not different at all. All these changes suggest that the cyclical headwinds the economy faces can be overcome by a "technological tailwind", in the words of Mokyr.[79]

One problem for the new digital economy being created is that it is not standardized and therefore is hard to measure. The "mass personalization"[80] made possible by 3D manufacturing[81] creates problems for statistical agencies when measuring GDP, which was devised at a time of mass production of standardized goods and services. Customized production, even of manufactured goods as is possible with 3D manufacturing technology, creates problems both for measuring their value and for deflation (which must also be done on an individual level). In the words of one historian of GDP, "the statistics of the twentieth century have become increasingly detached from the world as it is and ever more likely to mislead".[82] The problem also reflects abrupt changes in relative prices. While the overall level of prices remains relatively stable, there are large fluctuations in the relative price of commodities, services, tradable manufactured goods, and technological goods.

An example of innovation and technology dramatically changing outcomes is health care. Despite widespread predictions that healthcare costs would rise inexorably with the aging of the population, the 2.1% increase in nominal health care spending in 2014 was the lowest since 1997.[83] Even as the percentage of seniors in the population rose from 12.5% in 2002 to 14.9% in 2014, the share of healthcare spending dedicated to seniors was steady at 45%, according to the Canadian Institute for Health Information.[84] Wearable watches that monitor a person's vital signs are just the tip of how technology could change the delivery and cost of health care.

The scope for innovation extends beyond technology. The very nature of manufacturing could change from the basic act of producing items to combining manufacturing with services. In this model, "manufacturing businesses will act like consultants", investing time to understand the customers' requirements before creating the goods needed, and then providing follow-up on how the goods are

79. Joel Mokyr (2014). What Today's Economic Gloomsayers Are Missing. *Wall Street Journal*, (August 9).

80. Peter Marsh (2012). *The New Industrial Revolution*. Yale University Press: 57.

81. For a description of this process, see: Chris Anderson (2012). *Makers: The New Industrial Revolution*. Signal Books.

82. Diane Coyle (2014). *GDP: A Brief but Affectionate History*. Princeton University Press: 143.

83. Canadian Institute for Health Information (2014). *National Health Expenditure Trends, 1975 to 2014* (October): 14.

84. Canadian Institute for Health Information (2014). *National Health Expenditure Trends*.

used.[85] Only parts of this process can be automated or outsourced to low-wage countries. Already, we have seen a marked increase in high-wage factory jobs in Canada in recent years.[86]

Not everyone agrees that innovation will accelerate or even continue in the near future. In an opinion piece in the *Wall Street Journal* titled, "Why Innovation Won't Save US", Robert Gordon of Northwestern University wrote that "future economic growth will achieve at best half [the] historic rate of 2% a year between 1891 and 2007", grounded in a belief that "just about all important inventions had already appeared".[87] Alvin Hansen claimed in 1938 that investment opportunities were exhausted. More recently, Paul Krugman in 1998 forecast that "the growth of the Internet will slow drastically" because "most people have nothing to say to each other".[88] Subsequently, social media has become the dominant means of communicating on the Internet.

Conclusion

The goal of macroeconomics is to encourage long-term growth while maintaining short-term stability. Sometimes, pursuing policies that enhance long-term growth destabilizes the economy in the short term, such as shifting resources from manufacturing to the resource sector. At other times, as in the last recession, policies such as large government deficits are adopted to stabilize the economy in the short run that undermine long-term growth.

It has been nearly a decade since the onset of the financial and economic crisis. Inevitably, the lingering effect of the recession and the restructuring of balance sheets inhibited economic growth around the world. However, as the US business cycle starts to normalize in both form and speed, there is reason to be optimistic that the lingering effects on long-term growth are dissipating nearly a decade after the onset of the crisis. As the economy normalizes, a shift in policy emphasis from short-term stability to long-term growth would further boost growth.

85. Marsh (2012). *The New Industrial Revolution*: 245.

86. According to Statistics Canada's labour force survey, the number of factory jobs paying more than $30 an hour quadrupled between 1997 and 2013.

87. Quoted in: Anderson (2012). Makers: 38. Gordon elaborated on this theory in: Robert Gordon (2012). *Is U.S. Economic Growth Over? Faltering Innovation Confronts the Six Headwinds*. NBER Working Paper No. 18315 (August).

88. Quoted in: Heck and Rogers (2014). *Resource Revolution*: 123.

Canada has some unique advantages to boost economic growth. Having the world's most stable banking system means our credit system and financial markets can quickly respond to increased demand. We have ready access to, and knowledge of, markets in the United States as they strengthen. Our population is one of the youngest in the developed world, and its labour force one of the most educated. Governments could encourage more growth by creating an environment conducive to innovation by removing regulatory barriers, such as those being erected to inhibit the growth of innovative new technologies (such as Uber) or preserving protected sectors such as telecommunications and finance.

This leaves the major risks of a New Normal of slow growth originating from an aging population and low rates of innovation and productivity. Both imply policy should shift from short-term stability to boosting long-term potential growth. Instead of increasing aid to groups such as the long-term unemployed, we should be reducing the incentives unemployment insurance gives people not to move to areas with lower unemployment. Following the analysis developed by the IMF's Christine Lagarde, it is possible to boost economies from the "New Mediocre" to "New Momentum" with better policies and structural reforms.[89]

89. Lagarde (2014). The Challenge Facing the Global Economy.

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Philip Cross worked for 36 years at Statistics Canada, the last few as its Chief Economic Analyst. He wrote Statistics Canada's monthly assessment of the economy for years, as well as many feature articles for the *Canadian Economic Observer*. After leaving Statistics Canada, he has worked as a contract researcher for a variety of organizations. He has been widely quoted over the years, and now writes a bi-weekly column for the *National Post* and other papers.

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