

## **The Impact of Recession and Recovery on Our Standard of Living**

Although the data is not yet in, most economists expect that the Canadian economy is now in recession. We also expect that it will be late 2009 before economic growth turns positive and several years after that before the economy has recovered. Considerable attention has been directed at the expected timing, pace and characteristics of this recession and recovery on the economy overall. Much less attention has been focused on the impact of this recession and recovery on our standard of living. This paper identifies the impact of the recession and recovery on our standard of living as it is usually measured, then delves into a few important observations behind the numbers.

The most commonly accepted measure of our standard of living is real GDP per capita. As I have always noted in studies such as this – real GDP per capita (hereafter “GDP per capita”) is a good starting point for a serious examination of standards of living – no more and no less. There are some surprising conclusions from the examination of this data, most of them not too uplifting, but there are a few welcome exceptions.

### **Our Standard of Living Took a Hit in 2008, in More Ways Than One**

Over the 2004 through 2007 period economic growth moved along at a steady sustainable pace, close to 3% per year each year. With population growing about 1% per year, this yielded growth in GDP per capita per year of about 2% per year. In 2008 GDP growth fell to 0.5%. With population continuing to grow about 1%, this meant a decline in GDP per capita of -0.5% for 2008.

This decline in our standard of living (GDP per capita) in 2008 was as unusual as it was disappointing and unexpected. Our real GDP per capita had not fallen since 1992. Most economists did not forecast that the economy would grow less than 1% in 2008 (to yield a GDP per capita less than 0) until about September 2008. To “add insult to injury,” in 2008 Canada’s standard of living fell relative to the American’s. This is an observation not well known, and certainly unexpected by most Canadians.

In Canada we often measure our standard of living relative to the U.S. I have argued that this is a relevant statistic for purposes of assessing economic policy issues or issues relating to the potential standard of living available to Canadians. Many of the important drivers of Canada’s economic growth emanate from the U.S.

When the U.S. economy is booming, Canadian economic policy makers can make many mistakes and the Canadian economy will still put in a decent year. Conversely, in years like 2009, when the U.S. economy goes into a tough recession, there is little that we can do in Canada to prevent a year of very weak economic growth.

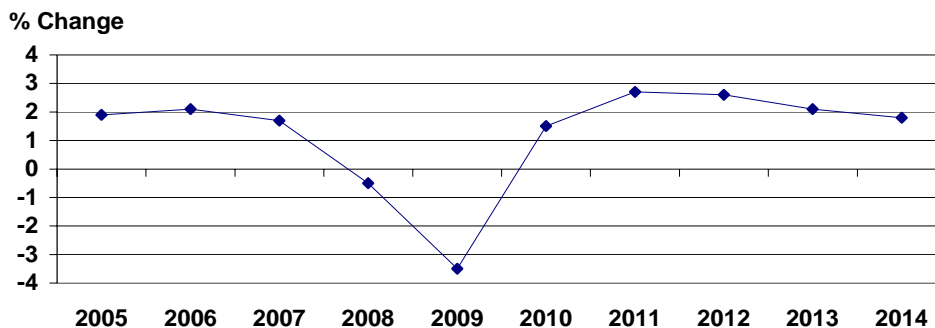
In this sense, any assessment of our economic policy choices must take into account the strength of the U.S. economy at the time. While in Canada we may opt for choices that sacrifice growth for a better income distribution or more leisure, the strength of the drivers from the U.S. economy are indicative of our potential. As well, Canadians are exposed in detail to the consumption habits of Americans, and we do set our expectations partly on what we see our American neighbors consuming. That applies to private consumption as well as publicly consumed goods and services such as health care, education and highways.

Canada's current recession is widely accepted to be the result of economic problems originating in the U.S. However, in 2008, economic growth was stronger in the U.S., at 1.1%, than Canada's 0.5%. With population growing about 1% in the U.S. in 2008, GDP per capita grew just slightly, whereas it was negative -0.5% in Canada. The main reason the U.S. economy grew more than the Canadian economy in 2008 is because their exports were so much stronger. Real exports grew almost 7% in the U.S. in 2008 while they declined by almost 8% in Canada. Certainly, in 2008 many Americans had much more serious declines in their standard of living than most Canadians, with more home foreclosures, more layoffs and steeper declines in home prices. However, in the economy overall, in 2008 real per capita income rose slightly in the U.S. while it fell slightly in Canada. In 2008 Canada's standard of living fell to just under 84% of that in the U.S. This is an observation both surprising and disappointing to Canadians, given our economic problems have originated in the U.S. However, we will probably more than catch up for this loss in 2009.

### **Standard of Living Will Take the Biggest Tumble in Decades in 2009**

Most economists are now forecasting economic growth in Canada will be about -2.5% in 2009. We must recognize that, as each month has passed since last September, the forecast for 2009 growth has been reduced by about 0.5%. That is, we have not found the bottom of this recession yet. So there is a distinct probability growth could be weaker than the current forecast. Economic growth has not been negative in Canada since 1991, and then it was -2.1%. With population growth in the 1% range, we are therefore expecting our GDP per capita to fall by about -3.5% this year. The expectation that the level of employment will continue to fall and the unemployment rate continue to rise over 2009 will re-enforce the feeling amongst Canadians that their standard of living is in decline over 2009.

*Chart 1. Standard of Living Growth Weak in 2008, But Much Weaker in 2009*



## **The Economy Will Recover Before Our Standard of Living Does**

With economic growth finally moving into positive territory in the final quarter of 2009, I expect 2010 to be a year of weak recovery, with growth in the 2.5% range. This pace of growth implies an increase in real per capita income of about 1.5%. While 2.5% growth is not far short of the medium term sustainable pace of about 2.7%, it is very weak considering the amount of excess capacity there will be in the economy.

Driving recovery in Canada in 2010 will be the tremendous amount of economic stimulus provided by monetary policy, and to a helpful but lesser extent, fiscal policy. This point must quickly be clarified to note that the pace and strength of Canada's economic recovery will depend most importantly on the pace and strength of recovery of the U.S. economy. The monetary and fiscal stimulus provided by Canadian economic policy will be helpful but supportive drivers of our recovery. It should be emphasized that the Bank of Canada began cutting interest rates in January 2008. The policy rate has been cut by 400 basis points to date, with another 25 basis points expected April 21.

Both the Prime Minister and the Finance Minister have commented that recovery in Canada may precede that in the U.S. There may be some confusion on this point. It is difficult to know for certain what is meant by their comments. In my view, Canada could well move into positive growth territory, or to a decent pace of growth before the U.S. economy, simply because the U.S. economy will be coming out of a deeper recession (-3.5% growth this year relative to Canada's -2.5%). However, this is a reflexion of the depth of the recession in each country rather than the ability of the Canadian economy to move forward in the absence of a strong recovery in the U.S.

There is an unusually wide range of forecasts for Canada's pace of economic growth in 2010. The Bank of Canada's current forecast, from their January MPR Update report, is for growth of 3.8%. They will surely be downgrading this forecast in their upcoming April 23 MPR. However, I doubt the downgrade will move the forecast

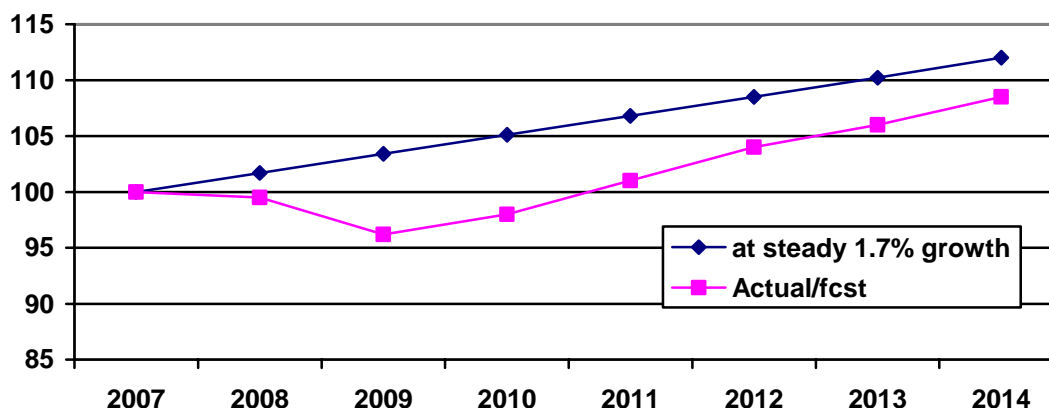
below 3% growth for 2010. The OECD recently forecast only 0.3% growth for Canada for 2010. Most private sector forecasts are in the 1.5% to 2.5% range.

Specifically, as long as Canada's population growth continues to be about 1% per year, the growth in real GDP per capita runs about 1% point below the pace of GDP growth. Therefore the growth in GDP per capita will not reach positive territory as quickly as will the pace of GDP growth. Specifically, we do expect GDP growth to be in positive territory in late 2009. However, unless and until it surpasses the 1% pace, GDP per capita will not be growing. This is not just arithmetic. The economy must grow faster than population growth for the typical family to have a higher level of income.

In 2010 overall I expect a growth in per capita income of about 1.5%. However, in terms of the level of per capita income, with this modest growth after two very weak years, the 2010 level will be below the 2007 level. Canadian's per capita income has grown every year since 1992, so it is disappointing to expect the 2010 per capita income level to be below the 2007 level.

*Chart 2. Real GDP per Capita: Actual/Forecast Relative to Steady Growth*

2007=100



## **Recovery Will Bring Strong, But Not Complete, Recovery in Our Per Capita Income**

In response to the extensive monetary and fiscal stimulus in both American and Canadian economies applied in 2009 and 2010, I expect very strong economic growth in Canada in 2011 and 2012. With this stimulus to demand, and still considerable excess capacity in the economy, these should be years of strong recovery from the recession of 2009. In fact, the fiscal stimulus may begin to crowd out private sector activity by late 2010, particularly in the construction sector. By late 2011 the Canadian economy will likely be at full capacity so this aggregate demand may begin to provide pressures to inflation.

The 3.7% growth forecast for 2011 and the 3.5% for 2012 should bring the economy to full capacity. In their January MPR report the Bank forecast the excess supply would not be eliminated until mid 2011, but I expect, in their upcoming April 23 report, the Bank will push this date out to late 2011.

The important but disappointing point that must be made here is that, even though the economy may have recovered by late 2011, in the sense of reaching full capacity again, we will not have regained the level of per capita income that we lost in the recession. In a recession the economy loses some of its potential, which is unlikely to ever be fully regained. Specifically, the lack of business investment and the higher level unemployment experienced in a recession reduce labor productivity beyond what can be regained in recovery. While the economy's medium term potential growth rate is about 2.7%, this potential was reduced to the 2.4% range over the recession of 2009.

For example, in the previous recession of the early 1990's, after negative growth in 1990 and 1991, the economy turned in positive growth in 1992, but it did not regain its 1989 level of output until 1994. In 1994 the recession and recovery had left the size of the economy about 1% smaller than it would have been had the economy grown at a stable 3% rate annually after 1989, instead of the recession and recovery experience.

After another above average year in 2013 of 3.0% growth, the recovery is expected to have run its course by 2014. At that point the economy will have recovered most but not all of the growth lost to the recession of 2009. Specifically, in 2014 I expect the size of the Canadian economy to be about 97% as large as what it would have been if we would have had stable, sustainable 2.7% growth every year since 2007, instead of the recession and recovery experience.

To be specific, this forecast path of recession and recovery will leave the level of economic output in 2014 at \$1,509 billion (real GDP chained 2002\$). Had the economy grown at a stable 2.7% pace since 2007 instead of this forecast recession and recovery, it would have been at \$1,558 billion, or about 3% larger in 2014. That is, the six year recession and recovery experience of 2008 – through 2013 cost us about one year of economic growth. In terms of per capita GDP, since we are assuming no impact of the economic cycle on population, our per capita GDP is also about 3% lower in 2014 due to the recession and recovery experience.

This loss of about one year's growth in our standard of living over the six year 2008 – 2013 period of recession and recovery, is probably yet another disappointing point to most Canadians.

## **Some Further Insights Into Our Standard of Living**

### ***Impacts on Income Distribution***

**At the outset I noted that per capita GDP was a good starting point for a serious discussion of standards of living, but no more and no less. Specifically, changes in per capita income, being a measure of average levels of income, do not take into account any changes in the distribution of income between people of different levels of income. This failure to account for how income is distributed is more important in cross section studies of standards of living than it is in a time series study of an individual economy, such as the present report. However, we should still contemplate how the recession and recovery is likely to impact the distribution of income in Canada.**

**Of course we will not know the answer to this question for many more years. Recessions are usually thought to impact lower income families more severely than higher income families. This is partly because lower income families are stretching their budgets just to cover the necessities of life before recession hits. The recession may reduce the incomes of higher income families, but some of this reduction can be met by a reduction in saving and lower spending on luxuries.**

**A point which can be made with respect to the recession of 2009 is that the layoffs and reductions in income have hit high income families more than is often the case with recessions. This is largely because the recession has hit the finance sector, home to many high income workers. As well, Budget 2009 did provide several tax breaks focused on helping lower income families. Thus, lower income families are probably having more difficulty dealing with this recession than higher income families, but the gap in this burden may not be as wide as it has been in other recessions.**

**Another measure of the impact of the recession on income distribution is to examine how the recession impacts economic growth rates in the various provinces across Canada. In this case we also conclude the recession of 2009 is impacting incomes more evenly across Canada than is normally the case in recessions. The recession of the early 1990's was not felt too severely in western Canada. However, in 2009, all provinces will have negative rates of economic growth, with the possible exception of Saskatchewan. All provinces are suffering weaker labor markets. In fact, Canada's two wealthiest provinces, Alberta and , are being particularly hard it by the recession of 2009.**

### ***Impacts on the Distribution of Goods and Services***

**Another very important aspect of our standard of living which is not detected in the GDP per capita measure is what goods and services are being produced. Taking account of the distribution of goods and services is also more important in cross section studies of standards of living than it is in time series studies of the same**

economy. Specifically, if one economy is much more of a “tax and spend” economy than another, much more of its GDP will be delivered through the government sector as opposed to the private sector. For example, when comparing the standards of living in Canada relative to another country we may also want to supplement our comparisons of GDP per capita with comparisons of differences in Personal Disposable Income per capita.

In this context it is important to note that, according to Budget 2009, after the stimulus spending by the federal government, program spending will rise from 13% of Nominal GDP in 2007 to 14.7% in 2009, but will fall back to 13.1% by 2013. On the tax side, revenues/nominal GDP are expected to be a bit higher in 2013 than they are today. Our federal public debt will have increased by almost 20%, although our debt burden will be about stable. This federal Budget plan implies slightly less economic freedom in Canada as a result of the fiscal policies adopted to deal with recession and recovery.

Canada’s experience is bound to pale in comparison to the increase in the role of government which Americans will face. The huge increase in public debt, the almost inevitable increase in taxation, and the increase in regulation which will result from the policies of recession and recovery in the U.S. will constrain personal disposable incomes in the U.S. for many years.

#### *Canada’s Standard of Living Relative to the U.S.*

Above we noted the relevance of comparing Canada’s standard of living relative to the U.S. We noted that our real GDP per capita was just under 84% of the U. S. level in 2008, but was expected to move just above 84% after their loss in 2009 was even greater than ours. From 2010 onwards the pace of economic recovery is expected to be approximately the same in each country, leaving Canada’s GDP per capita at about 85% of the U.S. level in 2014.

#### *A Look at Gross Domestic Income*

While GDP per capita reflects the goods and services per capita available to be shared across the population, it does not detect how a change in the terms of trade of a country affect the purchasing power of households and businesses as accurately as Gross Domestic Income (GDI). The path of GDP growth and GDI growth will be similar if the prices of Canada’s exports and imports are moving similarly. Over the medium term on average this divergence may not be too significant. However, given the implications of a divergence in growth between these two measures for our standard of living, it is always appropriate to check. GDI generally will grow at a stronger pace than GDP when the prices of our exports are particularly strong. That is, when commodity prices, particularly energy prices, are strong.

Over the 2003 to 2008 period, strong commodity prices pushed up the purchasing power of Canadian households and businesses beyond what was indicated by GDP

growth. However, in mid 2008 this impact turned negative. Commodity prices are expected to continue negative for the next several years. In fact, on average the price of our commodity exports will likely be significantly lower at the end of 2010 than it was in mid 2008.

The implication of this examination of GDI as a supplement to GDP when drawing conclusions with respect to standards of living for Canada is the following. Drawing conclusions based solely on GDP data probably understated the growth in Canada's standard of living over the 2003 to mid 2008 period and understated how well we were doing relative to the Americans. However, over the mid 2008 to end of 2010 period the opposite is likely the case.

## Conclusions

- This paper identifies the impact of the recession and recovery on our standard of living as it is usually measured, then delves into a few important observations behind the numbers.
- In 2008 GDP per capita fell by 0.5%. This decline in our standard of living (GDP per capita) in 2008 was as unusual as it was disappointing and unexpected.
- In 2008 Canada's standard of living fell relative the American's. This is an observation not well known, and certainly unexpected by most Canadians.
- I am expecting our GDP per capita to fall by about 3.5% this year. The expectation that the level of employment will continue to fall and the unemployment rate continue to rise over 2009 will re-enforce the feeling amongst Canadians that their standard of living is in decline over 2009.
- In 2010 overall I expect a growth in per capita income of about 1.5%. However, in terms of the level of per capita income, with this modest growth after two very weak years, the 2010 level will be below the 2007 level. Canadian's per capita income has grown every year since 1992, so it is disappointing to expect the 2010 per capita income level to be below the 2007 level.
- Our per capita GDP is expected to be about 3% lower in 2014 after the recession and recovery experience. This loss of about one year's growth in our standard of living over the six year 2008 – 2013 period of recession and recovery is probably yet another disappointing point to most Canadians.
- Lower income families are probably having more difficulty dealing with this recession than higher income families, but the gap in this burden may not be as wide as it has been in other recessions. I also conclude the recession of

**2009 is impacting incomes more evenly across Canada than is normally the case in recessions.**

- **The federal Budget plan implies slightly less economic freedom in Canada as a result of the fiscal policies adopted to deal with recession and recovery. However, Canada's experience is bound to pale in comparison to the increase in the role of government which Americans will face.**
- **Canada's real GDP per capita was just under 84% of the U. S. level in 2008, but was expected to move just above 84% after their loss in 2009 was even greater than ours. From 2010 onwards the pace of economic recovery is expected to be approximately the same in each country, leaving Canada's GDP per capita at about 85% of the U.S. level in 2014.**
- **Drawing conclusions based solely on GDP data, as opposed to also examining data on Gross Domestic Income, probably understated the growth in Canada's standard of living over the 2003 to mid 2008 period and understated how well we were doing relative to the Americans. However, over the mid 2008 to end of 2010 period the opposite is likely the case.**