

## **Recession and Recovery: What is Recovery?**

With so much talk of “green shoots” and other signs of economic recovery, it is appropriate to examine the expected path of recovery, the various aspects of recovery – and finally to examine what we actually mean by “recovery” from this recession.

In previous notes I have emphasized that the pace, character and sustainability of economic recovery in Canada will depend very heavily on recovery of the U.S. economy. We now see firm signs of recovery in the U.S. financial and housing sectors. In fact, most forecasts call for the U.S. economy to begin growing again by the fourth quarter of this year, followed by a weak, but definitely positive, year of growth next year. In response, credit conditions in Canada have definitely improved in recent months and most Canadian forecasters expect we are now near the bottom in terms of economic growth, with positive growth by the fourth quarter of this year, followed by weak growth next year.

Economic stimulus provided by fiscal policy and all-time low interest rates, increased liquidity and other monetary policy measures are important drivers of growth in both Canada and the U.S. for this year as well as next. With so much attention focused on economic recovery, and with the pace and character of recovery so critical to household, business, financial and government planning, it is important to examine exactly what we mean by economic recovery.

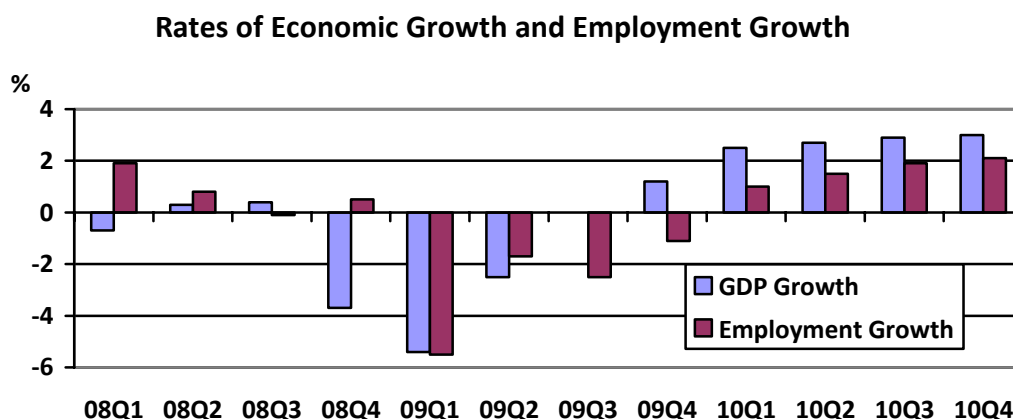
### **Economic Growth is Now Turning Positive**

The highest profile definition of a recession is two consecutive quarters of negative economic growth. Therefore, when economic growth turns from negative to positive, that is an obvious definition of economic recovery.

Latest data show that the economy grew -3.7% (Q/Q/ annualized rates) in the fourth quarter of 2008 after a positive third quarter. Growth was even worse in the first quarter of 2009 at -5.4%. Data on the second quarter of 2009 won't be released by Statistics Canada until the end of August, but this quarter is expected to be about -2.5%. Most forecasters expect the third quarter to be near zero, with positive growth returning in the fourth quarter. See chart 1. Therefore, unless most economic forecasters are wildly off the mark, we will have a recession of three consecutive quarters in Canada, with the economy reaching its lowest point in mid year and recovery in the fourth quarter.

In this case we are defining “recovery” as the return to positive real GDP growth (Q/Q/ on an annualized basis). This is probably the most appropriate definition of “recovery.” However, there are several other very important aspects and perspectives on economic recovery that must be taken account of in household, business, financial and government planning.

### Chart 1



Economic growth is comprised of net business and labor incomes as well as government expenditures. While real GDP (“GDP”) is probably the best over-all measure of economic performance, from a “main street” perspective, the performance of labor markets is probably more important. That is, employment and income growth and the unemployment rate, are probably more important to the typical household. While GDP is expected to bottom in mid 2009 and move into positive growth in the fourth quarter, employment growth is expected to lag behind. Businesses are generally reluctant to lay workers off as business turns down due to the difficulty and cost of replacing experienced employees. As business picks up in a recovery

period they are reluctant to add full time employees due to the costs of hiring and the fringe benefits involved.

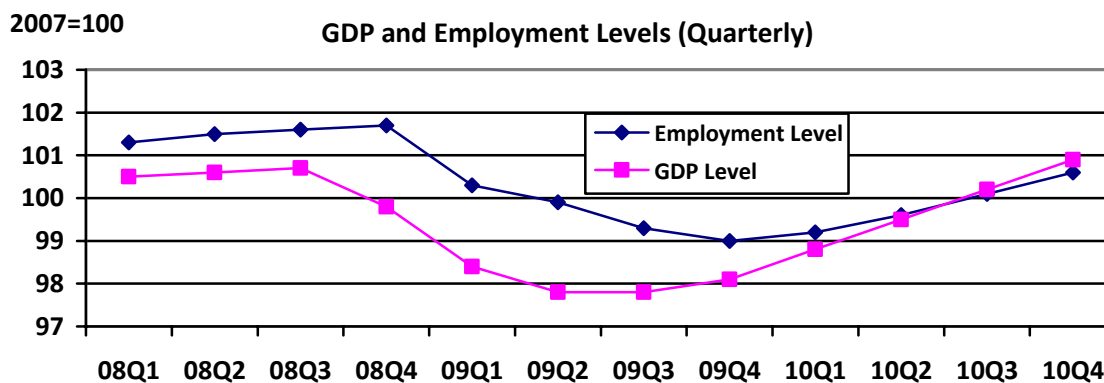
While economic growth turned negative in the fourth quarter of 2008, employment growth didn't turn negative until one quarter later. Correspondingly, while we expect economic growth to be flat in the third quarter and turn positive in the fourth, employment growth will remain negative until the first quarter of 2010.

### Recovery of Previous Levels

While the most obvious definition of “recovery” may well be the return to positive economic growth, it is very important to examine the level of economic output – that is the “size of the economy” at that point compared to previous levels. Has the economy “recovered” to its previous size? If not, when will it?

When the economy returns to zero growth in the third quarter of 2009, as opposed the negative growth of the three previous quarters, it is expected to be about the same size (level of real GDP) as it was in 2006.

### Chart 2



At this point (the third quarter of 2009) it will be about 97.8% as large as it was in 2007. In fact, the economy will not recover its 2007 size until the third quarter of 2010. It will not recover its previous peak size, realized in 2008 Q3, until the final quarter of 2010. See chart 2 and 3. Over the three

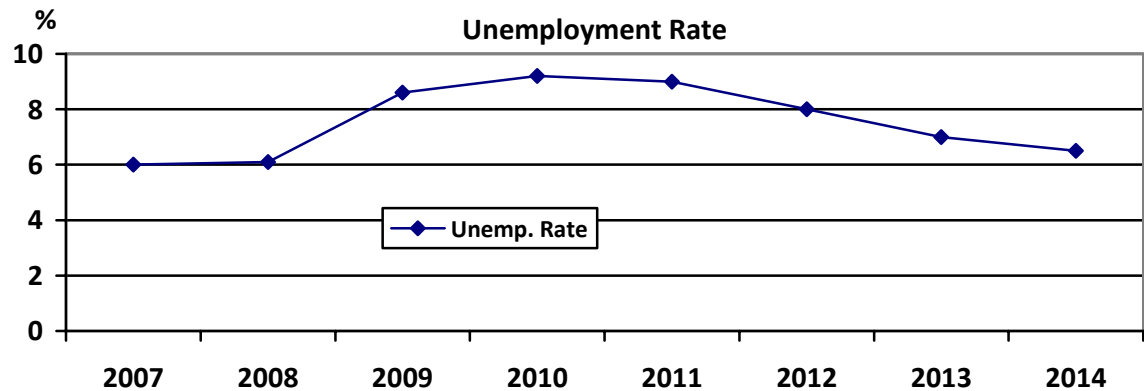
quarters of negative growth (2008Q4 thru 2009 Q2) we expect to lose about 2.9% of GDP on an annualized basis.

Turning to the labor market, note that the level of employment falls from 2008 Q4 through 2009 Q4 inclusive . At its lowest level, in 2009 Q4, the level of employment is only 99% of the 2007 level and is down 2.7% from its peak level of 2008 Q4. That is a loss of about 450,000 jobs over the recession. The level of employment does not re-attain that peak 2008 Q4 level until mid 2011.

### Chart 3



The rate of unemployment is one of our most important economic performance measures. As well, unemployment and the prospects of finding a job if and when needed, are one of our most important economic/social issues. The unemployment rate was on a steady downward trend from 2002 to 2007, reaching the lowest level since the mid-1970's at 6% in 2007. In 2008 the unemployment rate edged up only slightly. I expect the unemployment rate to reach 9.2% in 2010, peaking close to 10% on a monthly basis in early 2010. With the tepid growth of 2010 and employment growth lagging economic growth, I do not expect solid reductions in the unemployment rate until 2012. After the solid growth of the 2011 – 2014 year, I expect the unemployment rate to fall steadily to about 6.5% in 2014, but it is unlikely to fall all the way down to the 6.0% of 2007, even by 2014. Therefore, by this important economic/social indicator, we will not have near recovered from the recession, even by 2014. See chart 4.

**Chart 4**

### **Recovering the Output Lost During the Recession**

By 2014 the economy will have five years of positive growth (2010 thru 2014) behind it after the recession. While it will have been in “recovery” for five years from the perspective of positive economic growth, and it will have surpassed its previous peak level, it will not have “recovered,” even by 2014 from yet another important perspective. That is, recovering the output lost during the recession.

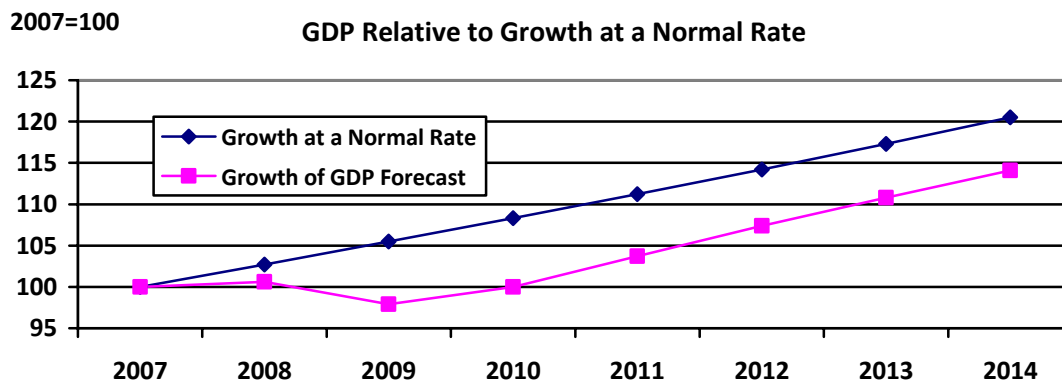
After a recession there is a significant amount of excess capacity in the economy, and, with appropriate fiscal and monetary policy we can expect the “output gap,” as defined by the Bank of Canada, to be eliminated over time, primarily by increasing economic growth. Indeed, my forecast for economic growth over the 2011 – 2014 period calls for an average rate of growth of 3.4%, relative to our “normal” sustainable pace of about 2.7%, over this period.

This movement to close the output gap will have occurred, only partly due to the above average growth over the 2011 – 2014 period. The movement to full capacity will have also been aided by a reduction in the potential of the economy to produce. This is a “lowering of the goalposts,” so to speak.

Over the recession people lose their jobs and they lose work experience which cannot be fully recovered. Business investment and innovation is lost, which is unlikely to be fully recovered. As well, the recession will cause some significant changes in the structure of the economy, especially in the financial and auto sectors. In 2014 I expect the output gap to be closed and

the economy to be in equilibrium. However, I expect the size of the economy to be only about 95% as large as it would have been had we experienced a “normal” 2.7% rate of growth every year over the 2007 – 2014 period, instead of the recession and recovery currently forecasted. See chart 5.

### Chart 5



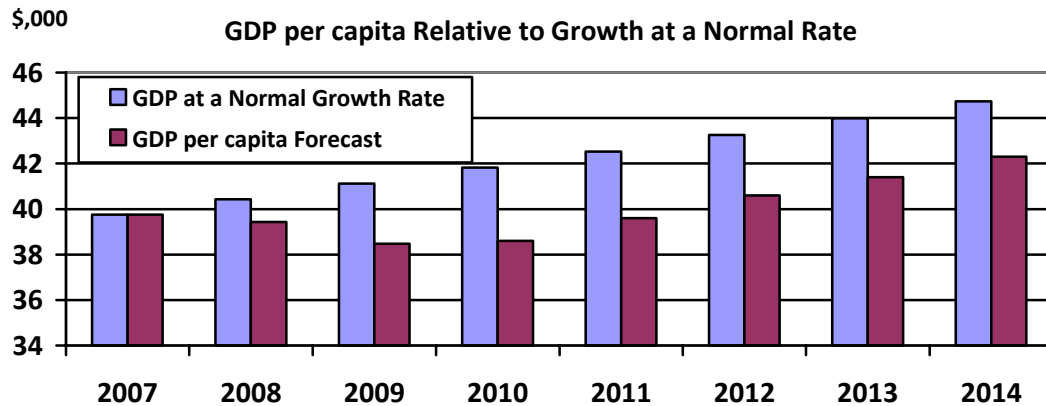
That is, even the years of above average growth over the 2011 – 2014 period will not be sufficiently strong to make up for the weak years of 2009 and 2010. Over the 2008 – 2014 period we will have lost the equivalent of about 2 years growth relative to if we had grown at a sustained normal pace over this period instead of the expected recession and recovery scenario. From this perspective, the perspective of the recovering being sufficiently strong to recover all of the growth lost over the recession years, the economy will not have fully “recovered,” even by 2014.

### Can We Recover our Standard of Living?

One of the most important measures of economic performance is our standard of living, most often measured by real GDP per capita. My April 2009 Special Issues piece “The Impact of Recession and Recovery on Our Standard of Living” focused entirely on this issue. In 2007 Canada’s real GDP per capita was \$39,760. Even though economic growth was slightly positive in 2008, it did not keep up with population growth, so GDP per capita fell. Over 2009, with GDP falling and population growing, our GDP per capita is expected to fall to only \$38,100 in the third quarter of 2009. This is 4.3% below the 2007 level. The 2007 level of GDP per capita will

not be re-attained until early 2012. After the recovery period, in 2014, our GDP per capita will be \$42,300, about 6.4% higher than it was in 2007. This represents a lot of recovery from the depth of the recession.

### Chart 6



Had the economy grown at the normal sustainable 2.7% pace every year, with population growth averaging 1% per year, our real GDP per capita would have grown at an average 1.7% per year. If our standard of living would have grown at an average 1.7% per year over the 2007 – 2014 period, as opposed to the recession and recovery pace, GDP per capita in 2014 would have been \$44,740, as opposed to \$42,300

expected in the recession and recovery scenario. That is, in 2014 our standard of living is forecast to be about 95% what it would have been if we would have had a “normal” 1.7% pace of growth per year over the 2007 – 2014 period. See chart 6.

### Conclusions

- With so much talk of “green shoots” and other signs of economic recovery, it is appropriate to examine the expected path of recovery, the various aspects of recovery – and to examine what we actually mean by “recovery” from this recession.
- The timing, the characteristics and the strength of economic recovery are critical to household, business, financial and government planning.

<b>Measure of Recovery</b>	<b>Date of Recovery</b>
<b>Rate of growth of GDP</b>	<b>2009 Q4</b>
<b>Rate of growth of Employment</b>	<b>2010 Q1</b>
<b>Level of GDP (from 2007 level)</b>	<b>2010 Q3</b>
<b>Level of Employment (from 2007 level)</b>	<b>2010 Q3</b>
<b>Unemployment Rate</b>	<b>2014 still higher than 2007</b>
<b>Level of GDP Relative to Growth at a Normal Pace</b>	<b>95% of potential level in 2014</b>
<b>Level of GDP per capita Relative to Growth at a Normal Pace</b>	<b>95% of potential level in 2014</b>