Recalculating Canada's Speed Limit

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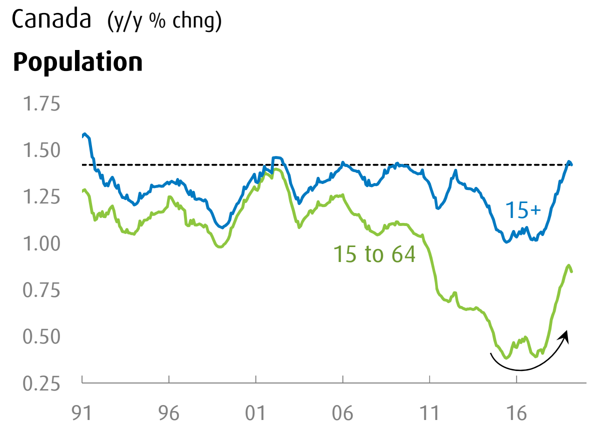
The Bank of Canada has some big announcements in coming weeks, but not on policy rates. In fact, it looks like the Bank will seemingly be on hold for an extended period of time—the last rate hike was almost six months ago already, and it could stay put well beyond this year. Instead, much of the focus in the coming Monetary Policy Report (on April 24) will be trained on two technical assumptions that are reviewed each April: the **estimate of the neutral interest rate** and **potential GDP growth**. We have covered the neutral rate before, and found that the longstanding official estimate of 2.5%-to-3.5% looks high. The low end of the range is likely closer to 2.0%, although Governor Poloz, in Nunavut on April 1, went out of his way to downplay the significance of the neutral rate, suggesting it was more of a guideline rather than a target for policy.

The other big decision will be on a **new estimate of potential GDP growth**. The Bank's point estimate has been drifting up recently to an average of 1.9% for the next few years, although the range is wide (latest estimate for 2020 is between 1.3% and 2.3%). **Changes to the potential growth estimate**—or the economy's speed limit—would be important as they **could drive changes in the estimated output gap**. If, say, potential is revised higher, this would imply that the output gap could widen even further, given that we see actual growth averaging only a bit better than 1.6% over the next two years. A wider output gap would further push out the timeline on possible future rate hikes, and may even raise the possibility of rate cuts at some point next year. On the flip side, a downward revision to potential would suggest a tighter output gap, and still keep rate-hike possibilities alive, even with our modest GDP growth forecast.

One factor that has changed significantly in the past year or so, which could have a big impact on potential—and why this is even an issue—is much faster-than-expected population growth. **Canada's overall population has bounced almost 1.5%** in the past year, **the largest percent increase in almost 30 years**. Even for the core working-age population (those aged 15-64), growth has suddenly popped higher in recent years, reversing a decade-long slide in the potential workforce (*Chart 1*). While this has made only a slight dent in the 10-year trend in the labour force growth rate, Canada's pace has consistently been faster than the U.S. since the turn of the century (*Chart 2*).

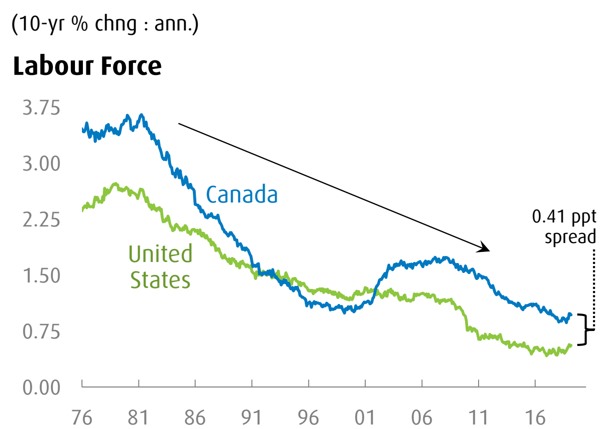
One reason for that faster labour force expansion in Canada is not just due to the pace of the underlying population, but also a **still-robust participation rate** (the share of the population actively in the labour market). While the overall rate has been sliding for a

Chart 1
Short Term: More Potential Workers



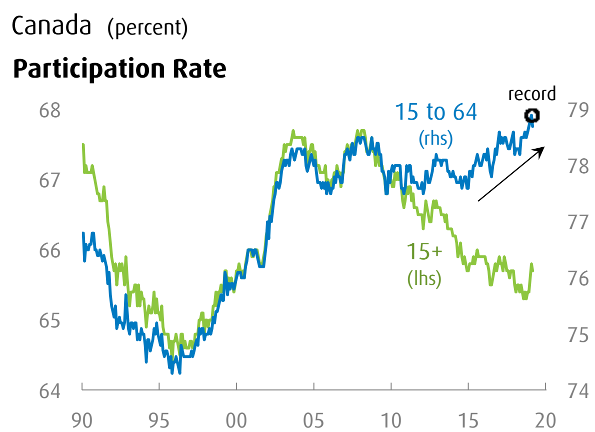
Sources: BMO Economics, Haver Analytics

Chart 2
Long Term: Fewer Potential Workers



Sources: BMO Economics, Haver Analytics

Chart 3
Partici-paction!



Sources: BMO Economics, Haver Analytics

decade, this is entirely a demographics story—it reflects the rapidly growing share of the population aged 65 and over, whom have a much lower part rate. Meantime, the part rate for those aged 15-64 has been grinding consistently higher to record heights in this cycle (*Chart 3*). Combining these two forces—a rapidly growing population and solid participation—has prompted a **recent burst in the overall labour force** (up 1.7% y/y in March; *Chart 4*). That represents an increase of nearly 30,000 per month, setting a much higher bar for job gains to hurdle each month, just to keep the unemployment rate from rising. Thus, in stark contrast to repeated warnings about Canada's possible decline in labour force population, we have just witnessed one of the largest increases in decades in the past year.

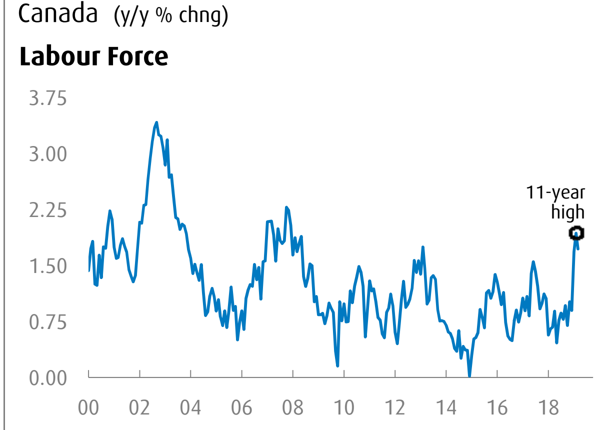
Given the much faster rise in the size of the workforce, does this alone raise the speed limit of the economy? Normally, yes; but, the rub is that productivity gains—the other major building block of potential growth—have been deeply disappointing. In the past four quarters, Canada has managed a meagre 0.2% gain in output per hour. And, hours worked per person have been slowly grinding lower over the past 20 years. That means **almost all of Canada's GDP growth has been driven by the brute force of rising employment**. Looking over a longer stretch, productivity gains have been a bit firmer at just above 0.8% per year in the past decade (*Chart 5*). But that still trails the U.S. pace by roughly half a point, effectively erasing Canada's head start from a faster-rising population.

Combining the two potential building blocks—labour force population and productivity—leaves Canada and the U.S. amazingly neck-and-neck in terms of overall growth over the past 20 years (*Chart 6*). Curiously, adding the long-run trends in productivity (just above 0.8%) and labour force population (just above 1.0%) gives us almost precisely the BoC's latest point estimate of potential growth.

For the Bank to meaningfully boost that estimate, it must also believe that the recent burst in population will be sustained, and/or productivity can improve meaningfully. We suspect that it will hold quite close to the latest estimates, with perhaps a slightly higher top-side to growth in the next few years. However, **longer term, the weight of demographics will bear down more heavily** on labour force growth; and, absent a serious revival in productivity, that means **the economy's speed limit will actually fall**, not rise, as we move into the 2020s.

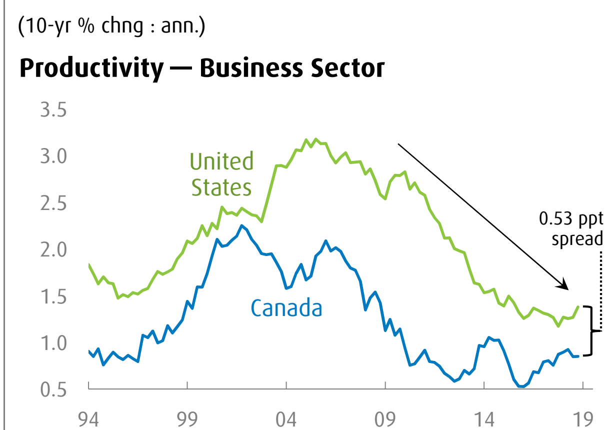
Bottom Line: Even with the sudden surge in Canada's labour force population, it appears that the economy's growth potential has barely budged from just under 2%, owing to paltry productivity. Further out, demographics will likely skew that figure even lower.

Chart 4
A Surprising Bounce



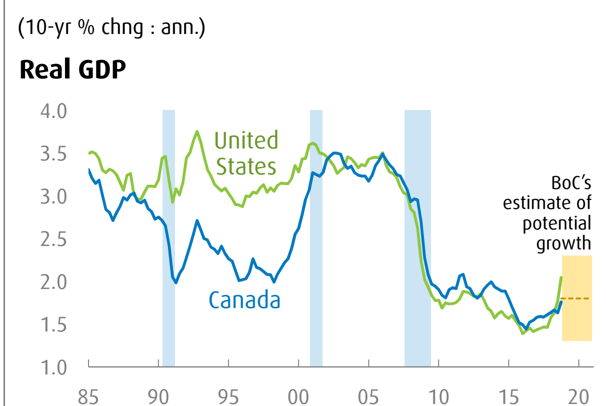
Sources: BMO Economics, Haver Analytics

Chart 5
Productivity: There's the Rub



Sources: BMO Economics, Haver Analytics

Chart 6
Long-term Growth—Staggeringly Similar



Full-height shading marks periods of U.S. recession
Sources: BMO Economics, Haver Analytics