ECONOMIC INSIGHTS
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How Great Can 2022 Be...Potentially?

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In 2021 we'll still be in the hands of our doctors. But further out, there are reasons to believe that growth in subsequent years could surprise consensus expectations to the upside. The nature of this particular crisis should lend itself to a solid demand recovery and the capacity to meet that demand, defying some of the caution that the prior cycle's sluggish recovery period engrained into post-recession forecasting.

These days, the conventional wisdom is that deep recessions leave a lower cap on the subsequent pace of growth. It's not just the challenge of reigniting demand, but there's also a haircut on the economy's capacity. That wisdom is evident in the Bank of Canada's current outlook, for example. It estimates that the economy's "potential growth rate," or in effect the ceiling for non-inflationary real GDP advances each year, has been cut to an average of just 1% over the next three years. While the Bank admits there's a greater range of uncertainty surrounding that forecast than normal, that mid-point projection is nearly a full percent slower than the annual potential growth rate seen in the three years pre-2020.

Can We Meet the Post-Covid Demand Surge?

In earlier work, we have already laid out reasons why we are optimistic on the demand recovery, both in Canada and in our key export markets. Household incomes have been well supported because lower-paid workers dominated the job losses (with the energy sector an important exception), and benefits were generous relative to lost income. Stateside, we're hopeful that Congress will agree to extend such benefits at least in the first quarter of 2021.

Those who have maintained employment have generally been middle-to-higher earners whose spending has been curtailed by social distancing, resulting in a build-up of excess cash worth 4% of annual consumption; that can fuel a lot of spending when people feel safe to come out of their home bunkers. As a result, we might not even need the fiscal stimulus that Ottawa projected for the next three years if that private demand is unleashed in full by 2022.

But has the economy taken a haircut in how well it can meet that demand? That has been the experience after some, but not all, recessions in recent decades. In the US, where we have a longer consistent series, the past two recessions significantly slowed potential growth in the subsequent three years (Chart 1), but we hadn't seen that after downturns in the 1970s and 80s.

In Canada, the Bank of Canada's slashing of the upcoming potential growth rate would vastly exceed what we saw after the prior two downturns. So we need to dig deeper into what drives the differences between recessions in terms of the severity of subsequent caps on growth.

Table 1

ECONOMIC UPDATE

CANADA	**20Q2A**	**20Q3F**	**20Q4F**	**21Q1F**	**21Q2F**	**21Q3F**	**21Q4F**	**2020F**	**2021F**	**2022F**
Real GDP Growth (AR)	-38.1	40.5	2.9	-0.5	4.9	8.9	7.0	-5.6	4.0	5.1
Real Final Domestic Demand (AR)	-38.4	50.8	-4.0	-2.7	5.1	9.8	7.6	-5.0	3.2	5.5
Household Consumption (AR)	-44.3	62.8	-1.7	-4.6	5.5	14.0	9.3	-6.6	4.1	6.5
All Items CPI Inflation (Y/Y)	0.0	0.3	0.6	0.9	2.2	2.0	1.9	0.7	1.7	1.9
Unemployment Rate (%)	13.0	10.0	8.7	8.7	8.4	7.5	6.9	9.5	7.9	6.3

U.S.	**20Q2A**	**20Q3A**	**20Q4F**	**21Q1F**	**21Q2F**	**21Q3F**	**21Q4F**	**2020F**	**2021F**	**2022F**
Real GDP Growth (AR)	-31.4	33.1	5.1	0.4	4.5	5.9	4.7	-3.5	4.1	3.6
Real Final Sales (AR)	-28.1	25.6	4.2	0.3	4.7	4.8	4.7	-2.9	3.4	3.6
All Items CPI Inflation (Y/Y)	0.4	1.2	1.2	1.5	2.8	2.3	2.5	1.2	2.3	2.3
Core CPI Inflation (Y/Y)	1.3	1.7	1.6	1.6	2.6	2.1	2.3	1.7	2.2	2.1
Unemployment Rate (%)	13.0	8.8	6.7	6.9	6.3	5.5	5.0	8.1	5.9	4.1

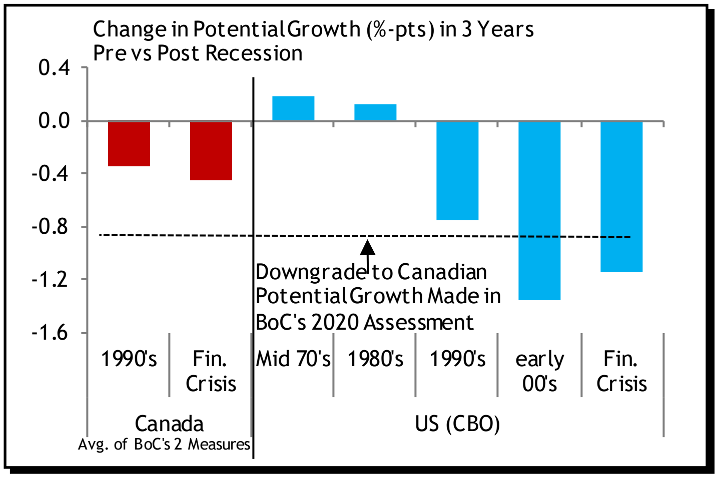
Table 2

INTEREST & FOREIGN EXCHANGE RATES

		2020	**2021**				**2022**			
END OF PERIOD:		**7-Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**
CDA	Overnight target rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
	98-Day Treasury Bills	0.11	0.25	0.35	0.35	0.35	0.35	0.50	0.55	0.75
	2-Year Gov't Bond	0.27	0.35	0.40	0.40	0.65	0.50	0.50	0.70	0.85
	10-Year Gov't Bond	0.77	0.80	0.85	0.85	1.25	1.10	1.20	1.35	1.40
	30-Year Gov't Bond	1.31	1.30	1.40	1.50	1.80	1.60	1.60	1.65	1.65
U.S.	Federal Funds Rate	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
	91-Day Treasury Bills	0.08	0.25	0.25	0.30	0.50	0.40	0.45	0.55	0.75
	2-Year Gov't Note	0.15	0.30	0.30	0.35	0.55	0.45	0.50	0.65	0.80
	10-Year Gov't Note	0.94	1.00	1.10	1.25	1.45	1.30	1.35	1.50	1.55
	30-Year Gov't Bond	1.70	1.70	1.75	1.85	2.20	2.00	2.05	2.10	2.10
Canada - US T-Bill Spread		0.03	0.00	0.10	0.05	-0.15	-0.05	0.05	0.00	0.00
Canada - US 10-Year Bond Spread		-0.17	-0.20	-0.25	-0.40	-0.20	-0.20	-0.15	-0.15	-0.15
Canada Yield Curve (10-Year — 2-Year)		0.50	0.45	0.45	0.45	0.60	0.60	0.70	0.65	0.55
US Yield Curve (10-Year — 2-Year)		0.79	0.70	0.80	0.90	0.90	0.85	0.85	0.85	0.75
EXCHANGE RATES	CADUSD	0.78	0.77	0.76	0.75	0.74	0.72	0.71	0.72	0.72
	USDCAD	1.28	1.30	1.32	1.34	1.36	1.39	1.40	1.39	1.39
	USDJPY	104	102	100	100	99	99	99	99	99
	EURUSD	1.21	1.20	1.19	1.19	1.20	1.21	1.20	1.20	1.20
	GBPUSD	1.33	1.32	1.31	1.31	1.32	1.33	1.32	1.33	1.33
	AUDUSD	0.74	0.76	0.77	0.78	0.78	0.79	0.79	0.80	0.81
	USDCNY	6.54	6.40	6.35	6.30	6.20	6.10	6.05	6.00	5.90
	USDBRL	5.10	5.00	4.80	4.80	4.50	5.00	4.80	5.00	4.50
	USDMXN	19.8	19.5	20.0	20.0	19.0	19.5	19.8	20.0	20.0

Chart 1

Instances of Potential Growth Hits in the US, Not So Much Canada



Source: Statistics Canada, BEA, BoC, CBO, CIBC

Will We Have the Workers?

There are two broad forces at play in determining growth in an economy's potential: how much additional labour you have to deploy each year at "full employment", and whether you have enough capital stock to grow what they can produce. Note that the discussion of underlying potential growth excludes the impact of containment measures that have been necessary to contain the virus and led to short-term limitations on supply.

Using US data, where we've seen larger dents to post-recession potential growth than in Canada, the lack of labour supply was the entire story in the last cycle and in the 1990s, and about half of the problem after 2001, as labour force participation was slow to recover (Chart 2). But that's not what the Bank of Canada fears for the 2021-23 period in Canada, with most of the reduction in its potential growth estimate coming from capital accumulation.

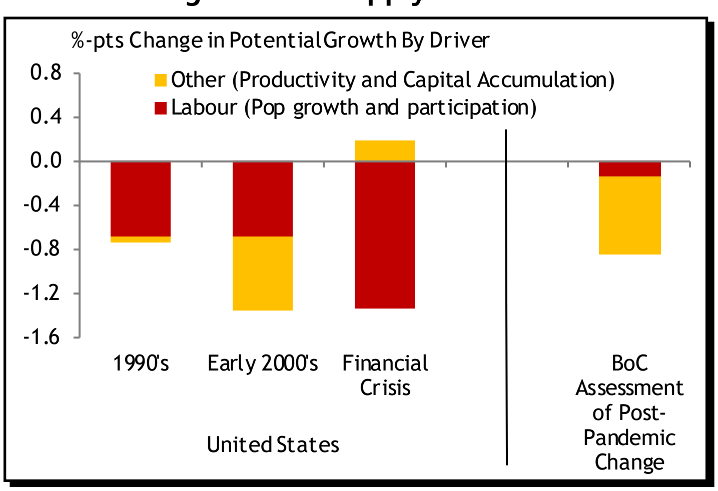
We concur that labour supply should not be a major constraint on potential growth in the years ahead. In the US, tighter controls on immigration limited the last cycle's growth prospects. While Canada has seen a soft year for permanent resident inflows in 2020, current plans are to make up for that shortfall under enhanced targets for immigration in the years ahead (Chart 3 left).

A large drop in labour force participation also hampered the US through the early years of the last expansion. Canadian labour force participation has, in contrast, rebounded quite well during this crisis (Chart 3 right), notwithstanding the challenges faced by parents due to disruptions in childcare and in-class education during the pandemic. Those challenges should be removed once all parts of the country return to classrooms, and as limits on daycare capacity are eased post-Covid. Ottawa is also still considering a national childcare program, although no details or timetable have yet emerged.

Labour supply can also be an issue if the workforce is ill-matched against the skills needed to perform the positions that come open. That will again be true to some extent after this downturn. But there are reasons to believe that skills mismatches will be less severe than what we have seen after other downturns that centred on manufacturing, where high-skilled positions vanished and were not replaced by similarly paid jobs.

Chart 2

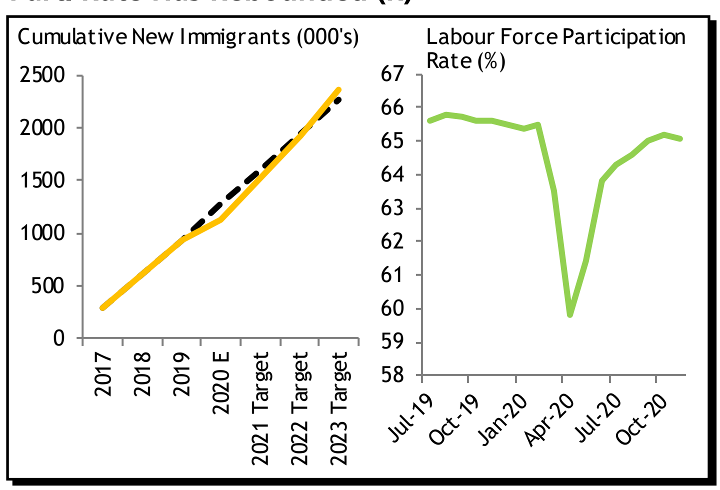
Impact of Recessions on Economic Potential Often Comes Through Labour Supply



Source: BEA, BLS, CBO, BoC, CIBC

Chart 3

Immigration Targets Suggest Catch-Up (L), Part. Rate Has Rebounded (R)



Source: Statistics Canada, Immigration Canada, CIBC

With the exception of the energy sector (which we will return to below) our previous research found that the majority of the jobs that have gone missing in 2020 are at the lower end of the skills spectrum. As demand for dining out, live entertainment and travel return, we won't face a lot of training requirement to find waitstaff or baggage handlers. Where there are key skills, we're confident that musicians will keep up their craft, pilots will remember how to fly, and so on.

True, there will be some sectors that don't make a full comeback to their former employment share, with in-store retailing being a key one. But unless consumption is permanently held back, there will be positions for similarly skilled workers in warehouse fulfillment centres, and with a bit of training, opportunities for truck drivers delivering the goods to homes. Much of Canada's workforce growth will come from immigration, and given that some qualify based on skills, they will be a source of additional labour in emerging, higher skilled positions tied to the greater use of on-line retailing and banking.

Will They Have the Tools?

The fact that job losses were in lower productivity sectors does mean that GDP didn't fall as far as we would otherwise have seen with such a sharp drop in employment. It, therefore, by extension, reduces the GDP gains we will get by reopening those same sectors in full. But that is built into the size of today's output gap. It doesn't relate to potential growth itself, which takes where we would be today at full employment, and where we can grow to at full employment a few years out. That's tied in turn to what the Bank of Canada is worried about, which is whether the growth in output per worker at full employment will be hampered by the lack of capital spending we're seeing during the downturn.

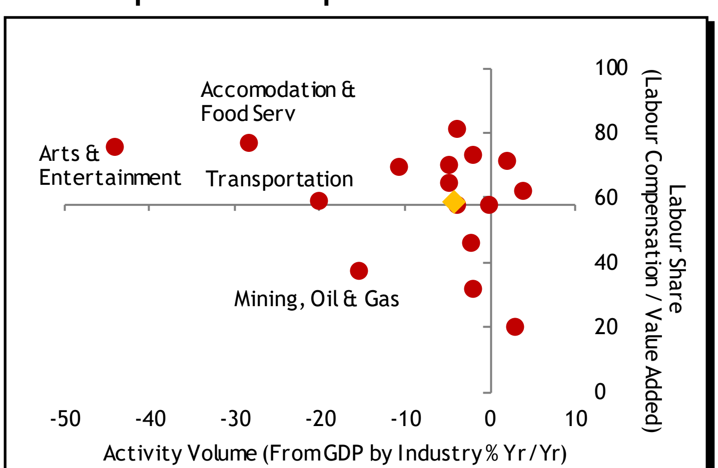
As in most recessions, capital spending has softened in this downcycle. But this will be less of a constraint on growth than in the past, with the energy sector a key exception. For one, growth will return to its pre-Covid trend of being tilted to services, and there's a huge overhang of existing physical assets available to meet that sector's needs. Office and retail vacancies were low in many parts of Canada prior to the pandemic, and we will no doubt be left with more elbow room in towers, malls and main streets in its wake, along with a lot of used equipment for restaurants. The hotels and airports are still standing, planes are under lease and ready to fly.

In sum, this isn't like a recession in which the steel mill or auto plant has been disassembled and carted away in the downturn, or in which the afflicted industries are ones that depend heavily on adding capital goods to labour in order to generate output. Energy aside, the weakest sectors in the economy, including arts/entertainment and accommodation/food service, are ones where the labour share of value added is higher than the average for the economy as a whole (Chart 4), and in transportation, we have lots of room to restore and then grow levels of activity on commuter subways and airlines.

Where capital equipment is critical, other than in energy, the situation looks more promising relative to past downturns. Manufacturing registered a relatively quick rebound in this cycle, and therefore has less reason to pull back from needed capital projects (Chart

Chart 4

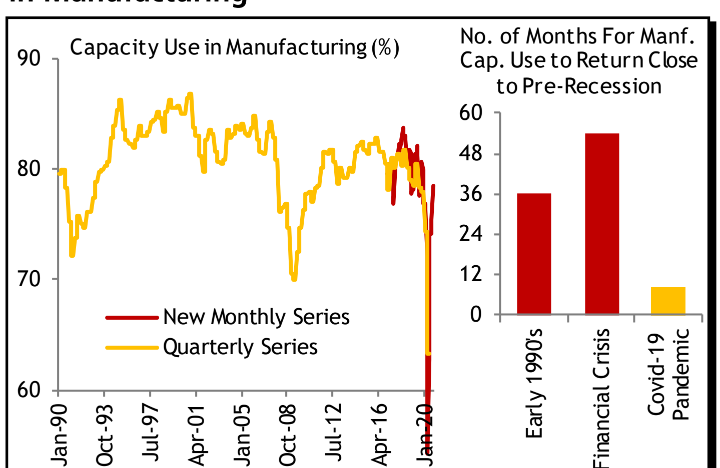
Excluding Oil, Biggest Demand Hits in Sectors That Don't Require Much Cap-Ex



Source: Statistics Canada, CIBC

Chart 5

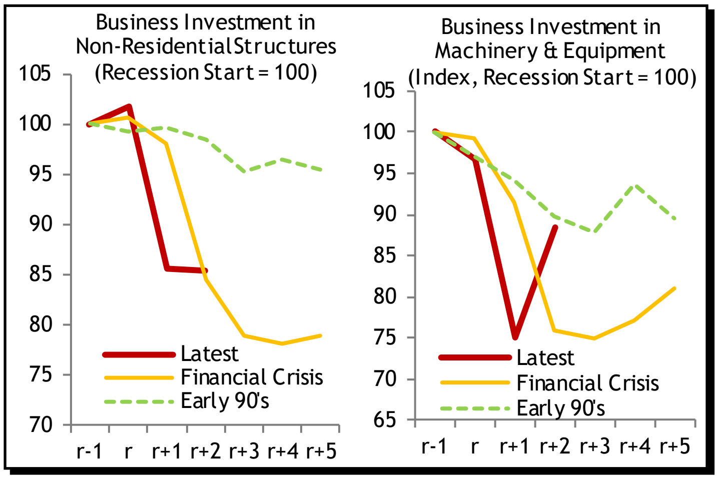
Capacity Use Has Rebounded Faster Than Normal in Manufacturing



Source: Statistics Canada, CIBC

Chart 6

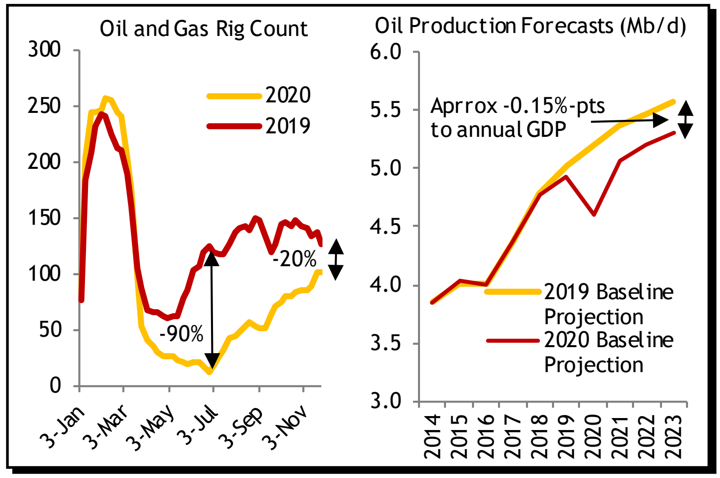
Investment in Structures Struggling, But Equipment Spending Improving



Source: Statistics Canada, CIBC

Chart 7

Oil Investment Depressed Even vs 2019 (L), Which Will Impact Potential Long-Term Supply (R)



Source: Bloomberg, CER, CIBC

5). A look at overall capital spending shows weakness in structures (some of which as we note above are available in abundance), but a nice rebound in equipment spending. While the decline in structures is similar to the drop seen during the financial crisis, the rebound in equipment spending in Q3 means we are doing better than during that prior period (Chart 6). It's also worth remembering that business spending wasn't exactly firing on all cylinders, and therefore contributing significantly to potential growth, even before the pandemic.

There is, as we've noted, one sector that stands out in terms of a reduction in growth potential. Again, we're not measuring the gap to current capacity, but how quickly that capacity will grow, and in the oil and gas sector we've seen a steady shrinkage in growth plans going back to a slide in crude prices in late 2014. That situation got even worse in 2020, and the soft levels for capital spending, now largely reduced to what's needed to maintain existing facilities, mean that oil production estimates have indeed been scaled back, even for the post-Covid period (Chart 7). But the scale of that hit relative to the national economy doesn't appear large enough to justify the Bank of Canada's pessimism on overall potential GDP.

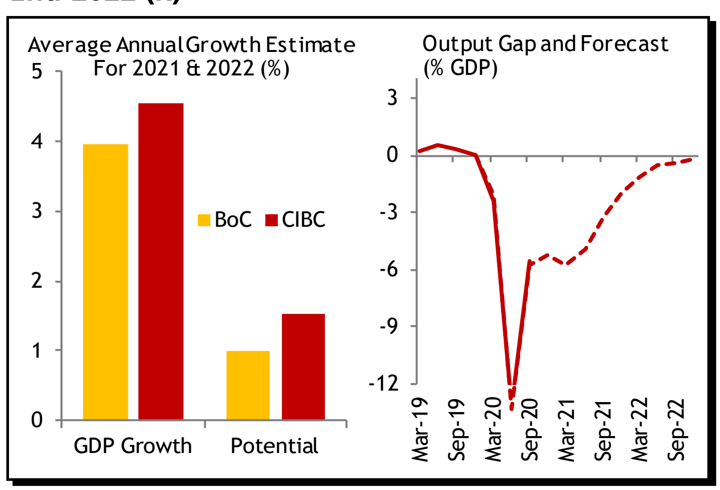
The Upshot: Better 2022 Growth, But No Earlier Need to Hike Rates

We're optimistic for reasons we've outlined elsewhere about having a big demand push in the second half of 2021, but also not as concerned about limits posed by the economy's non-inflationary capacity. Given similar forces at play in the US, including a likely return to greater immigration numbers under Biden, we're also optimistic about America's prospects. Both countries will have a transition year in 2021 as vaccines roll out, but will see an upsurge that will bring solid gains in excess of what their central banks are projecting for 2022 (Table 1, page 2).

For the Bank of Canada, these two forces will roughly cancel out in terms of when the output gap is closed. Our forecast implies that there is still a small output gap at the end of 2022 (Chart 8). That would allow policy interest rates to stay on hold at the front end, but longer-term rates to drift higher as QE efforts ease off and markets price-in better days ahead (Table 2, page 2).

Chart 8

CIBC Forecasts Are Higher For Actual and Potential Growth (L), Leaving Output Gap Almost Closed by End-2022 (R)



Source: BoC, CIBC

Rate hikes look to be on tap if all goes according to forecast in 2023. If the Canadian dollar hasn't weakened by then, as we believe it will, the Bank will likely wait until after the first Fed hike (which we also project for 2023) to avoid taking the loonie to excessive levels for exporters.

This is, in sum, a good news story for Canada in the post-vaccine world of 2022-23. And of course, we need a bit of good news to tide us through what looks to be a tough winter ahead.