ECONOMICS

THE WEEK AHEAD

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Head fake (The Week Ahead)

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We do not envy the poor souls at Statistics Canada that are in charge of producing the nation's productivity numbers on a quarterly basis. They probably wouldn't bet their paycheques on how accurate the numbers are. It is almost an impossible task — but somebody has to do it. Unfortunately, however, those numbers are important. Their fingerprints can be found in bond and stock market valuations and are key ingredients in determining your mortgage or GIC rates.

What's important here is not that productivity growth in Canada is subpar, but that it is getting worse. In fact, for the first time on record, productivity growth has been negative for nearly four consecutive years. Now, it is very possible that something is wrong with the measurement. But statisticians in the US are facing the same methodological issues, only to show surging productivity growth south of the border.

Beyond methodology and accuracy, there is another reason to be cautious in acting on the productivity numbers, especially at this critical point of the cycle. While the monthly Canadian GDP production numbers suggest that GDP growth in Q4 was better than expected, the quarterly expenditure numbers will have the final say, and they probably will not be quite as strong. Regardless, the economy is clearly sluggish, and if you look closely, you will find that the labour market is starting to dance to the same tune.

Now, during economic turning points, productivity exhibits elements of counter-cyclicality — largely due to the change in composition of labour during the early stages of an economic slowing. The most obvious example is perhaps the Covid recession. The asymmetrical nature of the crisis led to a situation in which most of the job losses were in low-wage industries or among low-wage workers in high-wage industries. That of course led to a significant increase in labour quality, which single handedly accounted for nearly two-thirds of labour productivity growth in mid 2020. That, of course, was not a "real" increase in productivity, and surely enough it was reversed very quickly after.

Fast forward to today's situation: reflecting the still tight labour market, employment quality in the US has been trending downward in recent quarters. And if history is a guide, productivity growth will follow (Chart). In Canada, the recent rapid widening in the performance gap with the US was largely due to the surge in the number of non-permanent residents (NPRs) in general, and foreign students in particular. We estimate that there are currently 500k foreign students in the Canadian labour force beyond what is officially reported. With labour market conditions starting to soften, those low productivity jobs will be the first to go, leading to an increase in employment quality, which should trigger a temporary improvement in reported productivity growth. The Bank of Canada and the market should not confuse that improvement with a real, structural productivity gain.

Bottom line: when the next productivity numbers come out — take a look but don't read into them too much. Any improvement will be nothing more than a head fake. We think the Bank shares that view. Quietly behind the scenes, the Bank of Canada is shifting its attention away from the concept of the output gap (which is a desperate attempt by economists to turn the art of economics into science, and relies heavily on productivity growth), into something that you can touch, such as the unemployment rate.