How to Heal the Deep Scars from the Financial Crisis

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Six years after the onset of the global financial crisis, the Canadian economy is still stumbling through a lacklustre recovery. Gross Domestic Product (GDP) is still well off its pre-recession growth path, too many workers remain unemployed or under-employed, and Canadian exports are far below the level we would normally expect at this stage of a recovery. It is reasonable to ask whether the Canadian economy will ever return to the longer-run growth path economists predicted before the recession started.

Many macroeconomic theories and models are based on the idea that temporary shocks and recessions do not have permanent effects on the economy. Output falls, businesses shrink, and workers get laid off – but these effects get reversed as the recovery takes hold and then strengthens further. We eventually return to our starting point or, more correctly, to the growth path we were on before the shocks occurred.

Yet economists have for many years also considered the possibility of "hysteresis" (pronounced his-ter-ee-sis), the idea that the economy's long-run path may actually be permanently affected by short-run shocks. Non-economists might refer to the scars left behind from the wound of a recession.

One way to see hysteresis at work is to think about how businesses behave during a recession and then in the subsequent recovery. During small recessions most businesses shrink, their output falls, and they lay off some workers. Profits are low and the outlook is grim. But when the recovery takes hold, they ramp up their production again, and eventually their workforce as well. A few years later, there may be no signs that a recession ever occurred.

But with deeper recessions, and especially those that last longer, more firms shrink to the point where they actually go bankrupt and close down their operations. They lay off all their workers, sell whatever assets they can, and go out of business. What happens when the economy finally recovers? Some of those bankrupt owners start up businesses again, possibly in a different sector or region. But many do not. Their production and employment numbers do not return, and nor do their exports to foreign countries.

Bank of Canada Governor Stephen Poloz made exactly this point a few weeks ago when he released the Bank's latest *Monetary Policy Report* and discussed the failure of Canadian exports to rebound – even in the presence of recovering foreign demand and a weaker Canadian dollar. When noting that exports from many sectors have fallen by over 75 percent since 2000, he said "capacity in these sub-sectors has simply disappeared".

The effects of hysteresis can also be viewed in the labour market. During normal recessions, some workers see their hours cut and many others lose their jobs altogether. But several

months later, after economic recovery usually takes hold, most if not all of these workers are employed again with their normal level of hours.

With deeper recessions and slower recoveries the story is quite different. After workers have been unemployed for several months, their skills atrophy and they begin to lose their ability to regain employment. Employers who are finally hiring are naturally looking for people with up-to-date skills and without large holes in their résumés. The long-term unemployed rarely appear near the top of their hiring lists.

In Canada today, even though the aggregate unemployment rate is reasonably low at 6.8 percent, the extent of under-employment and long-term unemployment is quite high. Over 20 percent of part-time workers are looking but unable to find full-time jobs; over 20 percent of the unemployed have been jobless for between 6 and 12 months; and 7 percent of the unemployed have been searching unsuccessfully for over a year. The longer these people remain without jobs, the harder it will be for them to ever get back to work.

What is the implication of all this for Canadian policy? First, we should not expect the economy to "automatically" return to its pre-recession growth path. The scars of hysteresis are real, and powerful.

As a result, monetary and fiscal policies need to be more expansionary than would otherwise be appropriate for this stage of an economic recovery – precisely to counteract the forces of hysteresis and to push the economy back to its pre-recession level of productive potential. Only then should we allow ourselves to be satisfied with our economic performance.

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