Fidelity Connects

Live with Don Drummond

Don Drummond, Former TD Bank Chief Economist

Pamela Ritchie, Host

Voiceover: Hello and welcome to Fidelity Connects – a Fidelity Investments Canada podcast – connecting you to the world of investing and helping you stay ahead.

We're pleased to welcome a special guest on today's podcast - renowned economist Don Drummond to discuss the health of Canada's economy.

Don has held several senior roles at the Federal Department of Finance, including Associate Deputy Minister, where he was responsible for economic analysis, fiscal and tax policies. Don later served as Senior Vice President and Chief Economist at TD Bank, and he is currently Chair of Canadian Centre for the Study of Living Standards; Fellow-in-Residence at the C.D. Howe Institute and a member of the Expert Advisory Group to the Canadian Institute for Climate Choices.

As the Canadian economy has changed rapidly over the last few years, investors continue to grapple with how to navigate its volatile landscape. With Canada's annual inflation rate sitting at 7 per cent, pushing food and gas prices higher, how can policy makers slow inflation and grow Canada's economy?

We pose these questions and more to Don today, with Don sharing his unique perspectives with host Pamela Ritchie. Enjoy.

This podcast was recorded on October 5, 2022.

[00:01:15]

[00:02:00]

Pamela Ritchie: It is a great pleasure to welcome you, Don Drummond. Thanks for joining us.

[00:02:03]

Don Drummond: Oh, you're most welcome. Thank you.

[00:02:05]

Pamela Ritchie: Very glad to have the chance to speak with you today. Let's do the zoom out; let's do the macroeconomics to begin with, ultimately. Are we, broadly speaking, coming out of 15 or so years of economic weirdness because there's been so much stimulus in the economy? Actually, are we going to go back to something that used to be called normal?

[00:02:28]

Don Drummond: The remarkable thing, basically, going back to the early 1990s, is we have had low and stable inflation. On the fiscal front, until COVID hit, we've had fairly stable fiscal conditions really going back to the mid 1990s. If you think about the original inflation targeting agreement between the Bank of Canada and the Government of Canada, it worked remarkably well for 30 years. The fiscal correction in the 1990s worked remarkably well and it delivered stable, low inflation. In turn, that delivered very low interest rates. Of course, everybody got hooked on it and thought that would last forever. In fact, a very particular aspect in the last couple of decades is interest rates being below the economic growth rate of the economy. Again, everybody seems to think that will continue forever, including Canada's own parliamentary budget office, although that's never happened for any sustained period of time. There have been some very unusual features of the Canadian economy from a longer perspective and now we're seeing some prospect that maybe they're not permanent, as we've seen the prospect...

[00:03:34]

Pamela Ritchie: Is that good or bad?

[00:03:36]

Don Drummond: I just think it's normal. It's probably not good or bad. It also depends on your perspective. The world has been unkind if you're a net saver. You've done reasonably well in equity markets, but if you're risk averse and been invested in fixed income, everybody knows the mathematics on that. You're typically not even covering the rate of inflation on a pre-tax basis never mind an after-tax basis. If you've been a borrower, yeah, it's been pretty good. You got to build up a lot of borrowing at a very low interest rate and, of course, now is a prospect that may come back and bite you as interest rates go up. So, it depends *[on]* who you are, what your positions are. It's just been different. We're in a period of adjustment right now, but I think the reality is when we get through this adjustment, things will probably be different. The interest rates on a sustained basis will be higher than they've been in the last couple of decades. I think over time the interest rates will be equal or maybe slightly above the rate of growth, which will go back to a more normal historical pattern and what would be predicted, in theory, as opposed to these exceptions we've had for some time now.

[00:04:42]

Pamela Ritchie: Rather than asking you when that will happen — it's hard to know and maybe I'll ask you that later — if we were more in balance with the rate of growth and where interest rates stood, what would be propelling the growth? Where is the growth going to come? Looking at Canada, but you can put it certainly in global terms. Where is the growth going to come from?

[00:05:05]

Don Drummond: The simplest model of economic growth is simply growth in the labour force, which we primarily derive from population growth and then growth in productivity. We'll take them in turn. The Canadian population growth has been growing as high as 1.4% because we've been adjusting to higher immigration levels. As immigration collapsed, it's been down more like 1% over the last couple of years. The government has very high immigration levels, 450,000 new permanent residents. If and when we hit, that we'll probably for a while see population growth a little bit above 1%. Since 2000, that's a record of 22 years now, we've been locked in an average productivity growth rate of 1%. If that was all that was going to happen, you would think a normal growth rate would be 2% but we have to inject the population ageing.

[00:05:52]

We are, on balance, moving out of a prime age population concentration into one of an older population. In my mind, the sustainable longer term growth rate of the Canadian economy is about 1.5%. We see the Parliamentary Budget Office uses 1.7%; the Conference Board recently did 1.6%. In the 2021 budget, the Department of Finance, went with much higher growth numbers, 1.9 and 2.1, for unfounded reasons, I think, assuming a real resurge in productivity growth alone. *[The]* 2020 budget, they brought that down to a lower growth rate, but let's call it somewhere between 1.5 and 2, which will be slower than we've seen for a long time and way slower than we saw in ancient history of Canada, the 1950s, '60s and '70s, when we had a much younger population, and we had a surge of women into the labour force.

[00:06:43]

Pamela Ritchie: Will that do it, though, Don? It's lower; it's going to be lower than decades ago, but is that going to be somewhat in line, will it be competitive with the rest of the world? Put it into context for us, if you will.

[00:06:59]

Don Drummond: The rest of the world is either in that world already and has been for a while or is similar to us. The demographics in the United States, for example, aren't terribly different than ours. The demographics of Japan are in the extreme. They're a much older society and they've had a very low birth rate for a long time. It is interesting, the Japanese authorities keep shooting out objectives like 1 1/2 and 2% growth, but they keep recording 1/2 to 1%. Unless they get a surge in the female labour force participation — and they don't really seem to *[audio cuts out]* the cultural features that prevent that from happening — they're going to be a lower growth economy even than us. The rest of the world will be generally slowing down to that kind of growth rate that we did. Most countries in... Europe is older than us, so that process is somewhat more advanced than other economies. We will get a taste of the situation we've seen in the United Kingdom and France and Germany, where on an average basis, their growth rates have been modest for some time.

[00:08:00]

Pamela Ritchie: To bring it a little closer into the near term, if you will, a few general questions on the type of action we're seeing out of central banks, whether, ultimately, the U.S. dollar strength, what it does... does that actually provide some opportunities for Canada? We look cheap, we can sell our goods, perhaps, comparable goods on the market tradable for less. Put the U.S. dollar in perspective for us as Canadians.

[00:08:26]

Don Drummond: We have roughly a 20% efficiency on average in the productivity level in Canada relative to the United States. Everything else equal, that famous economist term, if you want to be competitive, we have to have a dollar that's about a 20% discount. It was about that for several years; up and down a little bit, but it's kind of trending around that 20% discount. Of course, now it's somewhat lower than that. Fears that the Federal Reserve Board will raise interest rates more than in Canada, the pullback on the commodity prices; those two aspects, particularly sensitive. There is a potential, although our historical record is we have not typically taken advantage of a weaker Canadian dollar and it has tended to raise Canadian costs. Crudely put, that is often called the lazy manufactures hypothesis, that opportunities have been available, but they've tended to use it to let costs rise up than to increase market share. Maybe a bit different this way, but the particular aspect that hurts our prospect is business investment has been very weak in Canada for a number of years, so we're not really improving that competitive position. That's not just in the COVID period; that weakness in business investment has been apparent well before that.

[00:09:39]

Pamela Ritchie: What can policy do, ultimately, to light a spark underneath that? It's a big question, but what do you think… couple of the main reasons that doesn't move?

[00:09:49]

Don Drummond: There are some general ones, and they tend to be blunt instruments. Of course, we have to offer a competitive tax environment. When Canada, beginning in 2000, started to lower the corporate income tax rate for a while, we had a corporate income tax rate well below the United States —although that was really more true on paper than practice because the United States has so many specific incentives and loopholes and most companies were not facing that statutory rate. The so-called Trump tax reform, which was not a reform at all, all they did is cut the statutory rate and left all the bells and whistles and exemptions in place, so that doesn't qualify as reform, I say. But it basically wiped out the tax advantage that Canada had.

[00:10:30]

While there's enormous pressure, certainly populist pressure, to increase the corporate tax rate in anything we would want to go the other way, interprovincial trade barriers has to be the craziest ideas one ever has heard. We're trying to establish free trade unions with the rest of the world, and we don't even come close to having one in Canada. That's not shooting yourself in the foot, that's taking one right into the head. We've improved it somewhat, but it still exists. There's all kinds of regulatory barriers that we need to improve on that side, too. We need to use our strong education system to more advantage on a competitive advantage and create the nexus between universities and colleges so the workforce are tighter. There's some aspects where we could make greater use of our strengths, but these are all fairly general and blunt instruments. They're not magic bullets by any point, any stretch.

[00:11:19]

Pamela Ritchie: Do you think, broadly speaking —just to get into the weeds on whether the Fed will pivot, might pivot, what markets seem to read into it one way or the other—, I guess the question is, do you think there's going to be persistent inflation and therefore the Fed will not pivot? Because markets seem to be really hoping or thinking that they will.

[00:11:38]

Don Drummond: We have two key factors that will drive monetary policy and neither one of them suggest a happy ending. The first one is lags. It is the stereotypical ocean liner that takes a long time to turn around. Between a change in interest rates and a change in real activity is easily a year. There could well be another year between the change in real economic activity and the effects on inflation. When you put an interest rate setting in place, you don't really know whether it's going to work and is adequate for as long as easily a year or perhaps two years.

[00:12:12]

The second aspect is just human behaviour. The banks around the world, including the Bank of Canada, are undoubtedly stung by the acquisitions that they blew it; and they did. Let's face it, they all did it. They applied stimulus excessively and held it in place for too long. As a human reaction, when you have erred and are accused of erring in one direction, you're not going to repeat the same mistake and you're going to tend to err on the other side. They will be mighty fearful of saying, "well, maybe the present rate of interest rates levels is enough to do it, but if you're going to take that chance, because if it's not right and it's not adequate, inflation is still running hot in two years", you're going to be accused again of blowing it in the same direction you did before. There's a natural human tendency to go in the opposite direction and go too far.

[00:13:00]

The one caveat to the long lags is the very high debt levels in all economies and all sectors should make the economies more sensitive to an interest rate change than it was before. A particular feature in Canada has been the popularity of variable interest rates. It's not like you're waiting for five years for someone's long-term mortgage to really bite them. They're going to bite much sooner. That may suggest you might not have to hit the interest rate as hard and as long as you might have had to do historically. Two bad omens and maybe one that offsets that a bit.

[00:13:35]

Pamela Ritchie: For many years Canada has been kind of stereotyped or known globally for agriculture, oil, gas, commodities. Is that still valid or has Canada's economy changed, diversified to what extent?

[00:13:50]

Don Drummond: No, I don't think it has. What is really interesting, I find, and I even find that in the work — you mentioned my connection with the Canadian Climate Institute — the bulk of their work on clean growth is how to take what we think of as – quote unquote– dirty industries and make them less dirty. It's not really driving what you would think as clean growth. If you think about our financial sector, we're not well-positioned to do that. It's difficult for new growth, non-resource industries to get funding.

[00:14:23]

Pamela Ritchie: From the banks?

[00:14:24]

Don Drummond: From banks and angel investors, all kinds of sources. From birth we're taught how to multiply everything by 10 because most things in the United States are 10 times in Canada, but the number of wealthy people, the number of investment funds, the number of people that are willing to provide funding to risky and hold and patient capital is way more than a factor of 10 to 1 in the United States. It's harder to create that space. We do it and, even if you take the energy sector, which is a large share, –and some people think it'll disappear, I don't think that's at all–, if it's going to be successful, and some firms will and some firms won't, it'll be unrecognizable in 5 or 10 years because it'll be much cleaner but it'll still be a big portion of Canadians' economic activity.

[00:15:09]

Pamela Ritchie: Can you talk about that a little bit more, it'll be unrecognizable?

[00:15:13]

Don Drummond: Well, the emissions for everybody will be a lot lower and a lot of the energy companies will reduce their concentration in fossil fuel activity, and they'll go more to renewable. We already see that, and hydrogen will be a factor. They may be the same companies but it's the typical thing; some will recognize the need and make the conversion and it will be radical, and others will try to cling to the old ways, and they will disappear. That's been the nature of disruptive change in an economy. I think we'll still have a very prominent energy patch; it'll just be a different one than we've had historically.

[00:15:51]

Pamela Ritchie: Do you see disruption coming within five years? That's positive if you're look at it from the environmental side of things. I think investors are really grappling with that type of question.

[00:16:00]

Don Drummond: I think there's a lot of uncertainty. I thought until the pandemic hit that this time it's real; that most of the world is going to embrace a cleaner growth objective. Most probably will not succeed, but will try mightily to hit their climate change objectives. We've always seen any excuse to slow that is always [indecipherable]. Of course, the economy is softening right now, we have inflation problems, and you can already see governments backing off on that. In Canada we have an enormous amount of uncertainty. We have on paper a plan to see the carbon price go to $170 a ton. Do we know when? It's supposed to be achieved by 2030. which is not that far away. You would think...

[00:16:45]

Pamela Ritchie: What is it now?

[00:16:47]

Don Drummond: We're only at 50 right now and have barely gone to that, so we've got a long way to go. But, if you are a business trying to plan for that future... first of all, you don't even know if it's going to come. From the rhetoric and the policy positions, if we were going to have a Conservative government between now and 2030, they may not proceed with the carbon tax increases at all. We don't know; that's what they say. We don't know, even in the case of the Liberal government, if and when they're going to put those into place, so an enormous amount of uncertainty. If the world follows that course and let's assume for the moment they will, almost everything will be different. There will be huge reallocations across sectors and every firm will be differently and some newer firms will come along and grow, and others will disappear, which is the normal process when there's a disruptive force operating in an economy.

[00:17:42]

Pamela Ritchie: Do you think generations coming up will hold older generations to that, though? I mean, that does seem different this time.

[00:17:52]

Don Drummond: I'm always amazed that there isn't almost an intergenerational revolution at the moment because, on so many fronts, the younger generation is being handed a bad hand by my generation. Think about it, they're being handed unaffordable housing, maybe becomes slightly more affordable if we see some kind of adjustment. We've only had a slight one so far, but they can't buy a home. They are going to have to use all of the resources available to them for climate change, and that's not even for climate mitigation. That will simply be to adapt to the inevitable climate change because we have left it far too late to unambiguously change the climate change damage. A lot of that is going to be adaptation. On top of that, if we didn't need to give them any other problem, we're handing them very high government debt burdens and handing them a high debt burden. You sort of wonder why that voice has not been more active and say "wait a minute, you can't give us that kind of deal".

[00:18:56]

I always liken it back on my experience when we had a need to reform the Canada Pension Plan in the late 1990s and almost all the burden was handed to young people. At that time a young person could have bought the equivalent of the Canada Pension Plan for 5.5% of their salaries, but the premiums were set at 9.9%, meaning for their entire life they were going to subsidize the people that came before them. But they didn't say very much and that comes back to that stereotypical, quieter political voice of young people and the very strong voice of older people. I think we need the young people to say, "wait a minute, just climate change alone is enough of a burden to occupy us, don't pile all the rest of the stuff on us as well".

[00:19:41]

Pamela Ritchie: Fascinating. This is a question coming in from everyone joining us here today, how are some ways that Canada can, in fact, improve productivity? I might just say, are there ways through this transition that you seem to think we will, in fact, be going through?

[00:19:59]

Don Drummond: I'll first just deal with the labour force because I said if population growth be around 1 and the labour force growth probably more like a 1/2 or .6. That's if we continue to have the sort of labour force participation rates we've already got. But there's at least three aspects where we can and should change that. The first one is our very large Indigenous population in Canada, which is at a very low labour force participation rate. I did a calculation in 2017 that, if we were closing the education gaps for Indigenous Canadians to non-Indigenous Canadians, that would likely drive 20% of the labour force growth in Canada over the next 20 years, so that is a huge ... that's a small population but they have huge education gaps and that leads to huge labour force gaps, but the population is mightily skewed towards a large younger cohort. The Indigenous population is much younger. So, there's one aspect to it.

[00:20:58]

The second would be Canadians with disabilities, which have a very low labour force participation rate and there are steps that can and should be made to do that. The female labour force position rate in Canada has risen a lot over the recent decades. It's close to the male labour force participation rate, but it's skewed in a number of different ways. For example, quite low in the STEM sector and, even where females are present in the STEM sector, they're often earning less salaries. There's a lot of work still to be done on that front with some progress to be done. I don't think we could take the demographics as a given. Even if we do go back to having 450 new permanent residents coming in, we can and should do a much better job of the economic and social inclusion of them. They tend to have a lower labour participation rate and lower income, particularly in the early years.

[00:21:47]

We've had this controversy right now with a huge number of foreign trade nurses and how we've been very slow to do the credentials. We've got a bit of a fire going under that right now, but that's been a persistent problem. The backlog –there's about 18,000 foreign trade nurses in Canada in that backlog that we haven't gone to. So, there's things that can be done on that.

[00:22:08]

On the productivity front, interestingly, one of the silver linings from having a very tight labour market and 1 million job vacancies is companies will be forced to use labour better. They will have to use them more efficiently and they'll have to do some substituting machinery because you can't walk down the street without a help wanted sign out somewhere and [indecipherable], so that may be the saving. We have to invest more in technology and the key aspect of it, from labour productivity, is we have to get business to increase their investment. The conditions should have been reasonable; they've had, despite the effects of COVID, in on average corporate profits and corporate retained earnings have done quite well in the last couple of years. Interest rates, even despite the increase, are still relatively modest. The ingredients there should be better. It's not just that we have a small market, 39 million people, but we can and should be tapping into the world as part of our market.

[00:23:07]

Pamela Ritchie: Interesting. Let's look at housing prices. You mentioned this, but just to get your thoughts further on this. Do you see a correction in Canadian housing prices? Would it be a prolonged correction?

[00:23:22]

Don Drummond: I think there will be a correction, but I think it will be relatively modest. Economics is all about supply and demand and the demand is going to be rising very strongly. It will keep coming back; 450,000 new people coming in and they'll need some form of housing. Even if there are apartments, we have a very low vacancy rate in apartments with very little construction and that just displaces somebody else. We don't have nearly the number of housing starts or the number of rental apartments being built to accommodate that kind of population. Most of the immigrants go to three centres and, particularly, almost all of them are going to eight centres, so it's going to be a particular a problem. We've also seen in the last couple of years a bit of a movement out of the urban centres for affordability reasons to more remote areas. Unless we see some kind of collapse in the demand, and I don't see it, that's not going to happen.

[00:24:15]

The only thing that may ease it is we see a radical change in the positions on density rolls and, as interest, and you'll see some pilot projects like in Edmonton, where they are not going to permit anymore new single housing detached homes in certain areas, but there's a lot of pushback into that and there's a lot of hesitancy for other reasons to do that. The population who already have the single homes want single homes in the neighbourhoods and they don't want that density. The mathematics suggests we have limited space and an area like the GTA, unless you destroy the Greenbelt, and for all good reasons we shouldn't do that, you've got to build up the density, but we're not really doing that to a great extent.

[00:24:54]

Pamela Ritchie: This is so fascinating. Just a little bit on, ultimately, recently what you think the provincial governments could be doing going forward. You mentioned the trans-provincial trade and the hiccups that have been there for a long time and are still there and, as you said, getting a bit better, a lot of provinces actually were able to pay down debt during the pandemic, certainly the oil-producing provinces, is there something that you think, policy-wise, provinces could be perhaps putting money towards in some way in pursuit of better policy?

[00:25:30]

Don Drummond: For all the governments, federal and provincial, we have to realize that there's a bit of a head fake going on with the recent improvements, particularly the reporting of the big surplus from the federal Government the first three months. The first effect of inflation is to immediately inflect incomes and affects tax revenues. The programs that are indexed to inflation are indexed with a lag, so they're not affected immediately. The hit of the higher interest rates on interest payments goes to the term structure of debt and, particularly, the provinces, the term structure of debt is relatively long. You would expect inflation to have a positive impact on balances at first, but that should wane over time. I don't think their fiscal situation is quite as rosy as it might seem at the moment.

[00:26:15]

The number one challenge for provinces –and I would say, for Canada as a whole–, is our health care system. It was in trouble before COVID hit, but it got pressed to the limit of that. Basic facts like 4.9 million Canadians are not registered to a primary caregiver and we've seen the difficulty in emergency rooms closing down the surgeries. We have unprecedented wait times for health services in general and off the map of any other country for wait times for specialists. We have a very bizarre public coverage in which we're 70% public and 30% private, but it's less than half public coverage for pharmaceuticals and less than 10 for everything else.

[00:27:01]

Pamela Ritchie: You mentioned when we spoke off air a little bit that, in fact, one of the silver linings perhaps from the pandemic is that patients, customers, have become more demanding and maybe that will spark change. Can you just explain that a little bit? We've got about a minute here, but I just want to get your thoughts on that.

[00:27:18]

Don Drummond: Here we need to flashback that scene in Network where the announcer says, "I'm mad as hell and I'm not going to take it anymore." The public is getting to that position. They've never wanted to see anybody tamper with health care simply because they thought it was better than what was faced by many people in America, and they thought it was great. There's a realization it's not great. We spend a lot of money for mediocre results and we have unacceptable wait times and these things are going to get worse. We have fewer and fewer physicians are choosing family medicine. The nursing supply has been buoyed by 12,000 nurses coming back from retirement. They're not going to stay; they're going to go back to retirement in the next couple of years. We're going to have a doubling of the population of 75+ and we're probably short about 100,000 personal support workers already. You can do the math of what's going to happen and nobody's planning for this. We're going to have huge problems on that front and that's going to be the number one problem that's going to grab the attention and hopefully grab the attention of the provinces.

[00:28:13]

Pamela Ritchie: I was going to say, will we see that in the votes?

[00:28:]

Don Drummond: The distressing thing, if you look at the last couple of long-term fiscal statements put out by Ontario, they've shown health care costs in at 2%. That's not going to address the problems. I don't think it's a real altruistic portrayal of the challenges before them. If the economy grows at 1 1/2 and, if and when we get back to 2% inflation, that means the revenues will grow about 3 1/2% to address the ageing of the population. Healthcare costs will probably grow at least 5% or 6%. How do you make that work out?

[00:28:47]

Pamela Ritchie: Well, I guess we'll have to see whether it does come through the votes, ultimately. Don Drummond, it's fantastic to have time to have you share your thoughts with us. Really appreciate your time. Thank you for joining us.

[00:28:57]

Don Drummond: You're welcome.

Ending: [00:28:59]

Thanks for listening to the FidelityConnects podcast. If you haven't done so already, please subscribe to FidelityConnects on your podcast platform of choice - and if you like what you're hearing, leave a review or a 5-star rating.

Fidelity mutual funds and ETFs are available by working with a financial adviser or through an online brokerage account. Visit fidelity.ca/howtobuy for more information.

And, while visiting fidelity.ca, you can also find information on future live webcasts - and don't forget to follow Fidelity Canada on Twitter and LinkedIn. Thanks again, see you next time.

[end of podcast]