

Solving Canada's Participation Rate Puzzle

Emanuella Enejajor

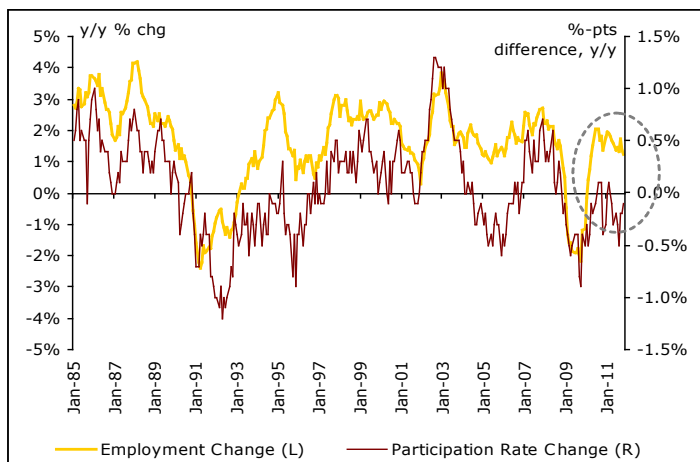
Despite recent weak hiring, Canada boasts one of the most robust employment recoveries in the G7, regaining all the jobs lost during the recession, and then some. But other metrics, namely falling labour force participation, suggest the pulse of Canada's jobs market is not beating quite as healthily. Taking a closer look at the drivers of Canada's falling participation rate, we find that although changing individual behaviour has contributed to that trend, shifts in the composition of the working-age population have had the greatest impact. And as baby boomers age, demographic trends could put further downward pressure on participation rates, and thus unemployment rates—lessening the need for the Bank of Canada to ease policy if hiring remains persistently weak, and increasing the need for prompt rate hikes when a more aggressive recovery takes hold.

Cyclical vs. Structural

True, the participation rate is linked to cyclical demand for labour. Rates tend to fall when employment growth is negative or slow, and increase when employment booms faster than a 2% annual pace (Chart 1). Since the recovery, the annual pace of employment growth has averaged around 1.5%, historically too slow to coax discouraged potential workers back from the sidelines.

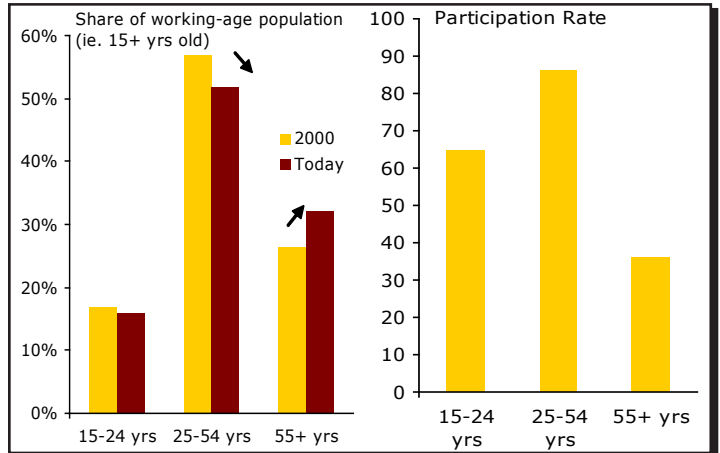
But demographic trends are also at play. The composition of Canada's population has shifted in the last decade, and older cohorts with a lower participation rate have

Chart 1—Speedy Hiring Typically Lures Canadians into the Workforce



Source: Statistics Canada

Chart 2—Working-Age Population Shifts to Groups with Low Participation Rates

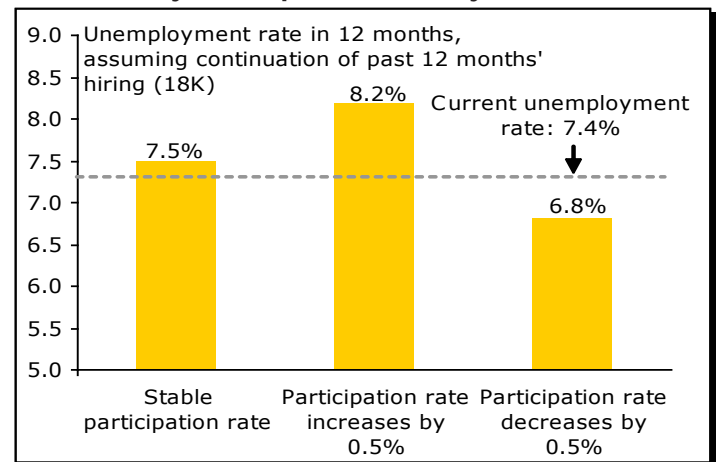


Source: Statistics Canada

taken up a larger share (Chart 2), owing to the aging of the baby-boomer generation. That cohort, born between 1947-66 is marching ever more notably towards retirement, with the oldest boomers turning 65 next year, slightly above the average 2010 retirement age of 62.

Were Canada's falling participation rate driven primarily by demographics, then the fall could persist regardless of cyclical re-hiring, restricting labour force growth and exerting downward pressure on the jobless rate. Indeed, the dynamics of the participation rate have a measurable impact on the unemployment rate—a given pace of hiring could mean starkly different things for the jobless rate depending on labour force participation (Chart 3).

Chart 3—Why Participation Rate Dynamics Matter



Source: Statistics Canada, CIBC

Why the Drop Won't Stop

In order to determine the drivers of Canada's falling participation rate, we use the methodology of Hotchkiss (2009). We use an equation (see endnote) to decompose the change in the peak-to-trough labour force participation rate into three factors: (1) cyclical trends captured by the change in the participation rates of the 15-24 year-olds and 25-54 year-olds, (2) delayed retirement trends seen in the change in the participation rate of 55+ year olds and (3) structural changes in the population share of the three demographic groups. We examine not only the drop in the participation rate since 2008 Q1, but also the drop triggered by the last recession in Canada.

We find that while declines in labour force participation for youth and peak-age workers explains a significant part of the fall in the participation rate, shifting demographic shares is a more prominent factor (Chart 4). Moreover, the importance has increased relative to the last recessionary period. In other words, the rising share of 55+ year-olds in the working-age population has made the decline in aggregate labour force participation an arithmetic reality, due to their lower participation rate.

Thus, continued demographic trends could put downward pressure on the participation rate, cushioning any increase in the jobless rate in the event of tepid hiring. That will take the pressure off the Bank of Canada to initiate a new round of rate cuts in coming quarters even if hiring is slow. Our deeper look at participation rates suggests that our previous call for the unemployment rate was too pessimistic, and we have lowered our call, consistent with our finding.

Arrested Retirement?

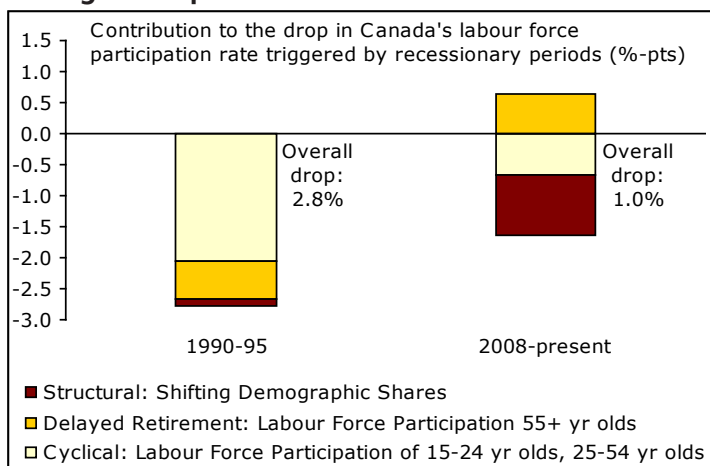
Delayed retirement of older workers has seen the participation rate of 55+ year-old individuals rise in the past few years. But that rise has stalled in recent quarters, as the population of mostly retired 65+ aged individuals has soared (Chart 5, left), dragging down the overall participation rate of the 55+ year old group. That trend is unlikely to reverse in coming years (Chart 5, right), as the wave of 65+ year-old baby boomers picks up. That could limit a key source of upward pressure on the aggregate participation rate.

Some regions in Canada are feeling the strain of adverse demographic trends more than others—namely Atlantic Provinces and Québec, where older populations, low birth rates and provincial outmigration will continue to weigh on economic growth, posing a challenge to provincial fiscal health in coming years.

A Very Different Story South of the Border

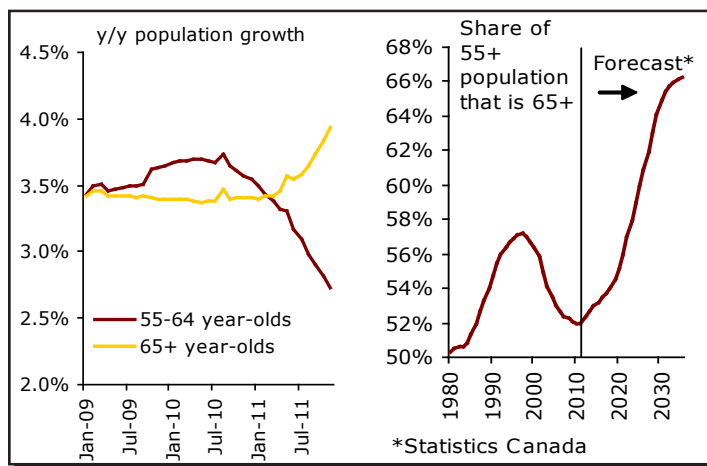
The US has also seen a drop in its participation rate since the onset of the crisis—a fall much deeper than in Canada. Using the same methodology to decompose the change in the US aggregate participation rate, we find that falling participation rates of specific demographic groups have contributed much more significantly to the drop in the aggregate labour force participation rate, with demographic factors playing a less prominent role (Chart 6). That finding is consistent with data on discouraged workers in the US, who, if added to the US labour force, would boost the unemployment rate by 0.7%. In Canada, the boost would be a tame 0.2%.

Chart 4—Demographic Shifts Increasingly Explain Falling Participation Rates in Canada



Source: CIBC, Statistics Canada

Chart 5—The Retirement Surge Begins



Source: Statistics Canada, CIBC

We simulate participation rates in North America to demonstrate the contrasting labour force realities in the US and Canada, using two scenarios of cyclical weakness and recovery. The first scenario foresees declining participation rates of youth and peak-working-age individuals, in line with the recent recession. In the cyclical recovery scenario, the participation rates of both groups gradually re-attain their respective pre-crisis peaks. Note that in both cases, the participation rate of 55+ year-olds is expected to flatten as delayed retirement is offset by a larger 65+ retired population. We find that in both Canada and the US, cyclical weakness would see the aggregate participation rate decline through to 2014. However, in a second scenario of a cyclical recovery, the trajectory for Canada and the US are quite different.

In the US, a cyclical re-entry of workers into the labour force could temporarily offset negative demographic trends, pushing up the aggregate labour force participation rate. So it may take a surprisingly long time for the Fed to see the unemployment rate decline to levels it feels comfortable with. That suggests near-zero rates for several quarters beyond an upturn in hiring—beyond the mid-2013 timetable outlined by the Fed, and conceivably well into 2014.

In contrast, in Canada, any re-entry of the small number of discouraged workers would be swamped by unfavourable demographic trends, likely keeping the labour force participation rate falling (Chart 7). So an eventual upturn in hiring could prompt the Bank of Canada to tighten much earlier than the Fed, as structurally falling labour force participation exacerbates declines the jobless rate.

Canada's Long-Term Demographic Issues

A well-known point, emphasized by the Bank of Canada, is that an aging population will put downward pressure on trend GDP growth in Canada. The Bank expects that trend labour input will grow at 0.9% next year, tapering off to 0.7% in 2014. But just how could demographic trends play out over the next decade? Although the Bank does not publish projections on potential output beyond 2014, given demographic projections from StatCan, we estimate labour force growth will slow to around 0.5% in the next 10 years. Absent more aggressive gains in productivity beyond the past decade's pace, Canada's potential GDP growth could shrink to around 1.5% by the end of the decade from about 2.0% in 2012.

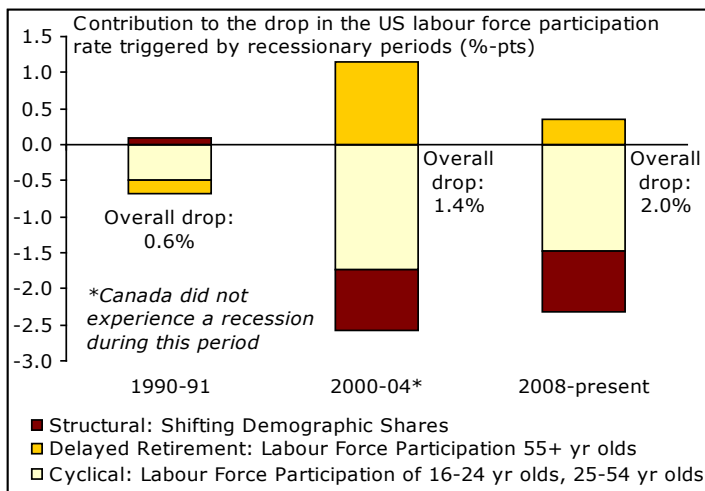
The economy's reduced non-inflationary potential means that even with slow growth, Canada's unemployment rate may not move up high enough to justify Bank of Canada rate cuts presently built into the yield curve for next year. Longer term, the larger issue is that with a slower trend rate of growth, Canadian governments will find it more difficult to use revenue gains to bring deficits down to earth.

ENDNOTE:

$$LFPR_t - LFPR_{t-1} = \sum_i \{ [LFPR_t^i - LFPR_{t-1}^i] p_t^i + [p_t^i - p_{t-1}^i] LFPR_{t-1}^i \}$$

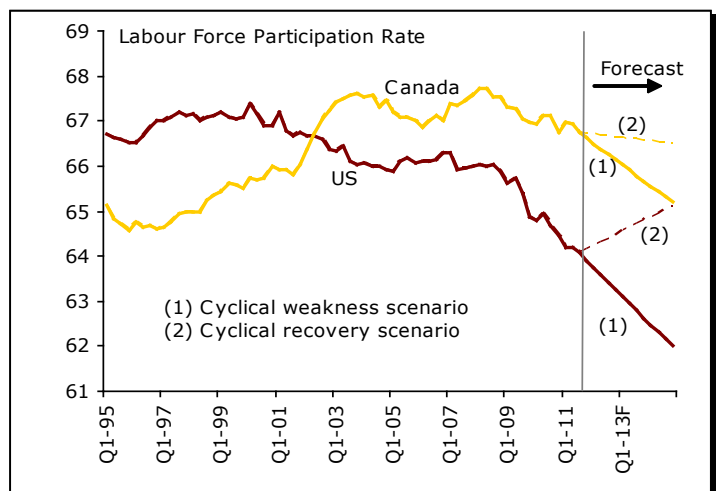
where the change in the aggregate LFPR can be broken down into the change in each demographic group's LFPR (weighted by the population share in the current period) plus the change in each demographic group's population share (weighted by the group's prior-period LFPR). See Hotchkiss, Julie 2009. *Changes in the Aggregate Labor Force Participation Rate*. Federal Reserve Bank of Atlanta Economic Review 94, no. 4: 1-6

Chart 6—US Participation Rate Weakens on Cyclical and Structural Factors



Source: US Bureau of Labor Statistics, CIBC

Chart 7—Canada's Participation Rate Under Structural Downward Pressure



Source: Statistics Canada, US Bureau of Labor Statistics, CIBC