The 2014 Outlook:

Moving from Constant Crises to Broad-Based Growth

Statement by

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Before the

Committee on the Budget

U.S. Senate

Chairman Murray, Ranking Members Sessions, and members of the committee, thank you for the opportunity to appear before you today to discuss the 2014 economic outlook and ways in which the Congress can enhance prospects for broad-based economic growth in the future.

My name is David Rosenberg and I am the Chief Economist & Strategist at Gluskin Sheff, a global wealth management firm based in Toronto, Canada. I have 30 years' experience in economic analysis, largely in the financial sector, including a 10-year stint at Merrill Lynch, initially as the Toronto-based Chief Canadian Economist and Strategist, and then as Chief North American Economist in New York from 2002 to 2009.

Over the past six months or so, I have become more optimistic over the durability of the economic expansion, and see the risks of a recession as minimal. The leading economic and financial indicators I pay most attention to tell me we can probably expect real GDP growth of 3% this year and slightly more than that in 2015. The most pronounced tailwinds are actually the fading of the many headwinds that held back the recovery for the past four years. Notable among these headwinds:

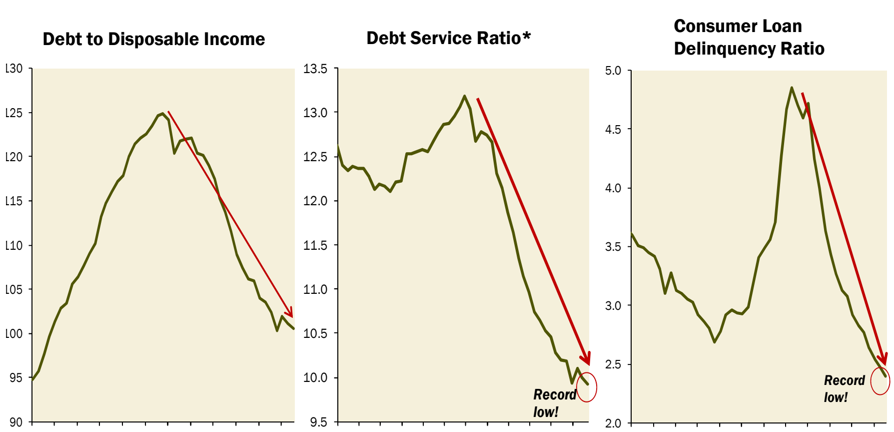
1. The end of the fiscal tourniquet at the state and local government level.

2. The end, at least for now, of the budgetary restraint at the Federal level.

3. What appears to be the end of the painful deleveraging cycle at the consumer level; and it is encouraging to see that the entire parabolic surge in debt-to-asset, debt-to-income and debt-to-net worth ratios that we saw during the household credit bubble from 2002 to 2008 completely unwind over the past five years.

CHART 1: HOUSEHOLD BALANCE SHEET REPAIR

United States: Household Debt Ratios
(percent)



*Debt-service payments as a share of disposable personal income
Source: Federal Reserve Board, Gluskin Sheff

4. Considering that most real estate agents consider 6 months' supply of unsold homes to be a balanced market, the current national housing unsold inventory backlog, which is now sitting at a tight 5 months' supply, leaves me comforted that homebuilding will continue to contribute to the economic expansion. Housing has not been a headwind for years, but the sector should still play a key supportive role for the economic expansion this year.

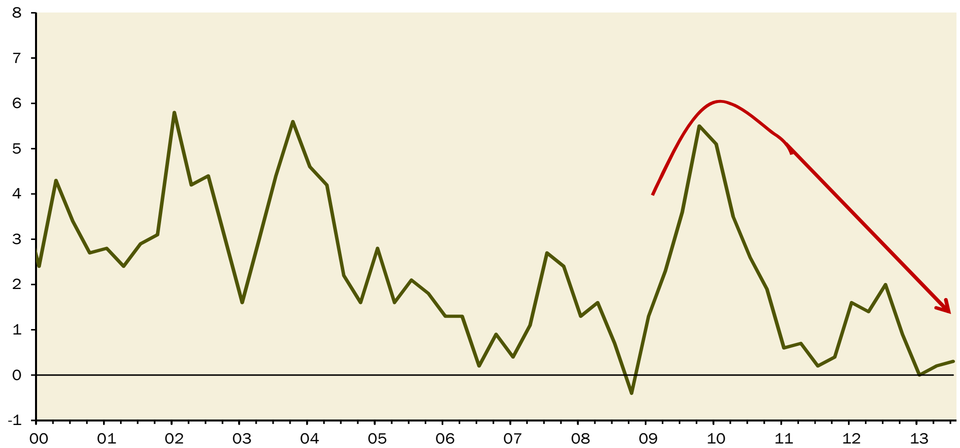
5. The final headwind that has ended is the European recession. We are seeing signs of a pulse along the periphery, as tentative as they may be. Even a fragile recovery is far better than a contraction, which is what we endured over the past three years in a part of the world whose share of global GDP is as large as the United States. A return to European growth will act as an important offset to the sudden slowing and instability we are now seeing in the Emerging Market region.

So with all that uplifting economic commentary, the question is what can go wrong and what is it that we could be missing? My principal concern actually comes down more to what I am seeing on the supply side of the economy as opposed to the demand side. Let me explain. When economists discuss their economic outlook, right away they talk about their GDP growth forecasts. But GDP is not the only measure of economic activity even though it is the one that we primarily focus on. GDP is all about spending — consumer spending, housing spending, business spending, government spending and the like. But there is also the supply side of the economy which receives scant attention but is equally important, and the reason it is ignored is because the Commerce Department doesn't report on 'aggregate supply' every quarter as it does with 'aggregate demand' via the GDP report – for aggregate supply, we have to actually roll up our sleeves and do the work ourselves. The inputs that go into the supply side of the economy are basically two-fold: productivity growth and labor force growth.

So we just got the real GDP data last week, and it was encouraging to see the demand side of the ledger finish 2013 with a 2.7% year-over-year growth rate. But over the past year, productivity has slowed to a mere 0.3% growth rate which is abnormal for this stage of the economic cycle; in fact, only in the sclerotic 1970s has productivity been so weak in the mid-part of the business cycle. And growth in the labor force is also running at only 0.3%, so here we have another measure of economic activity, from the supply side, growing at 0.6% when you combine productivity and labor force growth; and yet another measure, from the demand side, otherwise known as real GDP, running at 2.7%. I'm sure if we had come off a year when GDP growth was only 0.6%, we would all be very concerned about a deficiency of spending. Thankfully, that is not a problem we have to deal with. The problem is squarely on the supply side.

CHART 2: PRODUCTIVITY GROWTH*

United States
(year-over-year percent change)



**Real output per hour of all persons in the nonfarm business sector*
Source: Bureau of Labor Statistics, Gluskin Sheff

CHART 3: WEAK GROWTH BRINGS ALONG LOWER UNEMPLOYMENT?

United States

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Gluskin Sheff

There are two items I would like to bring to the Committee's attention. One is a report that Harvard Professor James Stock and Princeton Professor Mark Watson published in 2012 titled *"Disentangling the Channels of the 2007-09 Recession"* which concluded that 80% of the weaker economic growth experienced this cycle was due to the structural impediments on the economy stemming from supply-side deficiencies. The other item is a speech that Fed Chair Janet Yellen gave on March

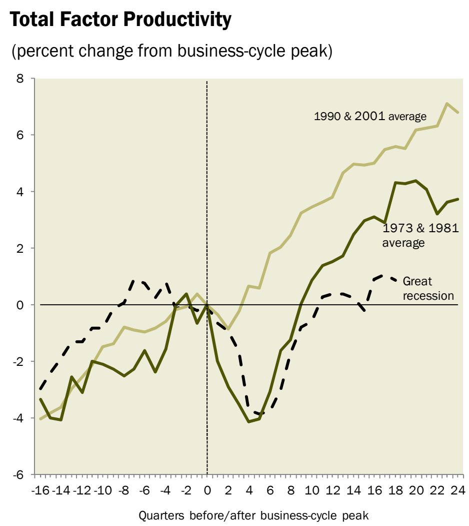
4th of 2013 titled *"Challenges Confronting Monetary Policy"*, where she stated, and I quote, *"the slow recovery has depressed the pace of capital accumulation, and it may also have hindered new business formation and innovation, developments that would have an adverse effect on structural productivity"*.

CHART 4: SUPPLY CURVE SCLEROSIS

United States

"The report cites three estimates of the extent to which a lower trend rate explains the weak recovery. One, published in 2012 by James Stock of Harvard University (now a council member) and Mark Watson of Princeton University, derives America's potential growth rate from the long-term average of variables such as employment and productivity. ***This approach concludes that 80% of the two-percentage-point shortfall in growth relative to other recoveries is caused by slower potential."***

The Economist, March 23, 2013

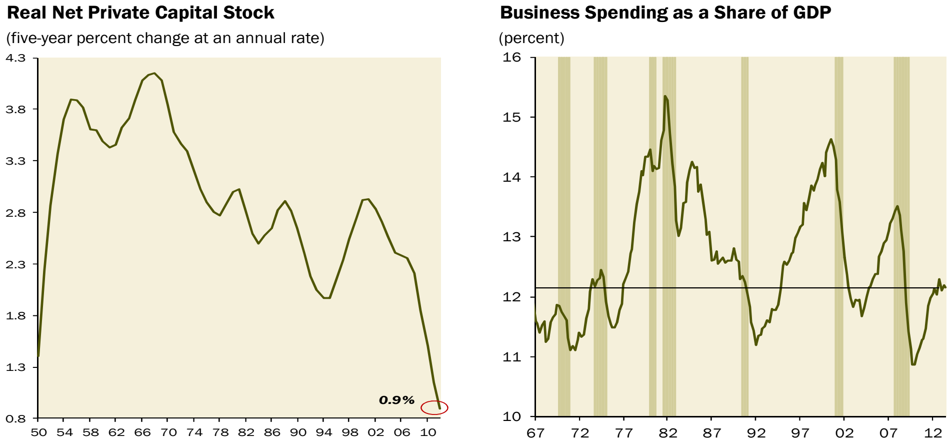


Source: Federal Reserve Bank of San Francisco, The Economist

And that is indeed what has occurred. Productivity growth has suddenly stalled for a country whose long-term productivity trend has been close to 2% on an average annual basis, and the question is why? From my vantage point, the reason is because the growth rate in the private sector capital stock over the past five years has been practically stagnant, just 1% annually, which goes down as the weakest pace in any half-decade period in the post-world-war-two era, and there is a direct, though lagged linkage, between capital formation, or lack thereof, and productivity growth down the road.

CHART 5: WEAKEST GROWTH IN THE PRIVATE CAPITAL STOCK IN SIX DECADES

United States



**Shaded regions represent periods of U.S. recession*

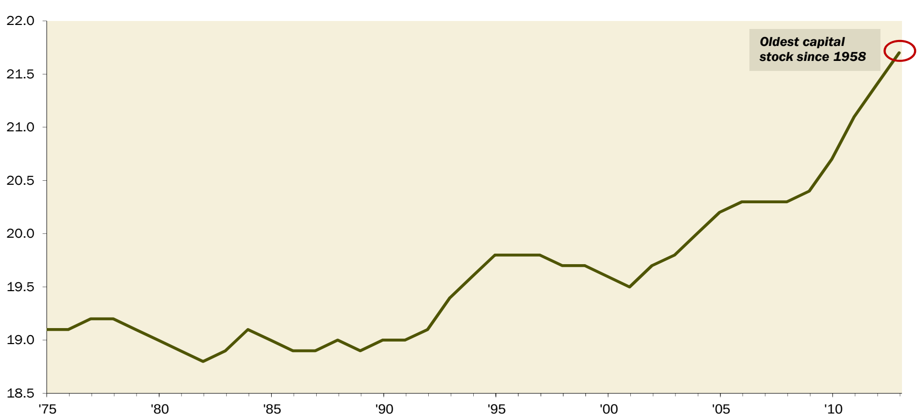
Source: National Bureau of Economic Research, Federal Reserve Board, Gluskin Sheff

So corporations have done a superb job in using its $2 trillion cash hoard towards delivering returns to shareholders via share buybacks and dividend payouts, but have not done much in the aggregate to invest organically in their own businesses beyond replacing obsolescence or depreciation. The data tell us that we have seen inadequate real business fixed investment to the point where the erosion in the capital stock is now impairing productivity growth. In fact, the average age of the private sector capital stock is fast approaching 22 years — that is total plant and equipment. The last time the private sector capital stock was this old and obsolete was back in 1958.

CHART 6: AN AGING AND AGED CAPITAL STOCK

United States: Average Age of Private Fixed Assets

(years)



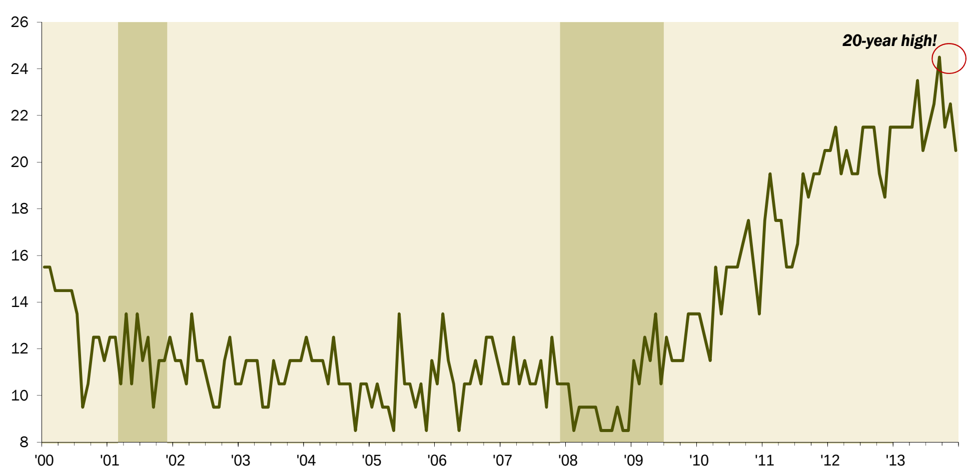
Source: Bureau of Economic Analysis, Gluskin Sheff

The situation is all the more unusual because the cost of capital could scarcely be lower than it already is, so something must be holding back 'ex ante' expected rates of return on long-term capital projects, or containing the animal spirits of CEOs and CFOs, and maybe this all boils down to merely injecting some certainty or clarity from a public policy standpoint to entice the business sector to reinvest in the real economy and arrest this disturbing downtrend in productivity.

One survey I pay very close attention to is the National Federation of Independent Business monthly poll on confidence in the small business sector. The 600-plus small businesses that are part of this survey are asked, among other things, what their top impediment is. In December, 43% of them said taxes and government regulation, and very few times in the past has this share been so high, and there is no other factor that comes close as the most prominent obstacle. There are always going to be business folks griping about government, but in the past, when this metric was closer to 30% than 40%, we found that there was much more vitality to capital spending and productivity. Perhaps a case can be made here for the sort of corporate tax reform Canada embarked on in the late 1980s and early 1990s by widening the base and cutting top marginal rates, reducing the complexity of the system in the process.

CHART 7: GOVERNMENT REGULATION GETS IN THE WAY

United States: NFIB: Government Requirements as the Top Problem
(percent of respondents)



Shaded regions represent periods of U.S. recession
Source: National Federation of Independent Business, Gluskin Sheff

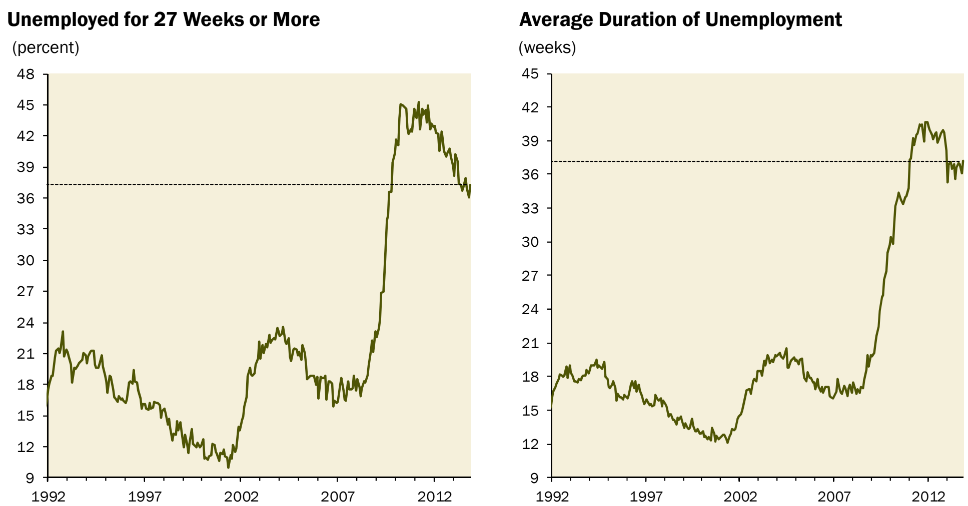
So I have dealt with the productivity side of the supply side story. What about the labor market?

Once again, in that speech by then Fed Vice-Chair Janet Yellen last March, the then Vice-Chair but current Fed Chairman said, and I quote:

"The large shortfall of employment relative to its maximum level has imposed huge burdens on all too many American households and represents a substantial social cost. In addition, prolonged economic weakness could harm the economy's productive potential for years to come. The long-term unemployed can see their skills erode, making these workers less attractive to employers. If these jobless workers were to become less employable, the natural rate of unemployment might rise or, to the extent that they leave the labor force, we could see a persistently lower rate of labor force participation."

CHART 8: LONG-TERM UNEMPLOYMENT ... A BIG PROBLEM

United States



Source: Bureau of Labor Statistics, Gluskin Sheff

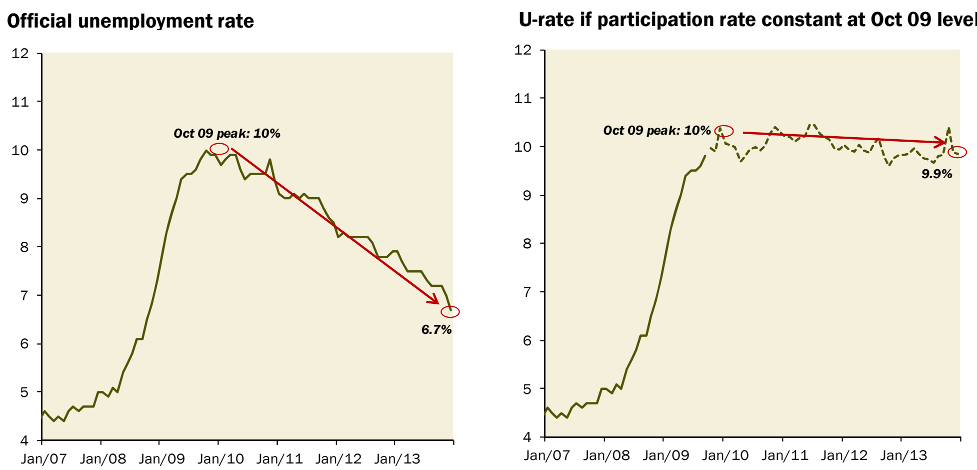
I also discovered a report by the economists at the Chicago Fed, published last July and titled "*Estimating the Trend in Employment Growth*", and here was the conclusion. Again, I quote:

"For the unemployment rate to decline, the U.S. economy needs to generate above-trend job growth. We currently estimate trend employment growth to be around 80,000 jobs per month, and we expect it to decline over the remainder of the decade, due largely to changing labor force demographics and slower population growth".

I can't speak for the Committee, but I find that conclusion startling. This is the way I look at the situation. In the past four years, the unemployment rate has declined from 10% to 6.7%. And all it took to accomplish that tremendous tightening of the labor market was average GDP growth of 2.4% at an annual rate. Only three other times in the past six decades has the unemployment rate fallen this far this fast: in the early 1950s, when growth averaged 6.7% per annum; in the late 1970s when GDP growth averaged 4.8%, and in the mid-1980s when growth averaged 5.2%. Today we accomplished this feat with only 2.4% growth which is disturbing because it means that it is not taking much in the way of incremental economic activity to drain valuable resources out of the labor market.

CHART 9: UNEMPLOYMENT RATE DOWN … BUT FOR THE RIGHT REASON?

United States: Unemployment Rate
(percent)



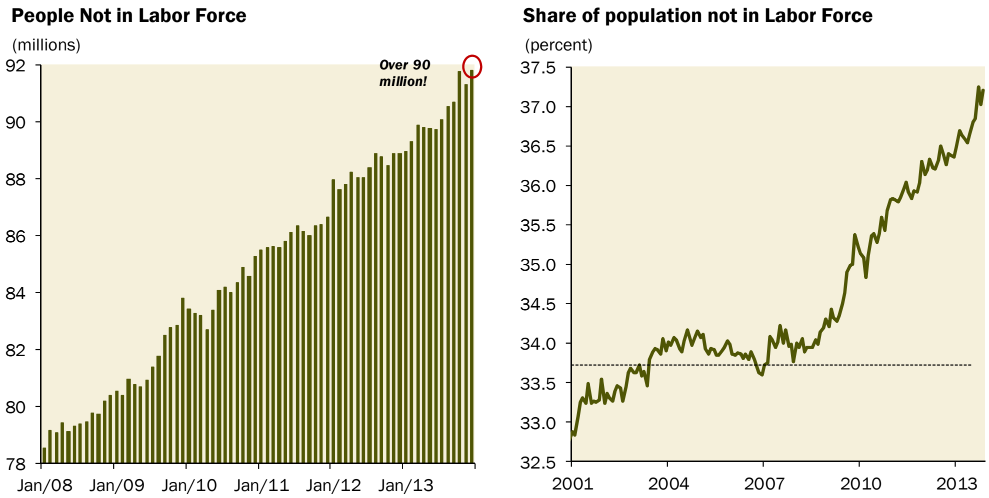
Source: Bureau of Labor Statistics, Gluskin Sheff

The dilemma is that people are becoming disengaged in the labor market at an alarming rate, for a variety of reasons which I will get into. In fact, the number of Americans who reside outside of the natural confines of the labor force soared 2.9 million in 2013 which far exceeded the 1.4 million jobs that were actually created. So people who say that the unemployment rate has been falling for the wrong reasons may not be far off the mark, but the question is why. As Janet Yellen has said, a good part of the explanation is the declining skill set among the long-term unemployed who number 3.9 million and represent 37% of the total ranks of the joblessness, which is still extremely high by historical standards — double the historical norm. But that is not the complete answer.

There are now 92 million Americans in total who reside outside the confines of the labor force. Five years ago that number was 80 million. Ten years ago it was 75 million. No doubt there is a demographic element since the first of the baby boomers turned 65 in 2011 and 1½ million turn that age annually for the next 15 years so the retirement wave is obviously one reason. But that doesn't explain why it is that the number of people in the 25-54 year age cohort who say they have left the labor market because they are "discouraged" has fallen 18% in the past year. When you look at this prime-aged adult cohort, what we find is that the number in this segment who have withdrawn from the labor market but don't want a job rose almost 5% last year, while those who said they have left the workforce but would take a job if offered one actually fell more than 3%.

CHART 10: A RECORD NUMBER OF AMERICANS HAVE LEFT THE LABOR FORCE

United States



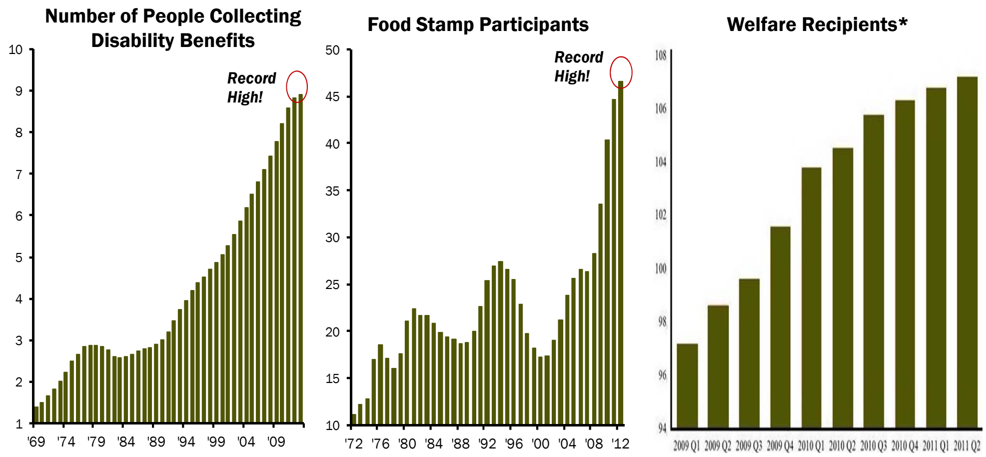
Source: Bureau of Labor Statistics, Gluskin Sheff

So something is going on here over and beyond the classic argument that people are either retiring or are dropping out of the labor force because of a weak economy — in fact, we know from other pieces of the employment report that the number of people who were working part-time for economic reasons actually declined 2% last year.

One theory that deserves examination is that we may have an abundance of separate benefits programs that provide for the disenfranchised in a very piecemeal and inefficient manner that are also perhaps abused or overly relied upon by some, which may lead to a distortion of work incentives. I point to a testimony on this matter by C. Eugene Steuerle on February 14th, 2013 to the House Committee on Oversight and Government Reform titled *"Labor Force Participation, Taxes and the Nation's Social Welfare System"*. Or perhaps the underground or barter economy is expanding at a faster rate than is generally appreciated and not getting picked up in the official employment numbers. Again, this is very tough to verify but offers a plausible explanation for why so many people seem to be falling through the cracks of the labor market as traditionally defined.

CHART 11: GETTING PAID NOT TO WORK

United States
(millions)



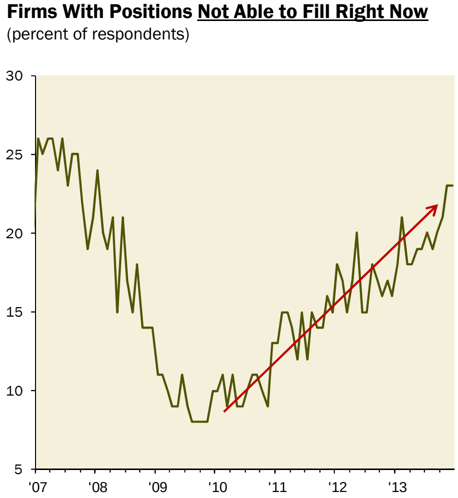
** Figures count means-tested welfare, not Social Security or Medicare*
Source: Social Security Administration, Department of Labor, Budget Committee Republican staff, U.S. Census' Survey of Income and Program Participation, Gluskin Sheff

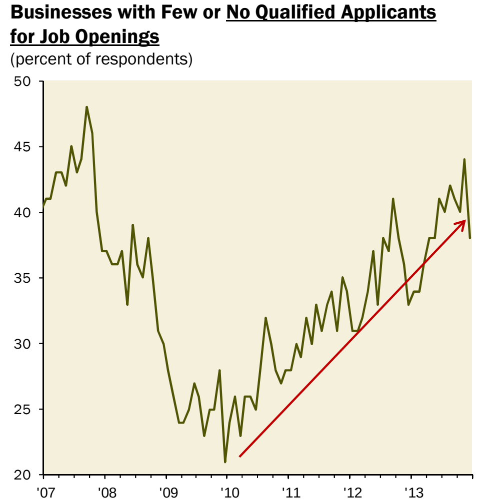
But what I do know with certainty is that we have a rapidly depleted pool of labor on our hands and it needs to be addressed. In fact, the Bureau of Labor Statistics reports on the size of the available pool of labor each month and that pool shrunk 13% in 2013 to 16.5 million which is the lowest it has been in five years and the decline is unprecedented. If this depletion continues at that rate, we will run out of available workers in this country in just about seven years – sooner than Japan.

I look at the data, again from the NFIB survey, and I see that 23% of small businesses have 'at least one position' open right now that they cannot fill; that is a number we have not seen in six years. The share saying that there have been 'few or no qualified applicants' for the jobs being advertised has risen to 38% from 33% a year ago. This is not about the demand for labor which is strengthening according to practically every survey on the matter. In fact, the number of job openings nationwide in November crossed above the 4 million mark for the first time since March 2008 and they are up 6% from where they were a year ago. The problem is that this is not translating into new hirings which are lagging well behind, with only a 1.7% annual rate of growth. In the latest Fed Beige Book, there were no fewer than two dozen references to "skilled labor shortages" in manufacturing, construction, transportation services and technology services which span almost one-quarter of the private sector workforce.

CHART 12: SIGNS OF SKILLS SHORTAGE

United States: NFIB Small Business Survey



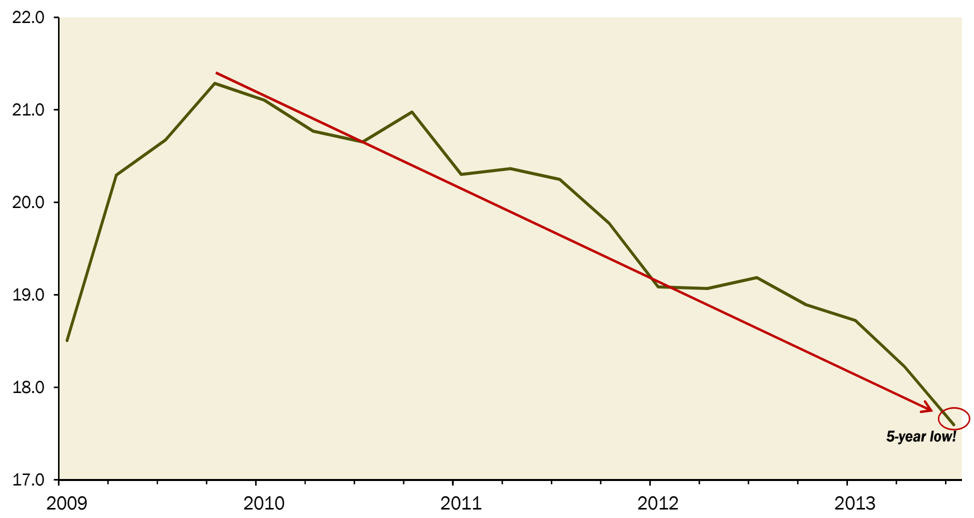


Source: National Federation of Independent Business, Gluskin Sheff

CHART 13: AVAILABLE LABOR SUPPLY

United States

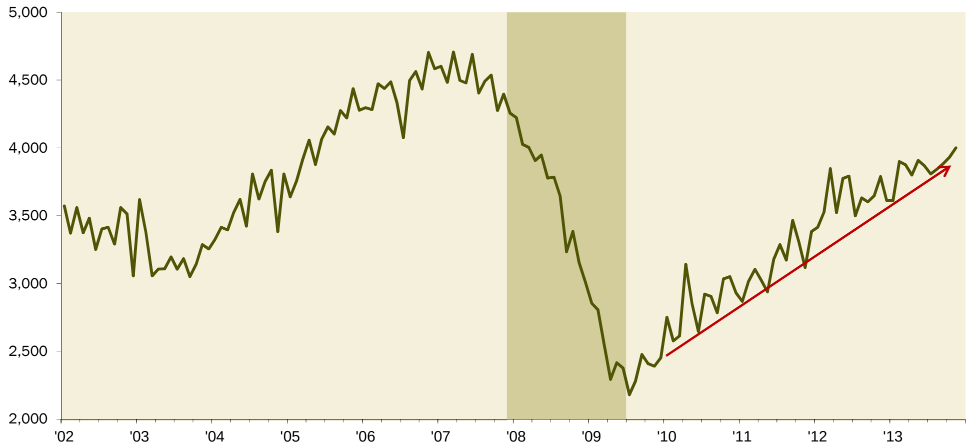
(millions)



Source: Bureau of Labor Statistics, Gluskin Sheff

CHART 14: JOB OPENINGS ON THE RISE

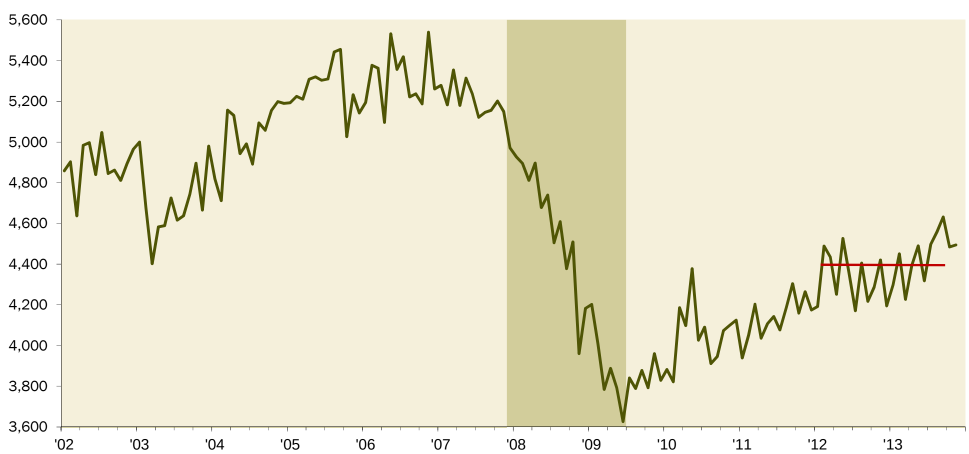
United States: Job Openings and Labor Turnover Survey: Job Openings
(thousands)



Shaded regions represents period of U.S. recession
Source: Bureau of Labor Statistics, Gluskin Sheff

CHART 15: BUT HIRING LAGS BEHIND

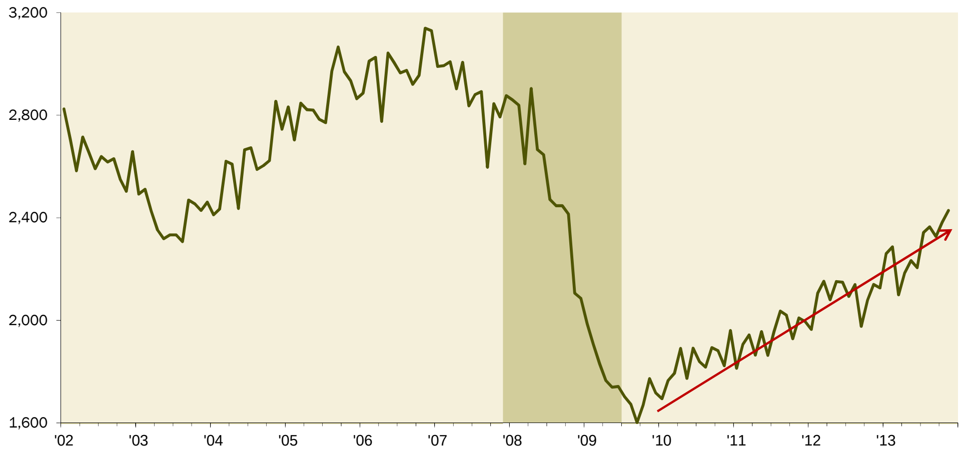
United States: Job Openings and Labor Turnover Survey: New Hires
(thousands)



Shaded regions represents period of U.S. recession
Source: Bureau of Labor Statistics, Gluskin Sheff

CHART 16: NUMBER OF JOB QUITTERS RISE TO CYCLE HIGH

United States: United States: Job Openings and Labor Turnover Survey: Quits
(thousands)



Shaded regions represents period of U.S. recession
Source: Bureau of Labor Statistics, Gluskin Sheff

From my lens, this requires emphasis on education, and I refer specifically to higher education because the unemployment rate for college graduates is now back close to 3%; college dropouts have over a 6% unemployment rate; those with a high school diploma have over a 7% unemployment rate; and those that never finished high school have an unemployment rate stubbornly close to 10%. The problem for employers is that they now have just 1.6 million people with a post-secondary education who are without a job but engaged in a search to choose from, and 6 million people without a degree who are knocking at their doors. Just to put the skills mismatch evident in that NFIB survey into some perspective, as well as another reason why productivity growth has decayed as much as it has. So one key to sustainable noninflationary growth and durable prosperity lies in helping people gain access to higher education — that is where the inequality is.

On top of that, I would say immigration and that includes the offspring of immigrants to the country as a key dynamic that I believe needs to be nurtured. The BLS reports the jobs data by ethnicity, and there is some valuable data here to glean. In the year to December, the White population saw employment growth stagnate and the labor force for this segment shrank 0.7%. Go to the Asian segment and here we saw employment growth come in at 5.2% for all of 2103 and the labor force expand 2.5%. Much the same for the Hispanics — employment growth of 2.7% in 2013 with an additional 1.3% in this group participating in the jobs market. Consider for a moment that there would have been practically no growth in total U.S. employment last year if not for these two minority groups — they represent

20% of the overall employment pie and yet managed to be responsible for 75% of the national job creation in 2013. Now, I'm not a sociologist and so I am not equipped to make sweeping statements over culture and the work ethic, but these minorities clearly seem motivated to be looking for work and they are finding work, just as other minority groups before them. Canada's experience in attracting foreign workers with skills and education, through its Immigrant Investor, Entrepreneur and Federal Skilled Trades Programs may be a template worth exploring. And it is worth noting that Canada's unemployment rate, on an apples-to-apples comparison is now 5.7% and has accomplished that with a participation rate of 66.4% compared to the 35-year low participation rate of 62.8% in the United States, and that 3.6 percentage point gap between the two countries is without precedent.

The big picture here is that I believe the policy agenda should be about boosting the productive capacity of the economy — the non-inflationary growth potential, in other words. Labor force growth in the past year is running at a fraction of one percent as is productivity, which means we have an historically extremely depressed potential growth rate on the supply side of the economy, far lower than the 3%-to-3½% range during the strong labor force growth years of the 1980s and the heady capital spending years of the 1990s and I believe lower than the 2%-to-2½% level the economics consensus has assumed in the current context.

In conclusion, we do indeed have a cyclical recovery in place, but if aggregate demand expands 3%-to-3.5% over the next two years, then we are going to begin to strain scarce supply-side resources in terms of available labor and capital. Then inflation re-emerges and interest rates begin to rise, potentially sharply, which is the last thing fiscal policymakers need since it was relief from lower debt-service costs that played such a crucial role in allowing the deficit to recede substantially in recent years. I estimate that if not for the current low interest rate structure, debt-service charges and the deficit would be $250 billion higher than they are today. But under current OMB projections, net interest charges go from $212 billion in 2013 to $822 billion in 2023, rivaling what the government will be spending on Medicare and severely impairing fiscal flexibility. At that time, nearly 20 cents of every revenue dollar will be diverted towards servicing the debt compared with fewer than 8 cents today, a dead-weight drag on the economy and the public purse that can be averted through macroeconomic policies that foster growth in the productive capacity or supply side of the economy, keeping inflation at bay even as demand growth expands, thereby freeing up vital financial resources needed to deal with the burgeoning demographic requirements and tough fiscal choices that lie ahead.

Thank you.