Paul Jenkins: Global economic trends - implications for Canada

Remarks by Mr Paul Jenkins, Senior Deputy Governor of the Bank of Canada, to the Saint John Board of Trade, New Brunswick, 1 February 2006.

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Thank you for the opportunity to speak to you today—I am delighted to be here. I would also like to thank Gilles Lepage, the Bank's director from New Brunswick, for joining me.

Wherever one lives in Canada these days, one cannot help but be aware that the world around us has been changing rapidly. Because Canada is so open to world trade and finance, we need to understand these changes so that we can manage our economy appropriately and take advantage of new opportunities.

World economic growth has been remarkably strong over the past three years, averaging close to 4 1/4 per cent, and it is expected to stay around 4 per cent this year and next.

But despite this solid overall performance, several interconnected global trends pose major challenges for the Canadian and New Brunswick economies. First, we have been witnessing large and growing global imbalances. Most important for Canada, the United States is running a very large deficit on its external current account (that is, the balance of trade in goods, services, and investment income with the rest of the world). The flip side of this deficit shows up primarily in Asia, where there are large current account surpluses and a massive accumulation of foreign exchange reserves. Second, we are seeing the emergence of China and India as economic powerhouses and formidable global competitors. Third, there is a divergence in economic performance across world regions, with North America and the emerging economies of Asia outperforming Europe and Japan.

What are the implications of these trends for Canada and for New Brunswick?

This is what I would like to discuss today. Let me begin by reviewing these global trends in greater detail.

Recent global economic trends

The U.S. current account deficit has widened—by about US$300 billion since 2002—to US$785 billion, or 6 1/2 per cent of that country's gross domestic product (GDP). And the level of U.S. indebtedness to the rest of the world has more than doubled over the past five years to more than 25 per cent of its GDP. Asia has been the primary source of foreign savings flowing into the United States. Moreover, Asian countries have accumulated over US$2 trillion in foreign exchange reserves, with China alone holding US$820 billion at the end of 2005. One factor contributing to this buildup of reserves is that some of these countries, most notably China, have been operating with fixed or tightly managed exchange rates (vis-à-vis the U.S. dollar) that are widely considered to be undervalued.

These large imbalances are not sustainable over the longer run. No country, even one as big as the United States, can keep increasing its external indebtedness as a share of its GDP. Ultimately, these imbalances will have to be resolved.

But this won't be simple. First, resolving the imbalances is not a short-term issue—it will take time. Second, what is needed is multi-faceted international policy action.

Part of the solution involves an increase in U.S. national savings. But higher U.S. savings means lower U.S. consumption, which would likely mean lower Canadian exports to the United States. To avoid the dampening effect that lower U.S. spending could have on overall global demand, other industrialized countries need to adopt policies that promote stronger domestic demand.

But this won't be enough. When significant global imbalances last emerged, in the mid-1980s, they largely occurred among the industrialized economies. That is not the case today. As I said before, major new players have appeared on the global scene. I'm referring primarily to the emerging economies of Asia. So, the resolution of today's imbalances requires that these countries, too, contribute through stronger growth in domestic demand rather than exports.

But this shift towards greater domestic demand growth in Asia will not come about smoothly if those countries currently operating under fixed or tightly managed exchange rates do not begin to promote greater nominal exchange rate flexibility. If this does not happen, there is a risk that countries with floating exchange rates, like Canada, may have to bear more than their fair share of the burden of resolving the imbalances. There is also a risk that protectionist measures could be taken worldwide, hurting all trading nations, including Canada. For these reasons, the Bank of Canada has been on the side of the debate that advocates greater exchange rate flexibility for China and other Asian countries. But equally importantly, we have also argued that greater exchange rate flexibility in those countries will, in fact, best serve their *own* needs, in terms of promoting sustained economic growth through stronger domestic demand and an efficient allocation of resources.

Now, what about the more general issue of the integration of Asia, and particularly China, into the world economy?

China's rising prominence in world trade has been partly a reflection of its increasing importance as an assembly platform for a broad range of exports. China's exports in the 1980s and early 1990s were concentrated in clothing, footwear, and other light manufactured goods. More recently, its share of world exports has increased in nearly all categories, with rapid growth in areas such as office machinery and telecommunications, furniture, textiles, travel goods, and industrial supplies. The increasing sophistication of Chinese exports means growing competition for Canadian products, both at home and in world markets.[1]

But we should not forget that the emergence of China and India as major economic players also offers Canadian firms the opportunity to profit by expanding into these huge export markets and by tapping into cheaper sources of supplies.

Let me now elaborate a bit on the implications of these global trends for Canada.

Implications for Canada

The rise of China and other newly industrialized countries to economic prominence, and the need to resolve the existing large global imbalances, have triggered sizable movements in key relative prices that are particularly relevant for Canada. I am referring specifically to the dramatic rise in the world prices for raw materials and energy, and to the marked appreciation of the Canadian dollar since 2002.[2]

When prices for energy and non-energy commodities rise relative to the prices of other goods that Canada produces, it is a signal that economic resources need to be shifted into the production of commodities. That's one implication. Another implication, given Canada's strength in commodity production, is higher real incomes for Canadians. As those incomes feed into stronger demand, the benefits extend to the sectors of our economy that are less exposed to global forces, such as housing and various services. But, of course, that's only part of the story. The other part is that large segments of the manufacturing sector, because of their exposure to growing competition from Asia and because of the higher Canadian dollar, will expand less rapidly relative to other sectors. As this process unfolds, labour and capital are reallocated across economic sectors.

A quick look back at the Asian financial crisis of 1997-98 might help to put this current challenge in perspective. What we went through then is essentially the reverse of the current situation. At that time, world commodity prices plummeted, the Canadian dollar depreciated sharply and, in response to these price signals, production resources moved out of commodities into manufacturing. And so we saw a period of exceptionally strong growth in output, exports, and employment in the manufacturing sector.

How are sectoral developments affecting regional economic growth in the current environment? Because of the differing industrial bases of Canadian regions, the effects of the recent sharp movements in relative prices are playing out differently across the country.

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[1] B. Desroches, M. Francis, and F. Painchaud, "Growth and Integration: The Emergence of China and India and the Implications for Canada." In *Canada and the Global Economy*. Proceedings of a conference held by the Bank of Canada (November 2004): 229-75.

[2] M. Francis, F. Painchaud, and S. Morin, "Understanding China's Long-Run Growth Process and Its Implications for Canada." *Bank of Canada Review* (Spring 2005): 5-17.

The energy-producing provinces of Western Canada are certainly benefiting from higher prices for raw materials and from surging oil and gas revenues. The result is increased profits and investment, strong growth in output and employment, and fiscal surpluses. But the sudden rapid economic expansion is straining the region's infrastructure. And it is creating labour shortages, not just in the energy sector but also in mining, manufacturing, and construction—all of which are competing for the same pool of labour, especially skilled labour. Certain professions (notably accountants, engineers, and project managers) are also in short supply.

Other parts of Canada with a significant resource-production base, including New Brunswick and Atlantic Canada more generally, are also benefiting from high commodity prices. For example, the construction this spring of a liquid natural gas (LNG) plant, right here in Saint John, has been spurred by high demand and prices for energy. As the largest producer of zinc and lead in Canada, this province is also benefiting from surging prices for these minerals. But in Central Canada and in those parts of New Brunswick where there is a concentration of manufacturing activity, overall economic performance has not been as strong. Since manufacturers export a good part of their production, the appreciation of the Canadian dollar and rising energy costs have reduced their competitiveness. Reduced profitability and declining employment in the manufacturing sector are a reflection of this. Several traditional industries, such as the fishery and forestry, have also been affected because of increased global competition, low selling prices, and the higher Canadian dollar. But it is important to note that, at the same time, there has been relatively broad-based strength across Canada in those sectors that are catering to robust domestic demand.

For many firms and individuals, adapting to global change has been difficult and, in some cases, painful. All of us understand the challenges they face. Encouragingly, evidence from the Bank's quarterly surveys confirms that across Canada businesses have been responding to the new global economic realities. Some have chosen to import more inputs and finished goods from lower-cost suppliers in Asia. Others have moved away from products and markets with low profitability towards those that are likely to yield higher profit margins. And firms have been investing in machinery and equipment to increase their productivity. Moreover, our latest *Business Outlook Survey* suggests that companies continue to be positive about the economic outlook, and that investment and hiring intentions remain firm across *all* regions and *most* sectors.

But what about macroeconomic policies—how can they contribute to the adjustment process?

Monetary policy, which is the responsibility of the Bank of Canada, is *national* in nature and scope. This means that we need to look at what is happening across Canada, add it all up, and gear monetary policy to the needs of the entire country. In this sense, the best contribution that monetary policy can make to the adjustment is by aiming to keep inflation at 2 per cent and the national economy operating close to its production capacity over the medium term. When inflation is low and stable, businesses can read price signals more clearly, which helps them to make sound economic decisions. This is particularly important during times of rapid change, such as at present. And when the economy is operating at capacity, production resources can be reallocated more effectively from sectors where demand is weak to those where demand is relatively strong.

Prudent federal and provincial fiscal policies, focused on keeping government budgets sustainable and balanced over the longer run, are also important to preserve investor confidence in Canada and to help keep interest rates relatively low and stable.

All in all, sound monetary and fiscal policies go hand in hand in providing a stable macroeconomic environment that can facilitate the required adjustments.

Let me now summarize the Bank's latest outlook for the economy and inflation, which we discuss in greater detail in our January *Monetary Policy Report Update* that we published last week.

Recent economic and financial developments

In the *Update*, we note that the Canadian and world economies have been evolving in line with our expectations and that the outlook for growth and inflation in Canada is similar to that in our October *Monetary Policy Report*. We also point out that the Canadian economy continues to adjust to global developments and to the associated changes in relative prices.

As I said at the beginning, world economic growth will remain robust—around 4 per cent this year and next.

Against this backdrop, our assessment is that the Canadian economy as a whole is currently operating at its production capacity. And we expect it to keep on growing roughly in line with its production potential through 2007. Specifically, we project annual average growth of 3.1 per cent this year and 2.9 per cent in 2007. For New Brunswick, we are looking for a slight pickup in growth in 2006–07—to about 2 3/4 per cent from 2 1/2 per cent in 2005—mainly boosted by investment projects such as the LNG facility I mentioned earlier.

Total CPI inflation for all of Canada, which was at 2.3 per cent in the fourth quarter of 2005, will continue to reflect changes in the prices of crude oil and natural gas. But it should return to the 2 per cent target by the first half of 2007. So should core inflation which, in the closing months of 2005, was at 1.6 per cent.

As always, there are both upside and downside risks to our projections. For 2006, the risks relate to the world economic outlook and the adjustment of our economy to global developments. These risks appear to be balanced. But through 2007 and beyond, the risks are tilted to the downside as the unwinding of global imbalances could involve a slowdown in world economic activity.

With our economy operating at capacity and expected to grow roughly at potential through the projection period, on 24 January we raised the policy interest rate by another 25 basis points to 3 1/2 per cent. And we indicated that, in line with our base-case projection and current assessment of risks, some modest further increase in the policy interest rate would be required to keep aggregate supply and demand in balance and inflation on target over the medium term.

Concluding thoughts

Let me conclude by summarizing my key points.

First, because our economy is very open to world trade and finance, we need to recognize today's global economic realities and to have the flexibility to adjust accordingly.

Second, sound economic policies have a critical role to play in facilitating the necessary adjustments. Such policies include, importantly, a monetary policy aimed at keeping inflation low, stable, and predictable—to which the Bank of Canada is fully committed.

Third, based on our history, there is every reason to believe that Canadian businesses and workers will rise to the current challenges and make the necessary adjustments to take advantage of the opportunities presented by an evolving and expanding global economy.