Sheryl Kennedy: Adjusting to economic change

Remarks by Ms Sheryl Kennedy, Deputy Governor of the Bank of Canada, to the Greater Saskatoon Chamber of Commerce, Saskatoon, Saskatchewan, 22 February 2007.

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It's a pleasure to be here in Saskatoon.

The last time someone from the Bank of Canada spoke to this Chamber of Commerce was five years ago, when Governor Dodge discussed "Inflation Targeting During a Difficult Year." Just five years ago, but what a different world it was then. The world economy wasn't nearly as strong. Commodity prices were soft. From that vantage point, it would have been difficult to predict what happened over the next five years. Who could have foreseen the price of potash rising 50 per cent, oil prices going up about 200 per cent, or the price of uranium appreciating fivefold? Who could have known that the Canadian dollar would appreciate by more than a third? More importantly, who could have predicted that the Canadian economy would fare so well in dealing with these significant changes?

The past five years have indeed been a period of great and relatively rapid economic change, both here in Saskatchewan and across the country. In my remarks today, I'd like to describe this change and discuss its significance to our economic well-being. Then I'd like to look at some of the factors that explain the success of the adjustment process thus far. Finally, I'd like to suggest what needs to be done to ensure that we'll continue to be up to the task of meeting the challenges ahead.

Changes in the economy since 2002

Let's start by turning back the clock, and looking briefly at what was going on five years ago. Of course, the big news five years ago this month was the Olympics in Salt Lake City. There, the fastest woman on ice, Saskatoon's Catriona LeMay Doan took gold – *again*, as she'd done in 1998 – in speed skating. And the women's hockey team, led by another Saskatchewan athlete, Hayley Wickenheiser, won all five games they played, and also took home the gold medal.

Now, how was the economy faring? Well, it wouldn't have won a gold medal, but the economy wasn't doing too badly, especially considering the slowdown that occurred in the wake of 9/11 in 2001. The world economy was growing at just over 3 per cent, and the Canadian economy at just under 3 per cent. The national unemployment rate was 7.7 per cent. And inflation, at just over 2 per cent, was under control.

Let's turn now to what has happened since 2002. In each of the four years that followed, world GDP growth has been over 4 per cent in real terms. Last year, it was 5.2 per cent. In fact, the world economy has grown more during this period than in any other five-year period since the second world war.

Of course, strong non-inflationary growth of the global economy is desirable and good for most countries. But it is particularly true for Canada, given that so much of our economic well-being is derived from trade with the rest of the world. The strength of the global economy has had the important effect of increasing the demand for – and raising the prices of – many commodities that Canada exports, including oil and natural gas, copper and nickel, potash and uranium. At the same time, the prices of many imports have fallen, owing in part to global competition. This has resulted in what is called a "positive terms-of-trade shock" – the prices we get for our exports have increased relative to the prices we pay for our imports. As a result, we are richer as a country.

In tandem with this improvement in our terms of trade, we've seen a major rise in the external value of our dollar. In February 2002, the Canadian dollar was at a historic low. Today, at around 85 cents, the dollar is worth about 37 per cent more against the U.S. dollar than it was then, and about 30 per cent more against a trade-weighted basket of currencies. This rapid and substantial movement in the exchange rate reflects fundamental changes in the economy. But that doesn't mean that adjusting to it has been easy. Adjusting to such an appreciation in the external value of the dollar can be difficult for many companies and workers, especially when competition is fierce, as it is now. But a strong dollar also presents opportunities. Businesses, for example, can more easily buy productivity-enhancing machinery and equipment from abroad, and the evidence is that they are doing just that. Consumers benefit because the prices of imports are lower when they're bought with a stronger dollar.

Changes in our terms of trade also have implications for the allocation of resources within our economy. The strong commodity prices I mentioned have led to increased profitability in mining and oil and gas extraction. This, in turn, has prompted strong gains in both investment spending and employment in those sectors of the economy. Most sectors with a low exposure to international trade (such as personal services) have also experienced relatively strong levels of profitability and solid gains in employment. On the other hand, with the substantial rise in the exchange rate and increased competition from many of the Asian economies, many industries with a high exposure to international trade – typically manufacturers – have faced difficult adjustments since the end of 2002. This has been reflected in lower rates of profitability, modest gains in production, and declines in employment.

But overall, Canada has adjusted well to the challenges of the past five years. Since 2002, our labour markets have performed well – the unemployment rate is now close to a 30-year low. And our average annual economic growth rate has been greater than the average growth rate of the G-7 countries as a whole.

That's the national picture. In many respects, Saskatchewan is a microcosm of these trends. Real provincial GDP growth is solid and close to the national average. In the past five years, Saskatchewan has seen its labour participation rate increase significantly – from 65.7 to more than 70 per cent – and the unemployment rate has dropped from 5.4 per cent in February of 2002 to 4.1 per cent last month, indicating a robust labour market. Of course, Saskatchewan has been helped a good deal by the increase in world commodity prices that I mentioned earlier – especially for energy, potash, and uranium, while manufacturers here have faced challenges similar to those faced by manufacturers elsewhere in Canada.

To summarize, the past five years have been a time of large and significant economic adjustment. Despite the stresses and strains that such a change can cause, Canada has done very well, all things considered. The economy is strong, Canadians are working, and they have seen increases in wealth and income.

What are some of the factors that explain this successful adjustment?

What explains the success of the adjustment process?

In an open economy like Canada's, the most important factor is flexibility. By flexibility, I mean the ability of the economy to adjust to changes in circumstance – that is, for resources to shift from areas of weakening demand to areas of strengthening demand – and for the economy to return to its production potential quickly, with as little cost as possible. But flexibility doesn't just happen – it's a function of structural policies, human capital, and our business culture. And flexibility is facilitated by two other elements that are required for success in economic adjustment – sound monetary and fiscal policies. Let's look at monetary policy first.

The two key components of our monetary policy framework are inflation targeting and a floating exchange rate. These work together and reinforce one another to promote stability and to facilitate economic adjustment. How does this happen? Let's look first at inflation control.

Low, stable, and predictable inflation provides many benefits. It helps people deal with change. One way it does this is by allowing prices to send clear signals, which in turn help individuals and companies to make sound, long-term economic decisions. In addition, and very importantly, when inflation is contained, monetary policy can be set to keep the economy running close to capacity, acting as an automatic stabilizer, so the economy can more effectively absorb shocks.

These benefits are complemented by our flexible exchange rate. A floating dollar also acts as an automatic stabilizer, helping the economy to absorb shocks – especially external shocks that affect our economy differently than the economies of our major trading partners. Movements in the exchange rate are also important for the information they contain. They send signals to businesses and consumers about where to make investments and purchases, thus helping them adjust to the shifting currents of the global economy.

But monetary policy cannot do its job well if it's not accompanied by sound fiscal policy. The federal government has had a budget surplus every year since 1997-98, and since 1999-2000, the provinces and territories as a whole have, more often than not, also been in a surplus position. Fiscal discipline is important, first, because it frees resources – resources that would otherwise be required to service debt – for more productive uses, and second, because it gives governments room to manoeuvre to deal with unanticipated events. Our sound fiscal situation has clearly helped Canada to weather the changes of the past five years.

But sound monetary and fiscal policies are not enough to explain the success of the adjustment process. The flexibility of our economy has also been extremely important. When I say flexibility, I mean first and foremost the ingenuity and skills of our workers and business leaders. That's why education and training are so vital. Of significance for Saskatchewan's future well-being is the recent rise in what is called the "educational attainment" of its labour force. But flexibility is also a function of the ease and speed with which resources can be reallocated in an open economy. That's why we need to ensure that there are no unnecessary structural impediments to economic adjustment – impediments such as barriers to investment, to labour mobility, and to trade. In the past five years, the Canadian economy has demonstrated increased flexibility. But, as I'll explain in a moment, more can be done.

Finally, I should point out that the adjustment process in the past five years has been helped a good deal by the favourable backdrop of strong growth in the global economy. Robust demand for Canadian goods has helped to offset some of the stresses and costs of adjustment. With this in mind, I think it's useful to point out that while Canadians *can* control their monetary policy and fiscal situation, and *can*, through various measures, encourage flexibility, we have less control over the external environment. And it's only prudent to keep in mind the possibility that the external environment may not always be favourable. So, the question arises: what do we need to do so that Canada remains able to respond effectively to the challenges of the future, in both good times and bad?

Meeting the challenges of future economic change

All Canadians have a stake in the national economy. And we all have a role in helping to promote policies and actions that foster sustainable economic growth – whatever the backdrop. For its part, the Bank of Canada will continue to work toward the goal of keeping inflation low and stable, and we will do our part in promoting a sound and efficient financial system.

Indeed, all policy-makers have a key role in promoting efficiency, productivity, and further economic flexibility. In an increasingly competitive world, the bar is always rising, so we cannot rest on our laurels. The policy areas in which we have more work to do will be familiar to you. In the financial sector, which I know best, securities regulation needs to be made simpler and more efficient. And generally, many business regulations need to be harmonized across Canada and some across the NAFTA region. And barriers within Canada to the free movement of goods, services and labour need to be removed. Tackling this issue is especially important now, as shortages of skilled labour are becoming more pronounced. And it will become even more important as demographic challenges begin to intensify. It would be helpful if trades and professional designations were recognized and fully transferable across the country, and if we could resolve the difficult issue of recognizing the qualifications of many talented immigrants. A related policy area that supports productivity and flexibility is education and training. Canadian workers benefit – indeed, the whole economy benefits – when they have the knowledge and skills required to take advantage of change and opportunity.

As I have already said, much of Canada's prosperity depends on active engagement with the wider world. The recently re-started World Trade Organization talks to reduce barriers to international trade are particularly important to us, and need to be brought to a successful conclusion. In addition, further action should be taken to promote the orderly resolution of global financial imbalances – which refers to the large U.S. current account deficit, mirrored by large surpluses in Asia and in major oil-exporting countries. The United States needs to increase its savings rate, while Asia and the OPEC nations need to increase their domestic consumption. And some countries, particularly China, need to develop more flexibility in their currency arrangements.

So that's the challenge for policy-makers. Business leaders and workers also face the challenge of adapting and prospering in a rapidly changing global economy. They have a stake in, and can lend support to, initiatives in the policy areas I have just mentioned. But businesses also need to innovate and aggressively tap new markets. They can invest in efficient machinery and equipment, and they can invest in their employees. And workers do their part when they invest in themselves – by learning and acquiring new skills.

Recent economic developments

Before I conclude, let me say a few words about how the Bank of Canada sees the Canadian economy adjusting to the changes that have been taking place in the world. As stated in the January *Monetary Policy Report Update*, the economy is judged at this time to be operating at, or just above, its production capacity at the end of 2006, following weaker-than-expected growth in the second half of the year. While the global economy has been expanding in a robust fashion, U.S. economic growth slowed in 2006, with weakness concentrated in the housing and automotive sectors. This weakness does not appear to have spread to the rest of the U.S. economy, and with signs that a significant amount of the adjustment in these sectors has already taken place, U.S. economic growth is expected to pick up through 2007. With continued solid growth in the rest of the world, the global economy is expected to grow by 4.7 per cent in 2007, and 4.5 per cent in 2008. Non-energy commodity prices are expected to decrease modestly from the very high levels reached toward the end of 2006.

This global outlook bodes well for Canada. Real GDP growth should average about 2 1/2 per cent in the first half of 2007, rising to about 2 3/4 per cent in the second half of the year. In 2008, growth is projected to stay in line with the growth of potential output, estimated to be 2.8 per cent, keeping the economy operating near its full production capacity. The underlying trend of inflation, as measured by core CPI inflation, should be close to 2 per cent through 2008. Total CPI inflation is expected to average just above 1 per cent in the first half of 2007, returning to the 2 per cent target in 2008. In line with this projection, in January we judged the current level of the policy rate to be consistent with achieving the 2 per cent inflation target over the medium term.

The risks to this outlook for the Canadian economy are reasonably well balanced. The biggest downside risk is sharper or more prolonged weakness in the U.S. economy, and the upside risk comes from the strength of the Canadian housing market and credit growth putting upward pressure on demand and inflation. In addition, there remains a small possibility of a disorderly resolution of global imbalances, particularly if policy-makers fail to take appropriate actions.

I'll conclude now, and then I'd be happy to hear your comments and answer your questions.

Conclusion

The past five years have been a period of significant economic adjustment. Canada is a wealthier country as a result of this change. We will continue to prosper, whether the external environment is favourable or not, provided that we learn the larger lesson – that it is essential to be flexible and adjust effectively to changes in economic circumstance.

The current favourable outlook, for both Canada and the global economy, should not lead to complacency. We all have a stake in meeting the challenge of adjustment. As citizens, business leaders, workers and policy-makers, we all have a role in ensuring that Canada can respond effectively to changes in the economic landscape, and that Canadians can seize the opportunities that such changes often bring.