Mark Carney: Employment in a modest recovery

Remarks by Mr Mark Carney, Governor of the Bank of Canada, to the Windsor-Essex Regional Chamber of Commerce, Windsor, Ontario, 30 September 2010.

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It is a pleasure to be here to discuss current economic conditions with the Windsor-Essex Regional Chamber of Commerce. I look forward to this opportunity to hear insights directly from business leaders.

Insights from financial markets are somewhat fleeting at the moment. A broad range of asset prices from the Canadian dollar to S&P500 futures to European sovereign spreads are unusually correlated and volatile (Appendix, ***Chart 1***). Every morning by looking at any one of these variables you can readily tell whether markets are in a risk-on or risk-off mode.

In the current environment, the macro dominates the idiosyncratic. The good and bad moves you make as business people will, for the moment, go largely unrewarded or unpunished. What matters most is the daily *perception* of the answers to three very big questions:

– Will the U.S. recovery falter under the weight of balance-sheet repair and slow employment growth?

– Can the rest of the world sustainably decouple?

– Will there be another systemic event concerning sovereigns or banks?

In this time of unusual uncertainty, businesses on either side of the border are responding in different ways. In the United States, investment has been relatively strong and productivity growth has been robust. However, hiring has been unusually weak, particularly by small businesses. In Canada, the opposites have been the case: investment has been unusually weak; productivity, poor; and hiring, strong, particularly amongst small and medium-sized enterprises (SMEs).

I would like to speak today about the possible reasons for these divergences, how long they are likely to persist, and their implications for growth and inflation in Canada.

The global economic outlook

The global recovery is entering a new phase. The easy bit is now over. In advanced economies, the temporary boost from the turn in the inventory cycle is largely complete. In many countries, fiscal stimulus is turning to fiscal drag. The panicked postponement of consumption and investment has been unwound. The question now is whether growth in advanced economies will be self-sustaining in the face of broad forces of bank, household, and sovereign deleveraging.

The evidence is mixed, depending on proximity to the crisis. For example, in Germany, where household and government finances are sound and the economy is externally oriented, growth has picked up smartly. In peripheral Europe, where households and governments are extremely leveraged and economies have been domestically focused, growth is slowing rapidly.

Similar forces threaten renewed weakness in the United States. For Canada, this prospect is of concern.

Financial markets are currently constructive but remain vulnerable to event risk. Renewed pessimism over the U.S. outlook has sharply reduced global bond yields. In effect, there has been a Goldilocks deterioration in the macro-financial environment as major government bond yields have fallen sharply but corporate spreads have not increased (***Chart 2***). For large corporations who want it, finance is readily available at historically low all-in costs.

In emerging economies, growth has persistently surprised on the upside. Healthy financial sectors and very stimulative monetary and fiscal policies have overcome the drag from weaker export markets. However, with the limits to non-inflationary growth approaching and the challenges of shadowing U.S. monetary policy increasing, this above trend growth is likely to come to an end.

In sum, there are several reasons to expect a modest and uneven global recovery. Not all countries can simultaneously export their way to growth. The ongoing process of balance sheet repair in major industrialised countries will restrain household consumption and business investment. The ability of some major emerging markets to maintain persistently higher domestic demand remains unproven. Finally, necessary real exchange rate adjustment threatens to come through inflationary pressures in emerging economies and deflationary pressures in major advanced economies rather than (far easier) changes in nominal exchange rates.

These forces make the economic outlook and policy environment unusually challenging for countries caught in the middle, like Canada.

The U.S. economic outlook

When faced with a potential collapse in private demand in the wake of the financial panic, U.S. authorities instituted massive and timely monetary and fiscal stimulus. This bought time for the necessary adjustments in the economy to begin. With U.S. fiscal policy transitioning from expansion to contraction, that time is now coming to an end. The success of the necessary handoff of growth from the public to the private sector is still in question (***Chart 3***).

The U.S. housing sector remains very weak, despite substantial falls in prices and housing starts. Valuations are more in line with historical averages, and inventories of unsold new homes have reached their lowest level since 1968. However, effective supply is much larger, given the overhang of distressed properties and the pent-up supply of "shadow inventories" in the resale market. Housing demand continues to be held back by subdued consumer confidence, the weak labour market, and the inability of some households to access financing, at historically low mortgage rates. While there appears to be limited prospect for substantial further deterioration in U.S. housing, a sharp rebound in the near term looks unlikely.

U.S. businesses have responded to the challenging environment by increasing productivity. While commercial real estate investment has been unusually depressed, investment in equipment and software has been robust and consistent with prior recoveries (***Chart 4***).

The same cannot be said of the U.S. labour market, which has borne the brunt of adjustment. The unemployment rate remains very high at 9.6 per cent, the incidence of long-term unemployment reached a record level above 40 per cent (***Chart 5***), and underemployment in the form of involuntary part-time work is rampant.

The prolonged weakness in the U.S. labour market reflects factors that go beyond weak output growth. The jump in the unemployment rate has been higher, by about 5 million workers, than the decline in GDP would have traditionally suggested. The restructuring of major industries such as autos, finance and of course, construction has deepened the job losses. In addition, credit constraints facing U.S. SMEs have contributed to the employment dynamics.[1]

The natural rate of unemployment may be increasing sharply. The scale of industry restructuring means that some unemployed workers do not have the skills suitable for the

[1] About 80 per cent of job losses in this recession have been from enterprises with less than 500 employees.

expanding sectors. Other jobseekers are tied to their local area, due to an inability to sell their homes in distressed markets, hampering the mobility that has been a hallmark of the American labour market. The current cycle is also self-reinforcing. As long-term unemployment becomes more entrenched, workers' skills deteriorate and their reintegration into the labour force becomes more difficult.

Reflecting weakness in the labour market and an ongoing need to repair stretched personal balance sheets, U.S. real personal expenditures are not yet back to pre-crisis levels. Two of the most visible indicators of this weakness matter tremendously to Canada: housing starts and motor vehicle sales (***Charts 6a and 6b***).

The good news is that recent data revisions indicate that the personal savings rate is now at 6 per cent, which is consistent with ultimately rebuilding U.S. household wealth to historic averages and stabilizing the U.S. net foreign liability position. If savings hold at this level (that is, absent a further shock to confidence), then consumption should grow next year at a moderate pace.

The Canadian economic outlook

Despite this challenging external environment, Canada's recovery has been stronger than that of its G-7 peers. As a result of the combination of the scale and speed of the policy response and our well-functioning financial system, Canada's economy is now back at its pre-crisis peak in output. However welcome, our recovery is relatively modest in comparison to its predecessors and has relied heavily on housing and personal consumption.

The limitations of this reliance are becoming evident. In recent months, the speed of the recovery has diminished. A modest pace of growth can be expected in coming months as our economy faces considerable headwinds from both the external sector and the limits of household balance sheets.

Allow me to expand.

Housing activity in Canada is declining markedly from high levels, as the Bank had expected. The slowing since the spring in resale, renovation, and new home construction activity has been driven by a number of factors, including the passing of pent-up and pulled-forward demand; the expiration of the federal Home Renovation Tax Credit in January; the tightening of standards for government-backed insured mortgages that came into effect in April; the introduction of the HST in Ontario and British Columbia in July; declining affordability; and subdued income growth. I will come back to that last factor in a moment, but overall it appears unlikely that private consumption will be bolstered by substantial house price gains going forward.[2]

The fiscal stimulus is also coming to an end. After making a major contribution to growth since the onset of the recession (***Chart 7***), the Bank estimates that the contribution of government spending to real GDP growth will turn negative in 2011.

Until recently, business investment has disappointed relative to past experience as well as to the imperatives of lagging productivity, increasing international competition, and the development of major opportunities in emerging markets. Survey evidence and recent data suggest that is now changing. The Bank expects that business investment will increase to

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[2] House prices matter principally because of the "financial-accelerator effect." When the value of a house rises, the owner can typically borrow against this increased equity to fund home renovations, a second house, or other goods and services. These expenditures can "accelerate" a rise in house prices, reinforcing the increase in collateral values, access to additional borrowing, and, thus, an increase in household spending. Of course, this accelerator effect can also work in reverse: a decrease in house price tends to reduce household borrowing capacity and amplify the decline in spending.

levels consistent with previous recoveries, reflecting competitive imperatives, firms' strong financial position, and easy credit conditions (***Chart 8***).

The auto sector provides an example. The recession crystallised a major restructuring, with North American capacity reduced by 3 million motor vehicles.[3] More than 576,000 jobs were lost since December, 2007. Today, U.S. demand for motor vehicles is about 11 million per year versus the average from 2000 to 2006 of 17 million, and while there will be some growth from here, the U.S. market is likely to be persistently smaller as households reduce debt.

As a consequence, business models are now being substantially adjusted. Canada is competing to host some of the handful of global OEM (original equipment manufacturer) platforms, training, R&D, and capital investment are being ramped up, and some Canadian tier 1 suppliers are aggressively expanding into emerging markets.

Similar bold moves will be required across our economy to create sustainable, wellpaying jobs.

Labour market dynamics in Canada

The most striking thing about the Canadian recovery has been the performance of the labour market (***Chart 9***). All 400,000 jobs lost in the recession have now been recovered. While the unemployment rate remains high at 8.1 per cent, this reflects in the aggregate the movement of more people into the labour force. With this, the incidence of longer term unemployment in Canada is about half that in the United States.

However welcome, these headline figures mask some important details. Much of the employment growth is in the public sector, with only half of the new jobs in the private sector. Many jobs are involuntary part-time. In fact, although employment has regained its pre-recession level, hours worked have not. Overall labour input (the combination of employment and hours worked) has made up only two-thirds of its decline during the recession.

Since the crash, on the margin, the composition of labour demand has shifted from jobs in the goods sector to jobs in the services sector. The change accounts for the majority of the gap between the current level and the pre-recession level of average hours worked. In the current cycle, the goods sector, such as autos, has experienced far more adjustment than services, such as retail. This appears to be largely a result of the export-oriented nature of the shock and the strength of the Canadian dollar. These dynamics would be familiar here in Windsor-Essex, where the unemployment rate is about 3 percentage points above the national average.

The Bank expects that average hours worked will return to its trend, but only very gradually. Those in involuntary part-time positions should eventually find full-time ones. This view is anchored by an expected slow recovery in goods sector employment, which in turn reflects our expectations for the pace of recoveries in U.S. demand and Canadian business investment. If the U.S. falters or the acceleration in Canadian business investment flags, then the pace of improvement in the labour market will be slower.

Household balance sheets and the outlook for consumption

With Canadians working, but not as much as they would like, they have been borrowing. Real household credit expanded rapidly throughout the recession, in contrast to previous downturns, and has continued to grow through the recovery. Canadian households have now

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[3] R. Harbour, "Automotive Manufacturing Transition," a presentation delivered at the *Center for Automotive Research, Management Briefing Seminars,* Traverse City, Michigan, 4 August 2010. Found at: <http://mbs.cargroup.org/2010/content/view/235>.

collectively run a net financial deficit for 37 consecutive quarters. That is, their investment in housing has outstripped their total savings for over nine straight years. In effect, households are demanding funds from the rest of the economy, rather than providing them, as had been the case through the 1960s, 1970s, 1980s and 1990s (***Chart 10***).

This cannot continue. The ratio of Canadian household debt to disposable income reached 146 per cent in the first quarter of this year, an all-time high and very close to the current level in the United States (***Chart 11***). In a series of analyses over the past year the Bank has found that Canadian households are increasingly vulnerable to an adverse shock and that this vulnerability is rising more quickly than had been previously anticipated.[4, 5]

It is true that the strength of housing and other assets has meant that the net worth of Canadians remains about six times their average disposable income compared with slightly below five times in the United States. However, while asset prices can rise or fall, debt endures. Despite the buoyancy of the housing market, the debt-to-asset ratio has risen to its highest level in more than 20 years.

In short, Canadian household balance sheets are becoming increasingly stretched. It is possible that Canadians are beginning to address some of these vulnerabilities. This would be consistent with recent data that indicate a slowdown in household consumption expenditures and housing activity, amid a labour market recovery that has been longer on jobs than on hours or incomes.

The Bank expects balance-sheet considerations will remain important ahead, likely limiting consumption growth to a rate more consistent with income growth over the medium-term horizon.

Reflecting recent developments, inflation in Canada has been slightly lower than the Bank's expectations, with core CPI of 1.6 per cent and total CPI of 1.7 per cent in August. However, its dynamics are essentially unchanged. Inflation expectations are well anchored at the 2 per cent target. Developments in the labour market described earlier, combined with expenditure restraint in the public sector and a pickup in labour productivity, should contribute to restrained growth of unit labour costs. This downward pressure on inflation is expected to be offset by the gradual absorption of excess supply as the economy grows. As has been the case with previous changes in indirect taxes, for the purposes of monetary policy, the Bank will look through the first-round effect of recent changes in provincial sales taxes on prices.

Policy implications

A durable global recovery requires a major rebalancing of global supply and demand. This will be a slow process, measured over a decade. During this period of adjustment, we should expect subdued growth in major advanced economies. Consider that in the 10 years following a typical financial crisis, the median rate of output growth in the crisis economy decreases by 1 per cent and the unemployment rate increases by 5 percentage points.[6] The United States is tracking this path.

In such an environment, very low policy rates could be in place for longer, and unconventional monetary policies could even be expanded in some major countries. But

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4 Bank of Canada *Financial System Review*, June 2010 and December 2009.

5 This analysis has been conducted with data from the *Canadian Financial Monitor* survey by Ipsos Reid Canada.

6 See C. Reinhart and V. Reinhart, "After the Fall," *Macroeconomic Challenges: The Decade Ahead*, Federal Reserve Bank of Kansas City Economic Policy Symposium, Jackson Hole, Wyoming, 26–28 August 2010.

clearly, monetary policy alone will not be enough. Advanced economies need to chart a course for fiscal sustainability, complete an ambitious restructuring of their financial systems, and implement domestic structural reforms. Emerging economies need to expand domestic demand and fulfill commitments to enhanced currency flexibility. Ultimately, all countries need to create a more flexible, open international monetary system to complete the transformation to a multi-polar world.

The Bank of Canada is working with other major central banks on this vital international agenda but, ultimately, our most important contribution to the economic welfare of Canadians is to continue to deliver price stability as defined by our 2 percent inflation target.

In response to the sharp, synchronous global recession, the Bank lowered the target rate rapidly over the course of 2008 and early 2009 to its lowest possible level. We almost doubled our balance sheet to provide the financial sector with exceptional liquidity. With our conditional commitment, the Bank provided exceptional guidance on the likely path of our target rate. These policies provided considerable additional stimulus during a period of very weak economic conditions and major downside risks to Canadian economy.

With the initial rapid narrowing of the output gap, the return of employment to its precrisis peak, the highly effective transmission of monetary policy in Canada, and the sustained momentum in household borrowing, the need for such emergency policies passed.

Since the spring, the Bank has unwound the last of our exceptional liquidity measures, removed the conditional commitment, and raised the overnight rate to 1 per cent. Following these actions, financial conditions in Canada have tightened modestly but remain exceptionally stimulative. This is consistent with achieving the 2 per cent inflation target in an environment of still significant excess supply in Canada and the demand headwinds described earlier. While Canada's circumstances and the discipline of the inflation target dictate a different policy stance than in the United States, there are limits to this divergence.

At this time of transition in the global recovery, with risks of a renewed U.S. slowdown, with constraints beginning to bind growth in emerging economies, and with domestic considerations that will slow consumption and housing activity in Canada, any further reduction in monetary policy stimulus would need to be carefully considered. The unusual uncertainty surrounding the outlook warrants caution.

Historically low policy rates, even if appropriate to achieve the inflation target, create their own risks. Aside from monetary policy, Canadian authorities will need to remain as vigilant as they have been in the past to the possibility of financial imbalances developing in an environment of still low interest rates and relative price stability.

Conclusion

Today's venue honours Giovanni Caboto, who, more than 500 years ago, combined the navigation skills of his home in Genoa with the commercial initiative of his Bristol sponsors to make landfall in Canada. His voyage marked the start of the opening of North America to global commerce. Similarly today, Canadian business must open new markets.

The world's economic centre of gravity is again shifting. With the integration of one-third of humanity into the global economy, the world is rapidly becoming multi-polar. Emerging-market economies are now the main drivers of commodity prices, they represent almost one-half of the growth in all imports over the past decade, and they currently account for about two-thirds of global growth. In contrast, the United States is undergoing a protracted adjustment, which will subdue demand for Canadian goods for the foreseeable future.

Canadians must respond. As a country we are under exposed to the economies that will drive global growth. The imperatives for business appear clear: new suppliers need to be sourced; new markets opened; and a new approach to managing for a more volatile environment developed. Workers need to build skills and be prepared to shift jobs and even careers, if necessary.

Business in Windsor-Essex has started. Our auto sector is undergoing a major restructuring and is emerging more competitive. There are recent signs that other sectors are beginning to follow. If business can sustain and then broaden this early momentum, all Canadian workers will be fully and productively employed.

Appendix

Chart 1: Asset correlations are unusually high

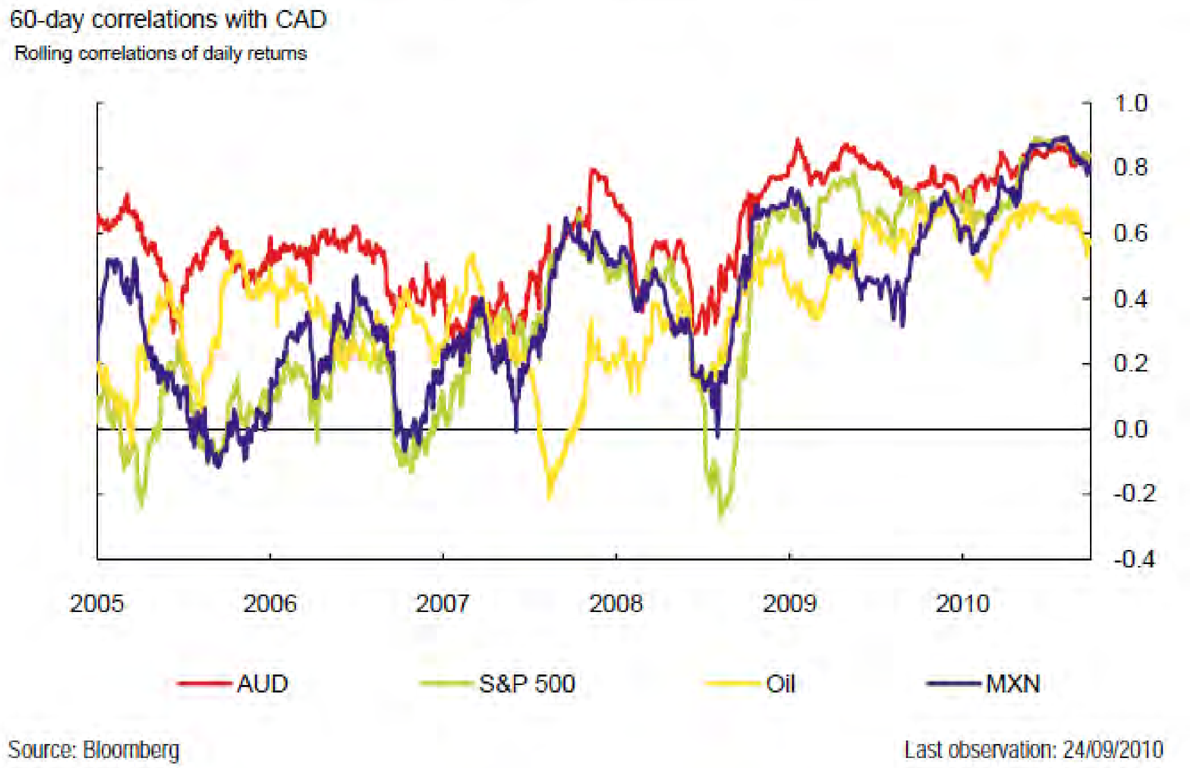
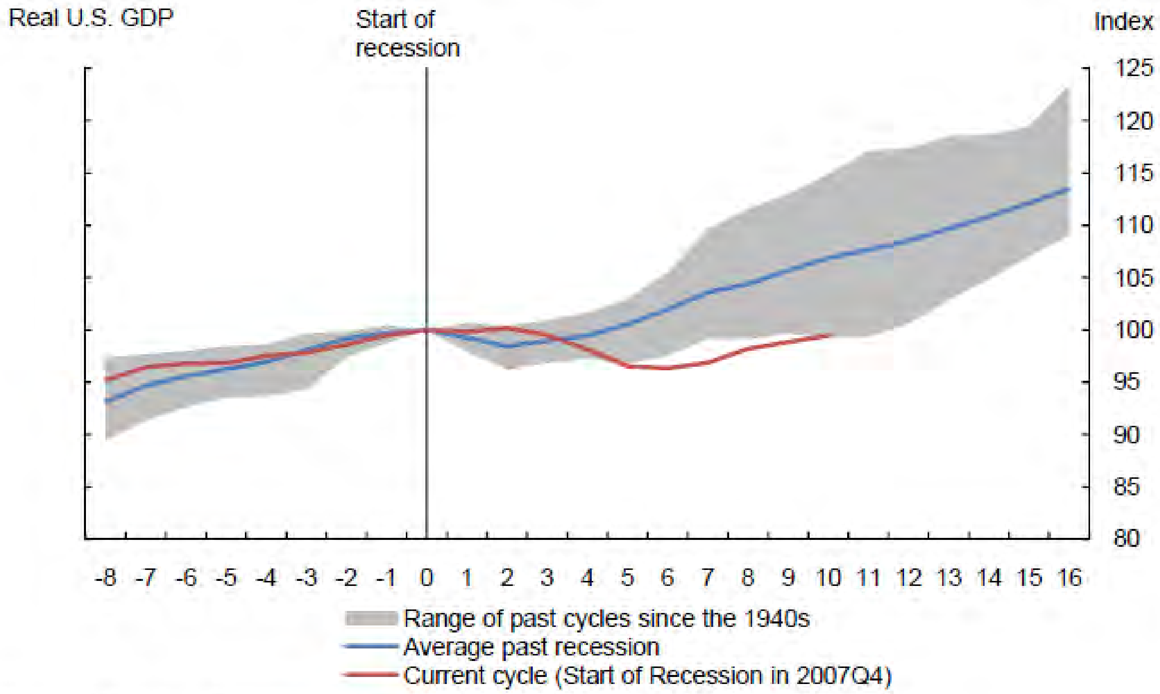


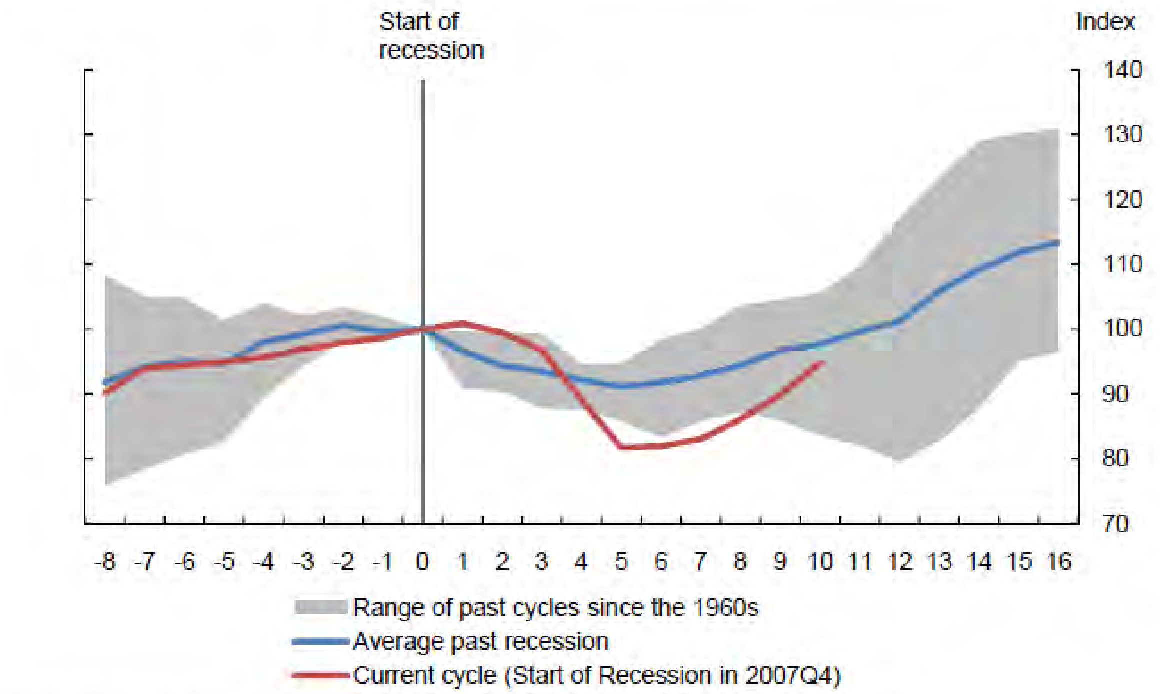
Chart 2: Corporate all-in yields at historic lows

Chart 3: U.S. recovery unusually weak



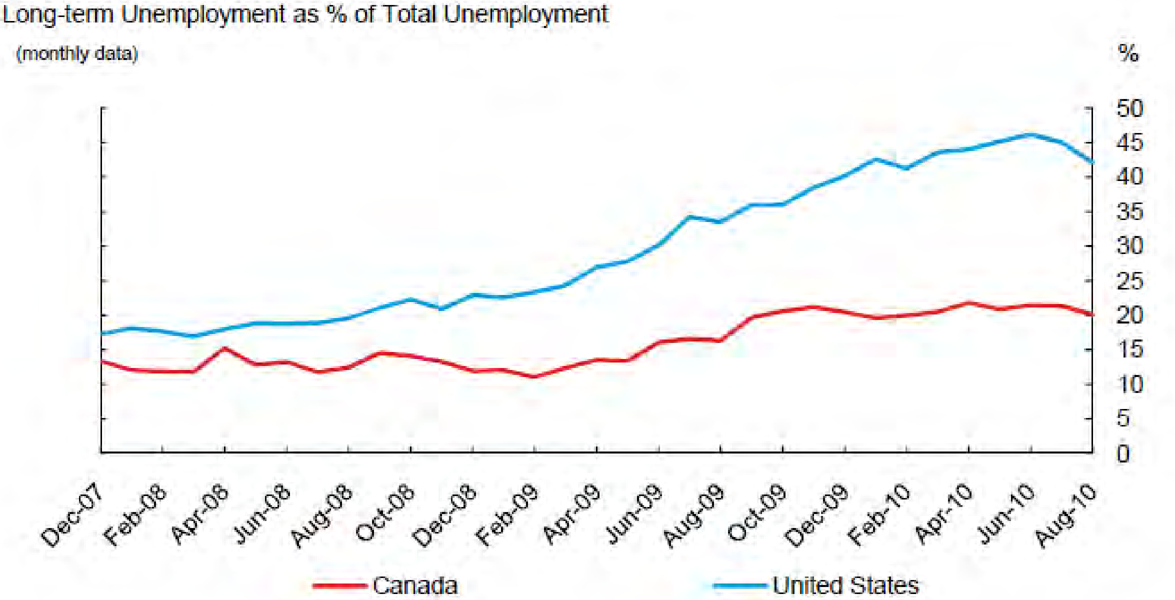
Sources: U.S. Bureau of Economic Analysis, NBER (dating of cycles), and Bank of Canada calculations

Chart 4: U.S. Investment in equipment and software is rebounding



Source: U.S. Bureau of Economic Analysis, NBER (dating of cycles), and Bank of Canada calculations

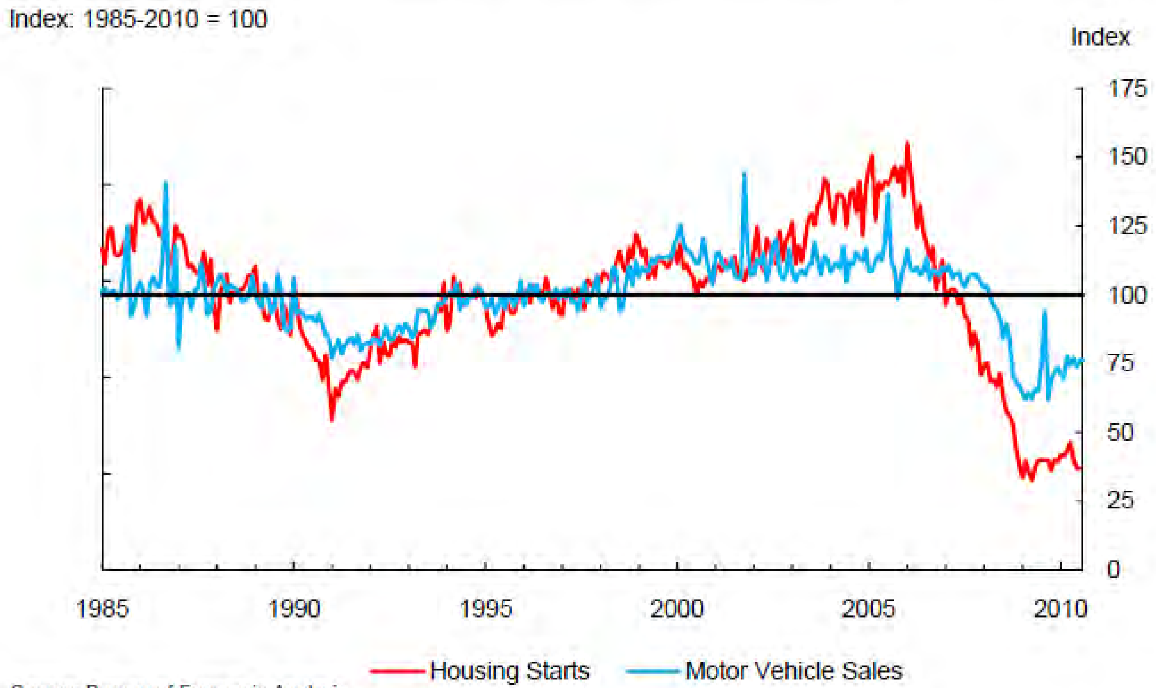
Chart 5: U.S. incidence of long-term unemployment is double Canada's



Source: Statistics Canada, U.S. Bureau of Labor Statistics, and Bank of Canada calculations

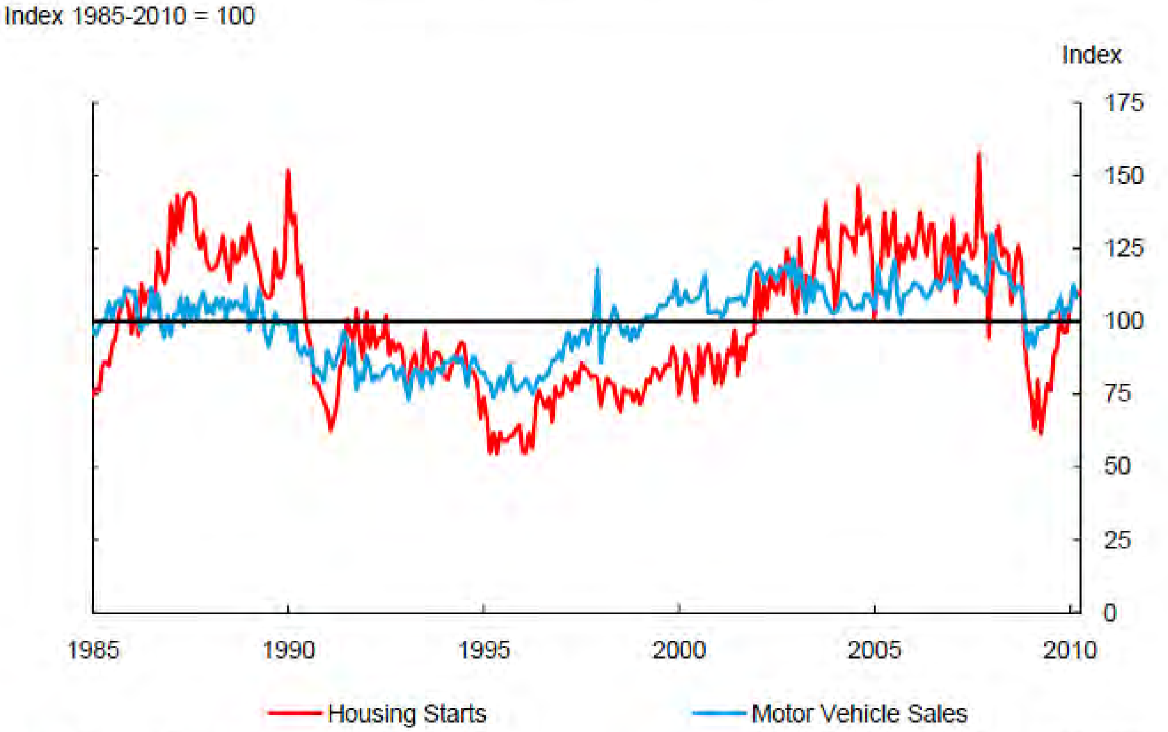
Last observation: August 2010

Chart 6a: U.S. housing starts and auto sales well below historic levels



Source: Bureau of Economic Analysis

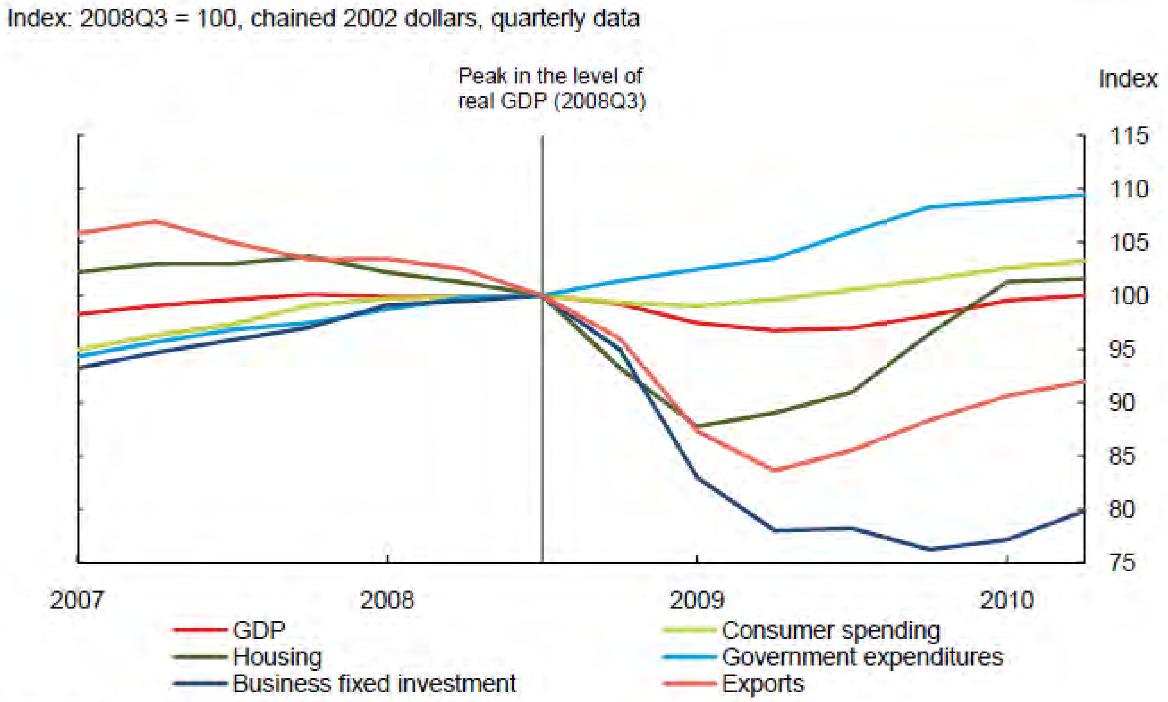
Chart 6b: Canadian housing starts, auto sales back to historic average



Source: Statistics Canada

Last observation: 01/04/2010

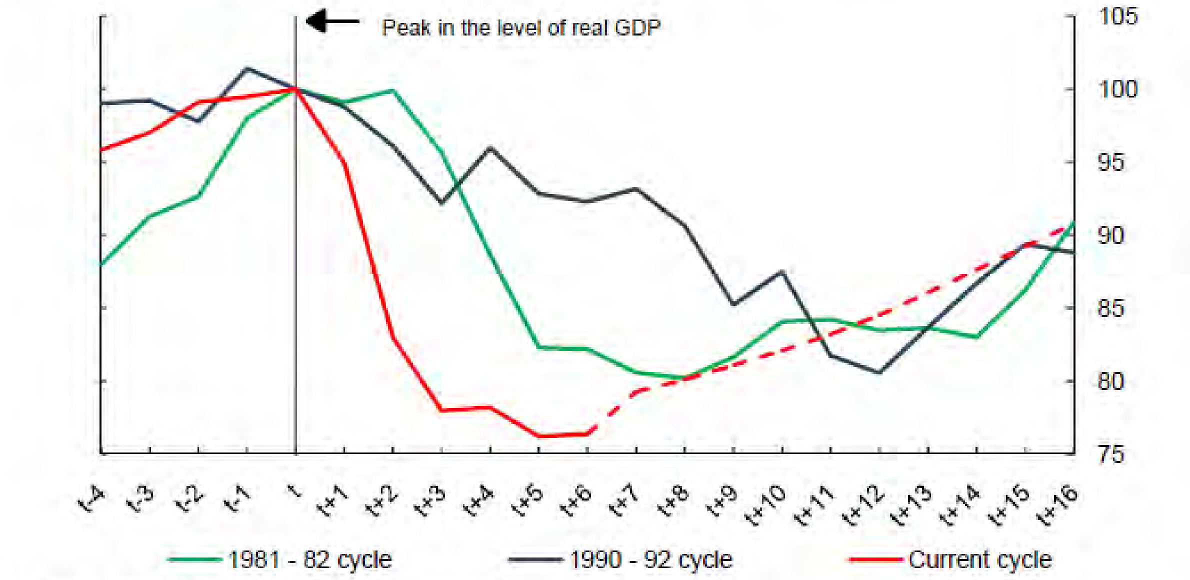
Chart 7: Canadian GDP by component



Source: Statistics Canada and Bank of Canada calculations

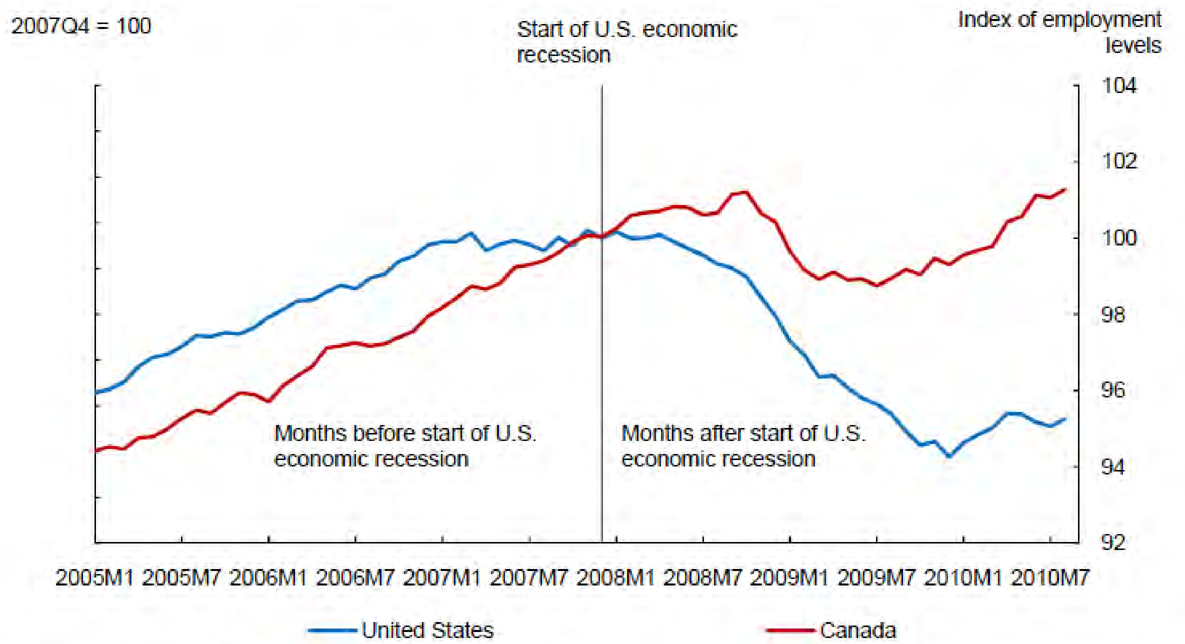
Chart 8: Canadian business investment to pick up sharply from trough

Comparison of Canadian real business investment across economic cycles;
peak of cycle = 100, quarterly data



Sources: Statistics Canada and Bank of Canada calculations and projections

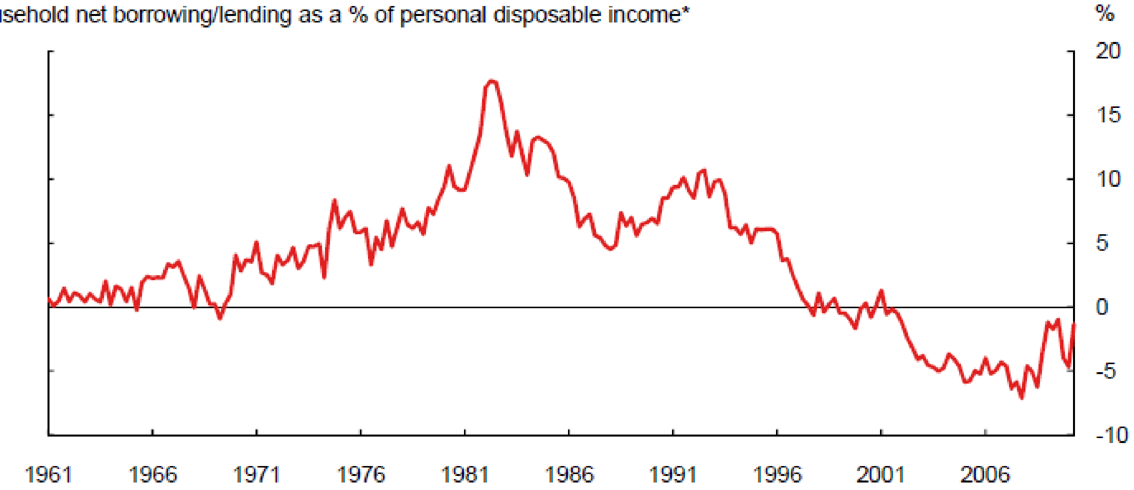
Chart 9: Canadian employment levels substantially stronger than U.S.



Sources: Statistics Canada, U.S. Bureau of Economic Analysis, NBER (dating of U.S. cycles), and Bank of Canada calculations

Last observation: 2010M8

Chart 10: Canadian household sector has become net borrower

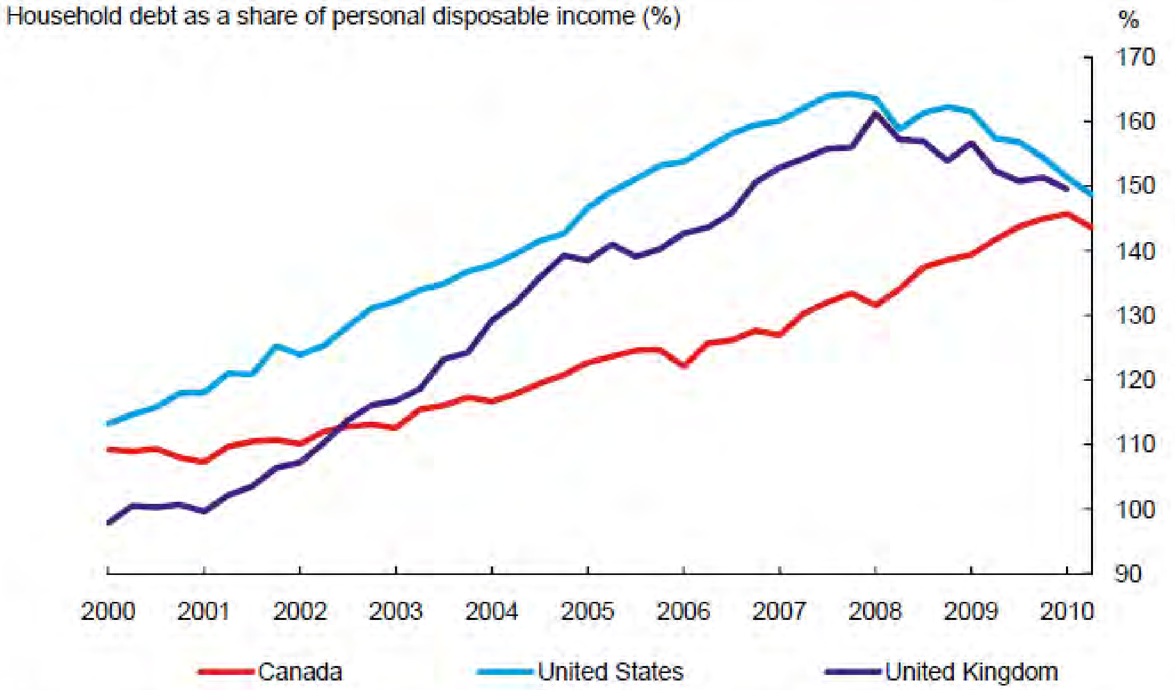


Source: CANSIM

Last observation: 2010/Q2

* Household net borrowing/lending represents the difference between the household sector's current saving and its net investment in a given period (or equivalently, its net financial source/requirement). The household sector includes unincorporated businesses.

Chart 11: Debt-to-income ratio of Canadian households is rising



Sources: Statistics Canada, U.S. Federal Reserve, ECB, U.K. Office for National Statistics

Last observation: 2010Q1