Mark Carney: Canada in a multi-polar world

Remarks by Mr Mark Carney, Governor of the Bank of Canada, presented to the Canadian Club of Ottawa, Ottawa, Ontario, 16 May 2011.

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Introduction

It is a pleasure to speak to this venerable institution.

When the Canadian Club was founded in 1903, the world economy was being transformed. A great wave of globalization was under way with commerce expanding and distance shrinking. International trade and capital flows were growing at historically rapid paces and, just a year earlier, Marconi had started a communications revolution from the peak of Signal Hill.

It was a time of tremendous opportunity for a young country with immense potential.

Canada took advantage, posting the fastest growth in the world in the 20 years preceding the First World War. Our economy evolved rapidly as trends that would extend far into the century began to crystallize. New industries, notably the wheat boom on the Prairies and steel in central Canada, emerged, supported by mass immigration and new technologies.

Our principal markets began to shift from the historic Empire preferences towards the rapidly rising United States. By 1990, after almost a century of continental integration, the share of our exports to the United States would double.

In the early decades of the 20th century, the new economic order supported, and occasionally buffeted, the Canadian economy. The United States went through the boom-bust-boom cycles typical of an emerging hegemon. The international monetary system strained to the breaking point under the weight of disruptive change in the economic order. A reflexively isolationist America was slow to replace the ebbing *Pax Britannia*, until depression and war gave birth to an uneasy multilateralism.[1]

In the process, Canada learned some important lessons:

Openness is better than protectionism. Trade brings innovation, growth and jobs. However, it also brings shocks, which demand resilient institutions and dynamic policy responses.

Economic flexibility is essential. Markets change; industries rise and fall; exciting new products emerge and then become commoditized. In a rapidly shifting world, only sustained education, ingenuity and investment can maintain competitiveness.

Sound macroeconomic policy is the cornerstone of prosperity. Fiscal profligacy erodes economic sovereignty; inflation hurts the most vulnerable while undermining confidence and investment; price stability is paramount.

These lessons will remain valid in the years ahead.

The new paradigm shift

We meet today in the midst of another great transformation – one that is occurring more rapidly than most recognise.

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[1] C. Kindleberger, The World in Depression 1929?1939 (Berkeley: University of California Press, 1973).

The financial crisis has accelerated the shift in the world's economic centre of gravity. Emerging-market economies now account for almost three-quarters of global growth – up from just one-third at the turn of the millennium.

Robust emerging market economies

Recent strength in emerging economies reflects the combination of spectacular secular trends reinforced by powerful cyclical forces.

Emerging Asia is rapidly urbanizing. Since 1990, the number of people living in cities in China and India has risen by nearly half a billion, the equivalent of housing the entire population of Canada every 18 months. This process can be expected to continue for decades.

In parallel, a massive new middle class is being formed, growing by 70 million people each year and set to double to 40 per cent of the global population by the end of this decade.[2]

Accommodative monetary policies, capital inflows and credit booms are currently reinforcing these secular forces and driving strong – in some cases, unsustainably strong – domestic demand in major emerging markets.

While many emerging economies have begun raising interest rates and applying other restrictive measures, monetary policies remain quite stimulative. Real interest rates are negative in many cases, despite excess demand (Chart 1). In some large emerging-market economies, nominal exchange rate adjustment is being thwarted and real effective exchange rate appreciation is being driven by inflation – in Asia, exclusively so (Chart 2).

These policies risk asset bubbles in emerging economies, more acute inflationary pressures globally and subpar global growth.

Listless advanced economies

The contrast between the emerging world and the advanced economies could not be starker.

The major advanced economies, particularly the United States, were Canada's future once. However, in the years ahead, they will be weighed down by the legacy of the crisis. Repairing the balance sheets of banks, households and countries will take some time (Charts 3 and 4).

None of this is surprising. History suggests that recessions involving financial crises tend to be deeper and have recoveries that take twice as long. In the decade following severe financial crises, growth rates are about one percentage point lower and unemployment rates five percentage points higher.[3] The current U.S. recovery is proving no exception.

In Europe, the recovery is being restrained by major competitiveness and fiscal challenges in peripheral economies, as well as the risks of contagion from under-capitalised banks. We support the current efforts of our European partners to resolve these issues through aggressive bank stress tests and, in conjunction with the International Monetary Fund (IMF), credible programs to support durable recoveries in the affected economies.

In Japan, the cost of the physical damage of the earthquake, tsunami and subsequent nuclear crisis could reach as high as 6 per cent of GDP. The resulting supply chain disruptions will hit growth in Japan and other advanced economies, including Canada, this

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[2] McKinsey & Company, "The Great Rebalancing," *McKinsey Quarterly*, June 2010.

[3] See C. M. Reinhart and V. R. Reinhart, "After the Fall," *Macroeconomic Challenges: The Decade Ahead*, Federal Reserve Bank of Kansas City 2010 Economic Policy Symposium. Available at: http://www.kansascityfed.org/publicat/sympos/2010/reinhart-paper.pdf

quarter. Over the longer term, Japanese growth will be weighed down by significant fiscal and demographic pressures.

The balance of these two major forces – weakness in advanced economies and strength in emerging economies – determines the global economic outlook. Last fall, the consensus was that a faltering recovery in advanced economies was a greater risk than overheating in emerging markets. Today, it is the opposite. Such reversals can be expected to continue.

Although this shift to a multi-polar world is fundamentally positive, it is also disruptive. Labour, capital and commodity markets are changing rapidly. The effective global labour supply quadrupled between 1980 and 2005 and may double again by 2050.[4] Cross-border capital flows have exploded, growing at almost seven times their rate when this club was founded. Commodity markets are in the midst of a super cycle.

Once again, it is a time of great opportunity for Canada, but navigating the cross-currents in the global economy will require boldness and skill.

Allow me to expand on three consequences for Canada.

Changing patterns of trade

Patterns of trade are evolving rapidly. In particular, the expanding urban middle class in emerging economies is having a major impact on a wide range of commodities. Whether it is travel, housing or protein, consumption levels in major emerging markets are currently fractions of those in advanced economies.[5] With convergence still a long way off, the demand for commodities can be expected to remain robust for some time. Based on the experiences of Japan in the 1960s and Korea in the 1980s, emerging Asia's energy and metals intensities should gain momentum in coming years.

Even though experience suggests that all booms are finite, this one could go on for some time.

The Bank's view is that a large, sustained increase in demand (most notably in China) is the primary driver of this boom. With more than three-quarters of commodities above their long-term averages, the breadth and durability of the rally underscores this conclusion (Chart 5). This is not to say commodity prices will not continue to fluctuate, sometimes abruptly. Recent declines could reflect a re-rating of global growth prospects combined with some adjustments to positions of financial market participants. But these are fluctuations around high levels.

The reorientation of production to Asia and the dramatic increases in its infrastructure spending have also fuelled an export boom of capital goods, which is supporting the recoveries in major economies.[6] This is one reason why U.S. production has led domestic demand. These exports of capital goods have fed the hiring and, by extension, the consumption growth that has occurred.[7]

Going forward, Canada's exposure to emerging markets will be increasingly important. At this stage, it is largely derivative (gaining more from the price impact of commodities than

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4 Adjusted for the percentage of the population in the traded-goods sector. See M. Carney, "The Implications of Globalization for the Economy and Public Policy," speech delivered to the British Columbia Chamber of Commerce and the Business Council of British Columbia, Vancouver, British Columbia, 18 February 2008.

5 See M. Carney, "The Paradigm Shifts: Global Imbalances, Policy, and Latin America," speech delivered to the Inter-American Development Bank, Calgary, Alberta, 26 March 2011.

6 During the financial crisis, U.S. machinery & equipment exports fell sharply relative to other export categories. The subsequent strength in growth of this category has largely been a *recovery* towards pre-crisis levels. It now sits at 54 per cent of total exports, slightly above its pre-recession share.

7 Labour input growth in the goods sector is 28 per cent.

from broader export sales). Higher commodity prices raise profits in the primary sector, which in turn stimulates production and investment in that sector, as well as greater spending more broadly on domestically produced goods and services.

However, since only 10 per cent of Canada's exports go to emerging economies and our non-commodity export market share in the BRICS has been almost halved over the past decade, activity in Canada does not benefit to the same extent as in past commodity booms driven by U.S. growth.[8] The current situation is more akin to a supply shock for our dominant trading partner, with higher commodity prices acting as a net brake on growth. With oil prices up 50 per cent since last summer, the effect is material.[9]

Increasing market share in emerging markets will require sustained efforts to develop trade, technical and academic partnerships. In tandem, Canadian business needs to improve its competitiveness, source new suppliers, and prepare to manage in a more volatile environment.

Changing capital flows

The second consequence of the shifting global landscape is dramatic changes in the scale, composition and direction of capital flows. These dynamics will have important implications for returns for Canadian investors, the cost of capital for our businesses, and the risks to our economy. Given the expected growth differentials between emerging and advanced economies and the substantially underweight positions of most Canadian investors, the opportunities appear substantial. However, it will be a crowded field in the short term.

Investors from advanced economies are substantially overweight in their home markets: advanced economies represent half of current global GDP, but their equity market capitalization is nearly three-quarters of the global capital market. A reallocation of 5 per cent of advanced-economy portfolios to emerging markets translates into a potential flow of $2 trillion, or 10 times portfolio equity flows to all emerging markets.

Unlike Canada, which imported on average 8 per cent of GDP per year in the three decades before World War I, emerging markets are currently net capital exporters (Chart 6). In effect, there is a massive recycling operation under way: private capital flows from advanced to emerging economies are being more than offset by official outflows in the opposite direction.

While emerging economies are having difficulties absorbing large private flows, advanced economies have often misallocated surges in yield-insensitive gross claims. In Canada, as elsewhere, large capital inflows will require vigilance from public authorities and private financial institutions. Financial history, particularly during times of large power shifts, is rife with examples of booms stoked by dumb money that turn good situations to bad.

Moreover, the current dynamics could have important effects on the exchange rates of countries like Canada. With some countries managing their exchange rates and restricting capital inflows, pressure for U.S.-dollar depreciation is re-directed to freely floating currencies. As well, the stock-flow problem of investors looking to rebalance portfolios towards emerging markets could lead them to invest in proxies such as Australia and Canada. Finally, the desire of major reserve holders to diversify their portfolios provides additional support. With financial market participants trying to ride these trends, volatility could become excessive.

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[8] BRICS refers to Brazil, Russia, India, China and South Africa.

[9] All else being equal, the IMF estimates that a 10 per cent increase in oil prices, reduces U.S. growth by about 0.2 to 0.4 per cent.

The imperative of macro stability

In this environment, domestic macro stability is paramount.

Sustained fiscal adjustment is now required in most advanced economies. Debt-to-GDP in G-7 countries is now the highest since the Second World War. The Age of Austerity is not a slogan but a timetable.

The task is enormous (Chart 7). Stabilizing debt will require increases in the primary balances of between 8 and 11 per cent of GDP for the United States, the United Kingdom and Spain. Moreover, these forecasts assume that nominal interest rates will be roughly the same level as nominal growth rates. However, if markets begin to lose patience, higher rates will ensue and the required adjustment will be even larger.[10]

Canada is one of the few advanced economies on a path to avoid this outcome. However, despite this crucial advantage, we cannot fully insulate ourselves from the spillovers from others. Fiscal slippage by some major countries may increase interest rates for all. Moreover, experience suggests that when debt exceeds 90 per cent of GDP (as it will for most of our trading partners), growth slows, with predictable consequences for our exports.[11]

In the extreme, if fiscal consolidation abroad is delayed too long, investors may even call into question the existence of a risk-free asset. This would have far-reaching consequences, including less-diversified portfolios, higher risk premia across asset classes and greater asset market volatility.[12] The resulting higher borrowing costs for individuals and firms would have broad-based implications for capital allocation and economic growth.[13]

In the end, given these risks, all countries should follow the Toronto G-20 accord to halve their deficits by 2013 and stabilize their respective debt-to-GDP ratios by 2016.

Implications for monetary policy in Canada

In this volatile world, the best contribution that monetary policy can make is to keep inflation low, stable and predictable. The outlook for inflation in Canada is importantly influenced by current manifestations of some of the longer-term trends I have mentioned.

Following the depths of the crisis, Canadian domestic demand grew very strongly, supported by highly stimulative fiscal and monetary policy. Now, aggregate demand is rebalancing towards business investment and net exports and away from government and household spending. However, the relative weakness in the U.S. economy, our under-representation in emerging markets, and our competitiveness challenges will likely weigh on export performance for some time.

While underlying inflation is relatively subdued, the Bank expects that sharp increases in energy prices (when combined with ongoing changes in provincial indirect taxes) will keep total CPI inflation above 3 per cent in the short term, as was the case in March, before it returns to the 2 per cent target by the middle of 2012. Core inflation is expected to rise to 2 per cent over the same period, as excess supply in the economy is slowly absorbed, labour compensation growth remains modest, productivity recovers and inflation expectations remain well anchored.

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[10] A 2 per cent increase in interest rates could require another 4 per cent of GDP fiscal adjustment for some countries.

[11] C. M. Reinhart and K. Rogoff, “Growth in a Time of Debt,” *American Economic Review* 100, No. 2 (May 2010): 573–578.

[12] A. Damodaran, “Into the Abyss: What if nothing is risk free?” (2010). Available at: <http://pages.stern.nyu.edu/~adamodar/>.

[13] F. Black, “Capital market equilibrium with restricted borrowing,” *Journal of Business* 45, no. 3 (1972): 444–455.

Data received since the April decision have generally supported the Bank's near-term outlook. Recent inflation and employment have been modestly stronger; auto sales and retail purchases have been a touch weaker. Indicators have been consistent with continued, strong business investment.

The possibility of greater momentum in household borrowing and spending in Canada represents an upside risk to inflation in Canada. The persistent strength of the Canadian dollar could create even greater headwinds for our economy, putting additional downward pressure on inflation in Canada.

The Bank's 1 per cent target for the overnight rate leaves considerable monetary stimulus in place, consistent with achieving the 2 percent inflation target in an environment of material excess supply in Canada. Any further reduction in monetary stimulus would need to be carefully considered.

Conclusion

The lessons of the past century would serve us well in this one.

As Barry Eichengreen observed, "Global shifts have almost always fanned economic conflict, created problems for economic management, and heightened diplomatic tensions."[14]

Challenges for economic management can be addressed by economic flexibility and sound macro policy. Canada's fiscal strength and monetary policy credibility represent crucial advantages that must be preserved.

Our commitment to openness should drive us not only to create new markets but also to help secure the new economic order. That is why we are investing so heavily in current G-20 efforts to develop a framework for open capital flows and reforms for more resilient financial systems. That is why we are working to help guide the multilateral cooperation and policy coordination required to support the global recovery. That is why we are trying to convince others to follow the lessons we learned in the last century, so that we can all realise the great promise of this one.

This is how we can best fulfill Laurier's vision, expressed in his inaugural address to this Club, when he called for a century "filled" by Canada.[15]

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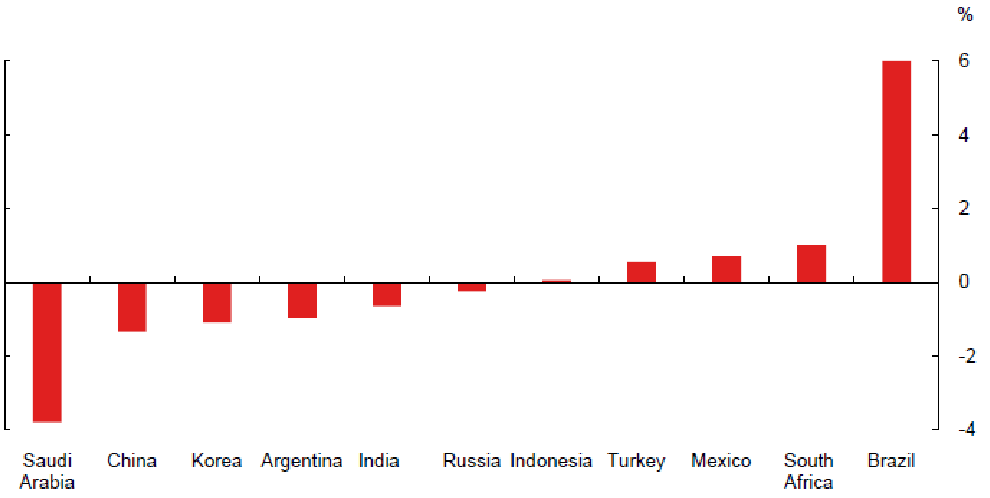
[14] B. Eichengreen, "Global Shifts," Paper presented at the Bank of Finland 200th Anniversary Conference, Monetary Policy Under Resource Mobility, held in Helsinki, Finland, 5?6 May 2011

[15] Laurier said, "Canada has been modest in its history, although its history, in my estimation, is only commencing. It is commencing in this century. The 19th century was the century of the United States. I think we can claim that it is Canada that shall fill the 20th century." Canadian Club of Ottawa, Ottawa, Ontario, 18 January 1904.

Appendix

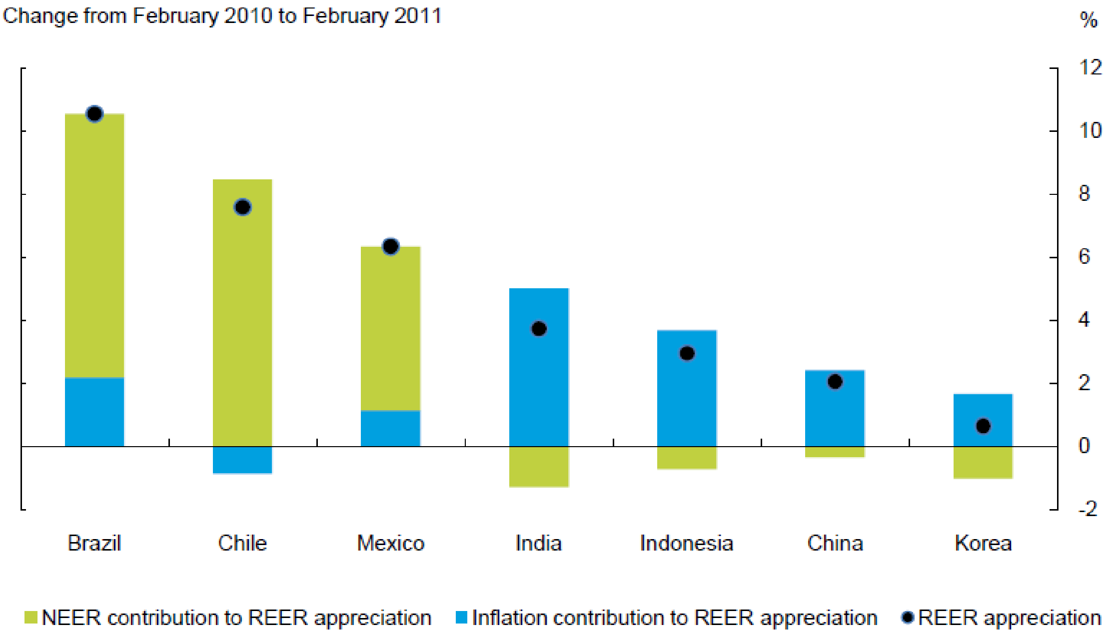
Chart 1: Real policy rates in G-20 EMEs



Source: National central banks, Consensus Economics

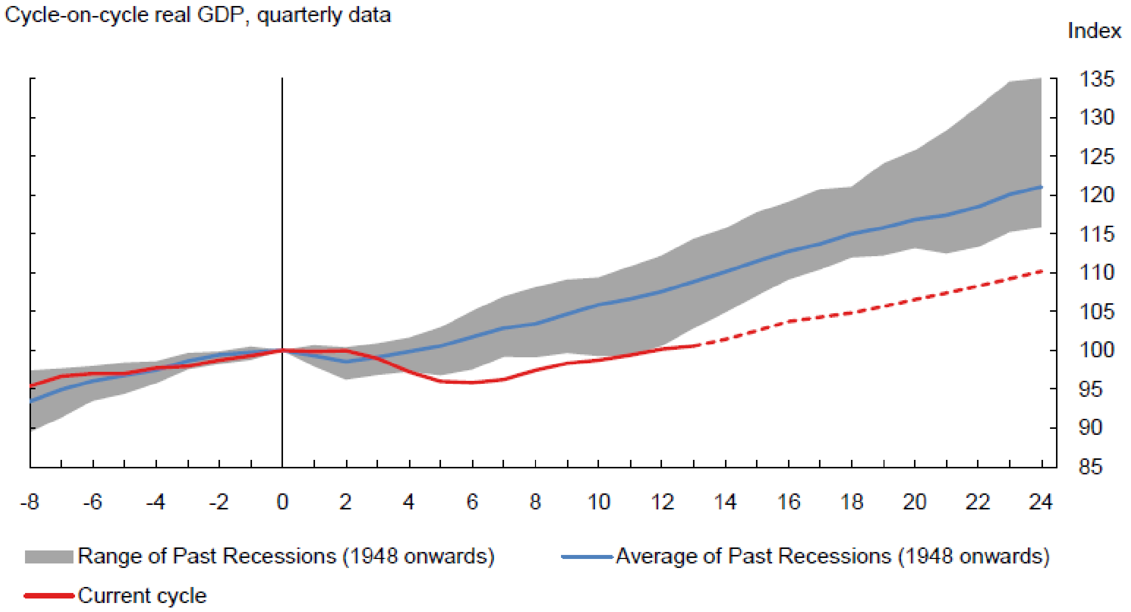
Chart 2: Appreciation primarily driven by inflation differential

Change from February 2010 to February 2011



Source: Bank for International Settlements

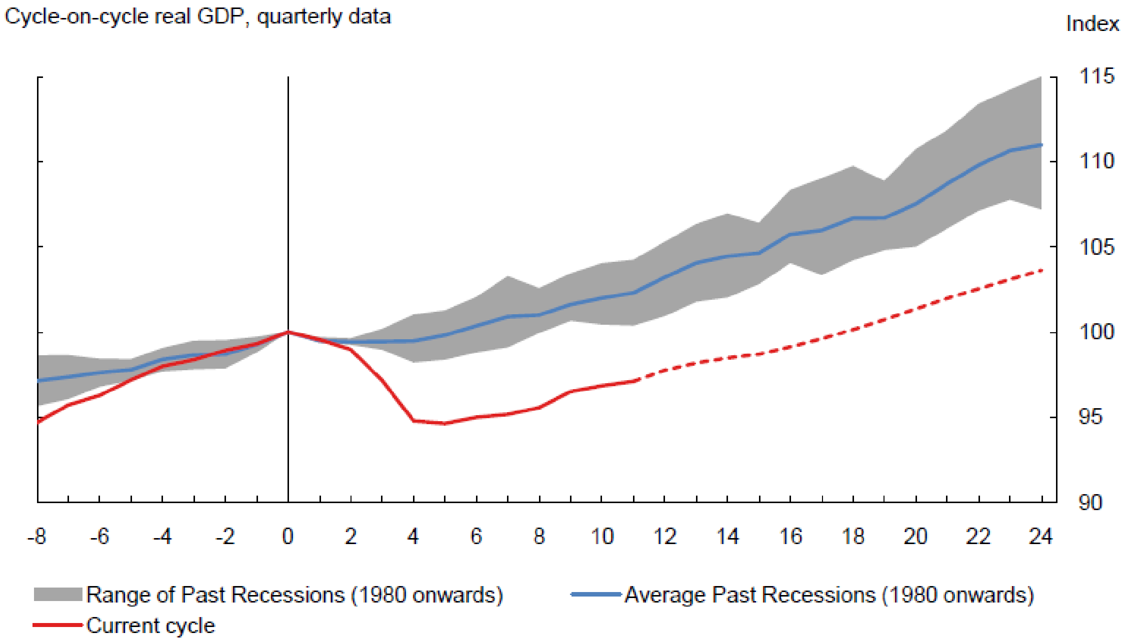
Chart 3: Listless U.S. recovery



Sources: Bureau of Economic Analysis and Bank of Canada calculations

Last observation: 2010Q4

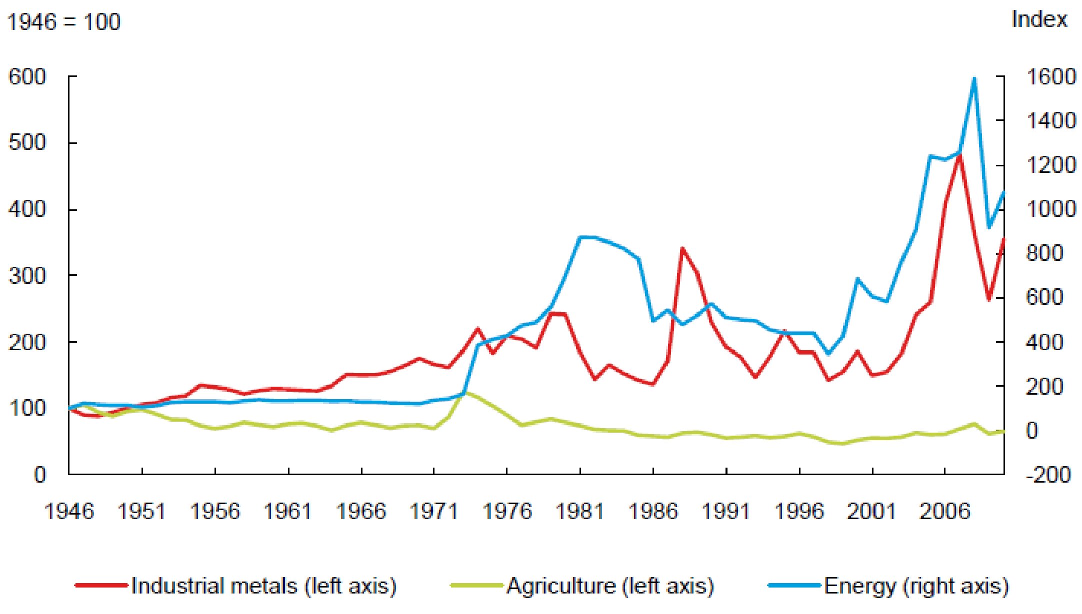
Chart 4: Listless Euro area recovery



Sources: Eurostat and Bank of Canada calculations

Last observation: 2010Q4

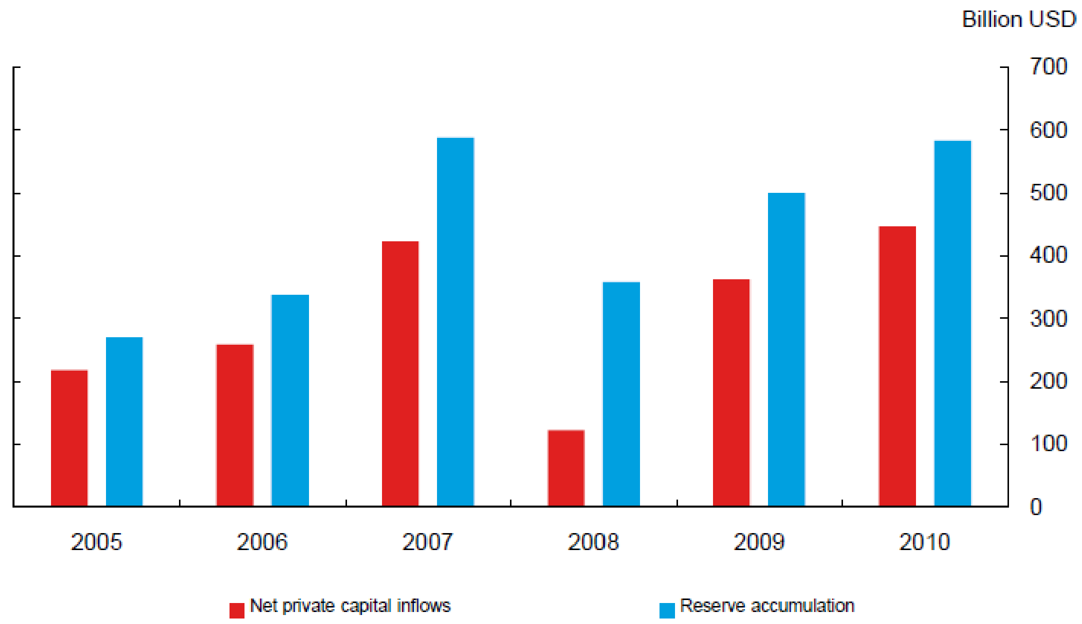
Chart 5: Commodity prices elevated



Source: Bank of Canada

Last observation: 2010

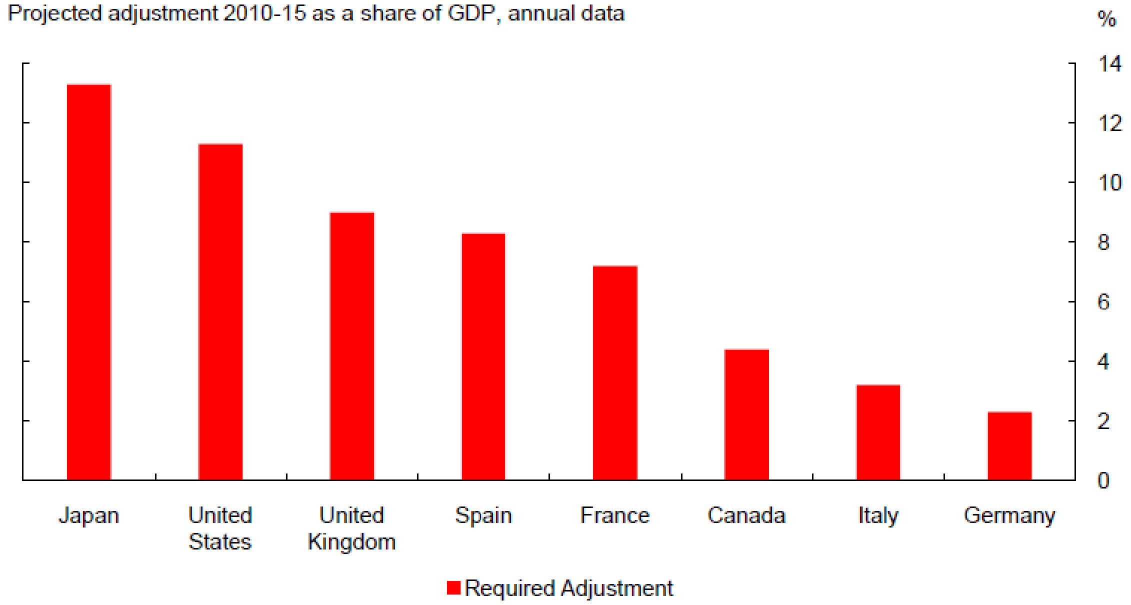
Chart 6: Capital inflows and reserves accumulation in emerging Asia



Source: Institute of International Finance

Estimate 2010

Chart 7: Large adjustment required



Note: Cyclically adjusted primary balance adjustment needed to bring the debt ratio to 60 percent by 2030. For Japan, the scenario assumes a reduction in net debt to 80 percent of GDP.
Source: IMF April 2011 WEO