Stephen S Poloz: Canada and Mexico - common issues in uncommon times

Remarks by Mr Stephen S Poloz, Governor of the Bank of Canada, to the CanCham México and Club de Industriales, Mexico City, Mexico, 4 May 2017.

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Introduction

I am thankful for the opportunity to speak with you today, as it is a good time for our two countries to be talking. It is true that nobody will ever confuse Mazatlán with Manitoba, particularly in February. But it is also true that Canada and Mexico have more in common than is usually appreciated, especially on the economic front.

A good deal of our commonality stems from the fact that we are both relatively small open economies that trade heavily with the economic powerhouse next door, the United States. But we share much more than a common neighbour. Resources, particularly oil, are an important part of both of our economies. The automotive industry plays a vital role in our manufacturing sector, along with high-tech manufacturing such as communications and pharmaceuticals. And while we may be at different stages of our economic history, we are following a similar trajectory. In both countries, the service sector now makes up the majority of output—more than 60 per cent in Mexico and 70 per cent in Canada—and the shares are rising. Finally, we are both committed to rules-based free trade, and we both maintain a floating exchange rate within an inflation-targeting framework for monetary policy.

Since we have so much in common, it is not surprising that shocks in the global economy have hit us in similar ways. Now we are facing similar economic challenges. More important, we have similar opportunities that we can capitalize on by using our strengths. So today, I want to discuss recent developments in, and prospects for, the Canadian economy, in a way that will hopefully resonate for the audience here in Mexico.

Oil price shock

Let us start by looking back at the second half of 2014 and the collapse in oil prices. Various benchmarks saw declines of more than 50 per cent. Given the importance of oil to both Canada and Mexico, the shock represented a serious blow to our economies. It had a substantial impact on the terms of trade—the ratio of the prices a country receives for its exports relative to the prices it pays for its imports. Canada's terms of trade fell by roughly 11 per cent from the middle of 2014 though the first quarter of 2016. This meant a significant hit to our national income, about $70 billion in that period, or roughly 3.5 per cent of Canada's annual gross domestic product (GDP). Meanwhile, Mexico's national income declined by about 500 billion pesos, or about 2.5 per cent of annual GDP.

In response to the shock, our currencies depreciated—the peso dropped by 28 per cent against the US dollar during the same period, while the Canadian dollar declined about 20 per cent. Of course, some amount of depreciation was not surprising. It was a natural consequence of the shock, and it helped economic adjustments happen by sending signals that prompted shifts in investment and employment.

Although both currencies rebounded early in 2016, the peso then began to fall again, while the Canadian dollar more or less stabilized. Global capital flows were likely one important factor.

Historically, flows in and out of Mexican capital markets have been closely tied to investor sentiment about emerging markets. Capital flows into Mexico fell sharply in 2015 and remained low in 2016, as the US Federal Reserve prepared to raise interest rates and eventually began tightening monetary policy. This put additional downward pressure on the peso, on top of the pressure coming from lower oil prices that both Canada and Mexico faced.

In terms of output, though, the oil price shock hit Canada harder than Mexico. The Canadian economy contracted outright early in 2015, while growth in Mexico remained fairly stable. This reflected, in part, the fact that Canada is a bigger oil producer than Mexico is—at the end of last year, Canadian output was about twice as large as Mexico's.

For Canada, the oil price shock meant a significant shifting of capital and workers out of the oil and gas industry. It established a two-track economy: while the non-resource sector continued to expand, it was not enough to offset the sharp decline in the resource sector. From the start of 2015, the negative impact of the resource track dominated.

While the adjustment process in Canada has been complex, and very difficult on a personal level for many, we are seeing encouraging signs that the worst may be over. Activity and investment in the oil and gas industry have stopped declining and are coming back to a level that is commensurate with current prices. And because that large negative force is now essentially past, it is no longer masking the sources of strength in other sectors. There is still a way to go, but the two tracks of the economy are gradually converging to become a single track for sustainable growth.

Policy responses

Now let me say a few words about monetary and other policies in the aftermath of the oil price shock. Both the Bank of Canada and Banco de México dealt with the impact through our shared framework—inflation targeting with a flexible exchange rate.

To set the scene, it is worth noting that Canada was a very early adopter of both aspects of the framework. After experimenting with a floating currency in the 1950s, we allowed the dollar's value to be set in financial markets as early as 1970, and we have not looked back. In contrast, Mexico moved to a truly free-floating system only in 1994. In terms of targeting inflation, Canada adopted the practice in 1991, 10 years before Mexico officially did. I mention this only because the experience of central banks worldwide is that inflation targeting builds credibility and improves an economy's resilience to economic shocks. And the longer this policy framework is in place, the greater this impact becomes.

There is no doubt that the predictability and certainty that come from inflation targeting helped Canada's economy respond as quickly as it has to the oil price shock. The response demonstrated our economic resilience and flexibility, certainly when compared with shocks of past decades. I do not mean to dismiss how difficult it has been for many individuals. But at the aggregate level, the economy has shown its ability to adapt quickly. Other structural factors, such as Canada's relatively flexible labour market, have also contributed.

Mexico's inflation-targeting framework helped make its economy relatively resilient to the shock as well. Indeed, it is worth noting that since Mexico adopted inflation targeting, the country has not seen the type of domestic financial crisis that it regularly experienced in previous decades. Mexico's tax collection has improved, and it has also made notable progress with other structural reforms. While some of these have been politically difficult, such as the measures to open the oil sector to private and foreign participation, they have been important for increasing Mexico's resilience and competitiveness.

In both countries, the inflation-targeting regime framed the monetary policy response. Recall that the oil price shock led to a contraction in Canada's economy, while in Mexico growth continued at a slower pace. The drop in income caused by the shock raised the clear risk that Canadian inflation would fall below the Bank of Canada's target. So, we lowered our key policy interest rate twice in 2015 to help offset the fall in income and facilitate the adjustment from resource industries to the non-resource sector.

By the end of 2015, the US Federal Reserve began normalizing its monetary policy, and it has raised its key policy rate three times amid strengthening US inflation and a labour market that is near full employment. But in Canada, given that core measures of inflation have drifted downward in recent quarters and slack in the economy and labour market remains, we have kept our policy interest rate unchanged. Importantly, longer-term expectations of Canadian inflation have remained anchored at 2 per cent.

Mexico's experience has been somewhat different. The oil price shock was less of a downside threat to the inflation target. Indeed, the greater depreciation of the peso led to concerns about upward inflationary pressure. So, the central bank has tightened policy, by a total of 350 basis points, to counter inflationary pressures on consumer prices from the depreciation of the peso and other factors, as well as to ensure the impact of the exchange rate did not de-anchor inflation expectations.

Trade uncertainty

As I said earlier, the worst of the restructuring in Canada's oil sector appears to be over. After the shock hit, we expected a natural sequence to take hold; that is, stronger global demand—particularly from the United States—would lead to stronger exports. The depreciation in our currency would support gains in non-energy exports. All of this would spark increased business confidence and investment, which would increase growth and ultimately help bring the economy back to full output with inflation sustainably at target.

However, this sequence has yet to play out fully. A major part of the problem has been a continuing shortfall in Canadian exports relative to what one would expect historically. We have looked at this closely and found both a permanent loss of export capacity that started more than a decade ago and ongoing competitiveness challenges for some of our exporters. And now, we have another challenge to deal with—uncertainty about the future of US trade policy.

Clearly, this uncertainty is a significant issue for both Canada and Mexico. Both of our countries' trade is dominated by the United States. Last year, fully 75 per cent of Canada's goods exports went to the US market. For Mexico, the number was even higher, at 81 per cent. Similarly, the biggest share of both of our imports comes from the United States. These numbers reflect the traditionally open trading relationship among the three neighbours.

This uncertainty has real consequences for companies. It increases the risks companies face, which can raise their cost of capital and restrain investment. The Bank's most recent survey of Canadian companies showed that many see negative risks from potential US policies. These risks include increased protectionism, reduced competitiveness of Canadian firms if US corporate tax rates are lowered and possible delays in implementing pro-growth US policies.

To be clear, the outlook for investment in machinery and equipment in the Bank's *Business Outlook Survey* has continued to improve, and many companies are saying they are maintaining or modestly increasing their level of investment. However, some are also saying this spending will be limited to maintenance work, rather than the type of expansion that supports economic growth. When you consider that the painful memories of the global financial crisis are still fresh, it is not surprising that companies would continue to hesitate to expand in the face of this uncertainty.

The situation is similar in Mexico. Both producer confidence and investment intentions fell after the US election, reaching their lowest levels since the global financial crisis. In concrete terms, we have seen several announcements by companies in the auto industry to cancel or delay plans for major investments in Mexico. The picture is certainly not uniformly poor, and we have seen auto companies based outside the United States announce plans to invest in Mexico. Still, the ongoing uncertainty represents a clear challenge for both of our countries.

Dealing with uncertainty

This naturally leads to the question of what can be done. Any economist will tell you that open trade supports economic growth and employment. We know the predictable effects of protectionism. We have seen throughout history how efforts to shield industries and workers from foreign competition have been counterproductive. Increases in tariffs lead to higher inflation and a stronger real exchange rate, as well as potentially higher interest rates. Work done at the Bank of Canada shows that a broad-based increase in US tariffs would ultimately lead to *lower* US output after about five or so years, whether or not other countries retaliate. Basic economic theory also suggests that protectionism leads to slower productivity growth and slower rates of innovation and technology adoption.

But while it is one thing to make theoretical economic arguments about the benefits of open trade, it can be more helpful to have concrete examples. Consider the auto industry. We can talk about how it is responsible for 18 per cent of Canada's goods exports and about 30 per cent of Mexico's. We can talk about how many times a single auto part might cross a national border during the assembly process. And we can talk about the intricate supply chains that have been developed over more than 50 years.

Or, we can show how building a single, integrated North American auto industry has led to jobs in all three countries. The Automotive Parts Manufacturers' Association has done a good job putting the numbers together. In Canada, 81,000 people are employed in the automotive supply sector, by both Canadian and foreign-owned firms. Those Canadian companies operate 150 plants in the United States, employing almost 43,000 American workers, and 120 plants in Mexico, providing jobs for roughly the same number of workers there. It is hard to imagine how interfering with open trade or implementing other protectionist policies would benefit these people and their families.

It would be helpful to hear many more examples from other industries. Policy-makers, business leaders and labour leaders all have a role to play in showing how open trade has meant jobs for workers across North America and around the world. Nobody can explain the importance of trade to an employee better than their employer.

Regardless of what evolves, though, there is no shortage of potential sources of growth for both of our economies. The first order of business should be to keep working on opening trade elsewhere in the world. In this respect, Canada has been playing catch-up to Mexico, which has successfully negotiated access to many more markets than Canada.

The numbers tell a clear story. As of today, Canada has free trade agreements in force with 15 countries that represent about 22 per cent of global GDP. Mexico has agreements in force with 47 countries that represent 44 per cent of global GDP. But if you take the United States out of the picture, Canada is left with free access to just 6 per cent of the world economy, compared with 28 per cent for Mexico.

The good news for Canada is that this gap will close significantly once the agreement between Canada and the European Union comes into effect. It is unfortunate that the Trans-Pacific Partnership, with its ground-breaking coverage of intellectual property and services, has been shelved for now. Still, the work that was put into those areas could prove useful for both Canada and Mexico in future trade agreements. The bottom line is there is still scope for both countries to improve access to markets outside of North America.

Within Canada, we had the positive news last month of the agreement to lower barriers to interprovincial trade. Perhaps the most encouraging part of the agreement is that instead of listing the few areas that are subject to open trade, the provinces are now listing the areas that are exempt. This makes open trade the default position, and it means the provinces will be under continuous pressure to justify any exceptions.

Beyond pushing for open markets, governments can pursue structural policies that allow our economies to be as flexible as possible. Canada is taking some welcome steps in this direction —for example, by investing in infrastructure that can increase our economic potential and by helping workers develop new skills to take advantage of a changing labour market. I hope policy-makers at all levels of government will continue to focus on measures to improve Canada's flexibility.

I have already spoken about the moves by the Mexican government over the past five years to introduce some major structural reforms. Besides energy-market reforms, there has been good progress in such areas as tax policy, competition policy and regulatory reform. These and other measures are all investments in flexibility that will improve economic potential and give Mexico a better chance to succeed and grow in the future, no matter what is happening in the global economy.

In terms of central banking, the Bank of Canada has been working on the implications of heightened uncertainty for the economy and the conduct of monetary policy. More fundamentally, the Bank renewed its five-year inflation-targeting agreement with the Government last year. After a thorough look at all the evidence, we concluded that setting interest rates to aim inflation at a target of 2 per cent remains the best policy. Amid all the uncertainty, we can provide Canadian businesses and consumers with certainty about the future value of their money.

Conclusion

Allow me to conclude. For both Canada and Mexico, the oil price shock represented a significant economic setback. Sound economic policies in both countries are supporting a return to more balanced growth. But now, again, we face a common challenge. Even though trade liberalization and increased economic integration have generated prosperity across North America, we are now faced with the threat of new protectionist policies from our largest trading partner. We know that with protectionism, everybody loses eventually, including the country that puts the policies in place. And the uncertainty around this threat of increased protectionism is holding back growth.

However, in these times it is important not to lose sight of the bigger picture. There is much that Canada and Mexico can do to support growth and employment in our economies. We have faced obstacles before, and have overcome them. Back in the 1860s, the United States pulled out of a free trade agreement with the colonies of British North America. This provided the impetus for Canadian confederation 150 years ago, which turned out pretty well.

The antidote to uncertainty is certainty. The Bank of Canada will continue to provide certainty around the future value of our money through our commitment to inflation targeting. This is the best contribution we can make to Canada's economic welfare. And more broadly, Canada and Mexico's shared commitment to open trade means both of our countries are well placed to thrive, whatever the international environment.