Mark Carney: The coming thaw

Remarks by Mr Mark Carney, Governor of the Bank of Canada, to the Winnipeg Chamber of Commerce, Winnipeg, Manitoba, 4 February 2010.

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It is a pleasure to be here in Winnipeg. Today, I intend to elaborate on elements of the Bank of Canada's economic outlook.

After putting the recession in context and offering the Bank's perspective on the shape of the recovery, my remarks will focus on Canada's corporate sector. A focus on business is appropriate in Manitoba. This province is not only the geographic centre of our country, but also mirrors Canada's economic diversity. Manitoba's distinctive blend of primary, manufacturing, and service businesses represents a true cross-section of the Canadian economy. A focus on business is also appropriate at this stage of the economic cycle. A key determinant of the pace and sustainability of Canada's recovery will be how investment and hiring intentions of businesses in all sectors evolve as policy stimulus begins to fade.

My message is relatively straightforward: the thaw is coming. That may sound a little premature to someone standing at the corner of Portage and Main in early February, but it broadly captures the state of our economy. While its pace will likely be somewhat muted (given the depth of the recession) and while there may be setbacks, the recovery has begun. After a brutal economic winter, spring is within sight.

There is, however, a catch. The economic climate that Canadian business will face will be considerably different. Canada is entering this period of adjustment with many strengths, but the efforts required of us will be historic.

The global recession

In the fall of 2008, the intensifying financial crisis triggered a deep, synchronous global recession. The economic shock in the United States was spread – and in many cases amplified – through trade, finance, and confidence channels. We are just emerging from the worst economic downturn since World War II.

The speed and virulence of the slowdown took business by surprise. Over the turn of last year, there was the equivalent of a corporate heart attack: inventories surged, production was slashed, capital spending budgets eliminated, and employment cut. The cascade of collapsing demand through global supply chains shook widely held perceptions. Given the shock of the downturn, many firms understandably have been waiting for confirmation of the recovery before acting.

The Canadian recession in context

Canada experienced a short, sharp recession. In its depths last year, with the exception of government spending, all major components of aggregate demand declined. At its worst, industrial production fell 15 per cent. Canadian exporters suffered particularly, owing to the sharp fall in the components of U.S. economic activity that matter most for Canada. For example, U.S. demand for motor vehicles fell by more than half and housing starts by two-thirds.[1] In response to this new profile of U.S. demand, major Canadian industries (particularly the automotive and forestry sectors) began deep restructurings, which continue to this day.

[1] Overall, the Bank's trade-weighted measure of U.S. activity fell by 22 per cent. In this light, the 20 per cent drop in Canadian exports is less surprising.

The recession has had a considerable impact on employment. At its depth, 400,000 Canadians lost their jobs and the unemployment rate spiked by almost 3 percentage points to its highest level in more than a decade. Although the deterioration of the labour market appears to have stopped, too many Canadians who want to work are still out of a job, and many of those still employed are working fewer hours than they would like.

As painful as our recession was, Canada has suffered less than most other advanced economies. Domestic demand, fixed capital investment, and employment in Canada all held up substantially better than in the United States. Real GDP fell cumulatively by 3.3 per cent in Canada. That compares with declines of just less than 4 per cent for the United States, about 5 per cent for the Euro area, 6 per cent for the United Kingdom, and more than 8 per cent for Japan.

Canada's better performance can be explained by two factors. First, with a highly credible monetary policy and the strongest fiscal position in the G-7, Canadian policy-makers were able to respond swiftly and effectively with extraordinarily accommodative measures. The Bank of Canada began cutting interest rates in December 2007 and proceeded with a series of aggressive reductions until our key policy rate reached one-quarter of one per cent in April of last year, the lowest it can effectively go. Further, the Bank then provided extraordinary guidance on the likely path of interest rates necessary to achieve the inflation target in order to maximize the monetary stimulus from its policy rate. Fiscal stimulus has already been substantial and will continue to have an important impact on growth this year.

Second, Canada entered the recession with notable advantages, including a well-functioning financial system, strong corporate balance sheets, and relatively healthy household finances. In addition, our economy has a demonstrated ability to adjust quickly to changing circumstances.

We will have to draw on these advantages as the world emerges from recession. While the downturn was synchronous, economic performance across markets and sectors is likely to be increasingly diverse. For some Canadian businesses, the recovery may prove as challenging as the downturn.

Global economic recovery

The global recovery, which began in the second half of last year, can be characterized as multi-speed and policy-led.[2] In the industrialized countries, growth is relatively sluggish and heavily dependent on the exceptional monetary and fiscal policy stimulus, as well as the extraordinary measures taken to support financial systems. In emerging markets, where internal demand is already more robust, policy support is beginning to be withdrawn.

Ultimately, the sustainability of the recovery depends on the private sector. As yet, there are few indications of autonomous private demand in most advanced economies. In these countries, high unemployment rates, still-challenged financial sectors, and weak household balance sheets will slow the return to pre-crisis growth rates. In this regard, the strength of Canadian domestic demand (currently the strongest in the G-7) is noteworthy.

In many economies, it will take time for real output to return to pre-crisis levels. For example, although the Bank expects that the Canadian economy will attain its pre-crisis peak by the third quarter of this year, it will be yet another year and a half before the European and Japanese economies do the same. In contrast, many major emerging economies are already operating well above pre-crisis levels.

This is just one illustration of how the nature of the world economy has changed. Indeed, despite its brevity, this *was* the Great Recession. Recent events will likely have far-reaching repercussions. Over the medium term, the pattern and pace of global growth could be

2 See *World Economic Outlook Update*, International Monetary Fund, January 2010.

significantly altered. The rate of potential growth in the global economy has likely fallen and will take time to rebuild. The rotation of global demand and the restructuring of corporate and household balance sheets are generating important headwinds to economic activity in advanced economies. Conversely, emerging markets are becoming more dominant in the global economy.[3]

Global growth may not only be lower in the future, but could also be more volatile as a result of some fundamental vulnerabilities. First, fiscal pressures will be immense. Once the recovery is assured, most economies will need to make concerted efforts to restore fiscal sustainability. But with the debt-to-GDP ratio in industrialized countries expected to rise from 80 per cent, pre-crisis, to 120 per cent by 2014, this challenge should not be underestimated. Even abstracting from the difficult political decisions that will be required in many countries, policy-makers will have to balance the fiscal drag from reducing deficits against the dangers of crowding the private sector if they are not.

Second and more immediately, capital inflows to emerging-market economies are creating new pressures. By both resisting exchange rate appreciation and forestalling monetary tightening, these countries are increasing the risk that their economies will overheat. As a stopgap, some of these economies are resorting to regulatory measures[4] of unproven effectiveness. The net result could be higher growth in the short term followed by a sharp contraction later on.

Third, policy-makers must ensure that business can operate, as much as possible, in an open and stable trade and regulatory environment. We must live up to the G-20 commitment to resist trade and financial protectionism. It is also essential to maximize the degree of regulatory certainty and coordination across countries as we move forward on vital financial sector reforms. Further progress on this will be one of Canada's priorities for this weekend's G-7 meeting in Iqaluit.

Securing strong, sustainable, and balanced global growth will require changes in behaviour and policy adjustments on several fronts.[5] These include: a sustained fiscal consolidation in the United States and several other advanced countries; an upward adjustment of U.S. household savings; increased, policy-induced domestic demand in China and other major emerging-market economies; and a real exchange rate appreciation in countries with large current account surpluses.

Should these conditions fail to materialize over the medium term, two, equally troubling, paths for the global economy are possible. First, a return to the large, and unsustainable, current account imbalances of the past cannot be discounted. This would only serve to build financial imbalances anew. Alternatively, the combination of fiscal contraction over a number of years and the real prospect of ongoing sluggishness in private consumption in some major economies creates the possibility of deficient demand, with sharp disinflationary pressures at a global level. This scenario can be avoided by the development of new sources of domestic demand in major emerging markets and some surplus industrial countries.

Business outlook

Against this backdrop of relatively subdued global and U.S. growth, domestic factors in Canada will prove decisive for the recovery in the near term. Current strength in housing

[3] About three-quarters of global economic growth is represented by emerging-market economies this year and next, compared with two-thirds in the pre-crisis decade (1998–2007).

[4] Examples include changes to loan-to-value ratios, use of reserve requirements, and administrative guidance to lending standards.

[5] Among the changes we can anticipate is greater global collaboration and coordination in the oversight of financial markets. The G-20 reform agenda could reshape the financial services industry. The fundamental objective is to create a resilient, global financial system that efficiently supports worldwide economic growth. The system must be robust to shocks, dampening rather than amplifying their impact on the real economy.

demand and consumer spending will provide important impetus this year.[6] Owing to the improved financial and economic conditions, 2010 should mark the hand-off from growth that is heavily influenced by public policy to growth that is largely determined by the private sector. By next year, the private sector should be the sole contributor to domestic demand growth in Canada.

Canada's corporate sector begins with a number of advantages. Domestic demand is expected to be relatively strong, providing a base of support for some sectors. Corporate balance sheets are in outstanding shape, and margins have held up very well for this stage in the economic cycle.

In addition, Canada's overall financial conditions are now contributing to, rather than retarding, the recovery. While net financing needs would be expected to be limited, given the stage in the economic cycle, business credit has started to grow again. In part due to monetary stimulus, overall borrowing costs for Canadian businesses remain very low.[7]

Taken together, results from the Bank's latest *Senior Loan Officer Survey* and the *Business Outlook Survey* suggest that, following a period of substantial tightening, credit conditions for businesses eased slightly in the fourth quarter of 2009, for the first time since the financial crisis began. The improvement in credit conditions mainly affected large firms, as some small and medium-sized entities continued to experience tightened conditions.

It is in this environment that the first signs of a thaw in corporate attitudes have begun to emerge. In our latest *Business Outlook Survey*, more firms said they are now planning to increase investment spending and employment than did either last summer or fall.[8] With the improvement in financial conditions, economic activity, commodity prices, and growing confidence, business fixed investment should pick up in 2010. This recovery will be relatively modest; it is not until 2011 that we anticipate an acceleration of investment spending, as the excess supply in the economy is taken up.

However, given the external environment, the question is whether this pickup will be sufficient. The significant drop in investment that occurred during the recession included spending on new technology, which could have helped firms address coming economic challenges. The relatively slow recovery expected in our most important trading partner, along with ongoing sectoral adjustments, means that firms have to find new markets. In doing so, they will face increased competition. For example, due to exchange rate moves and stellar productivity performance, the competitiveness of the U.S. corporate sector has improved significantly. The need for capital investment by Canadian businesses to meet these challenges is clear.

In short, Canadian companies are emerging from the recession to an altered world – one that may require deeper restructuring and bolder strategic initiatives than currently contemplated. New suppliers need to be sourced; new markets opened; a new approach to managing for a more volatile environment developed. To recognize this reality is also to recognize the opportunities available to corporate Canada.

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6 For more detailed discussions of these components of domestic demand, see Mark Carney, "Current Issues in Household Finances," remarks delivered to the National Forum (Canadian Club of Toronto and Empire Club of Canada) in Toronto, 2009, and Timothy Lane, "Canada's Housing Sector in Recession and Recovery: Beyond Bricks and Mortar," remarks prepared for delivery to the Edmonton CFA Society, 2010. Available at http://www.bankofcanada.ca/en/speeches/.

7 Borrowing spreads paid by households and businesses spiked in 2008, but fairly quickly dropped back and now are within the normal range. The Bank expects these spreads to return to their longer-term historical averages by early 2011 (although not as tight as they were pre-crisis), which is another factor that will help boost business investment.

8 Nonetheless, while firms expect sales to grow at a faster pace over the next 12 months than over the past 12 months, they still anticipate that the recovery will be gradual.

The labour market

One of the most important questions for many Canadians is what the coming thaw in business attitudes will mean for employment. Through the recession, Canada experienced significant job losses. Some of these jobs are unlikely to come back. Moreover, substantial slack remains in the labour market in the form of underemployment – for example, people working part-time who prefer to work full-time. The duration of unemployment has also risen, which raises understandable concerns. When an individual is out of work, his or her skills tend to deteriorate, making reintegration into the labour market more difficult. The longer the period of unemployment, the more difficult it can be for the individual. For the economy as a whole, this can translate into higher structural unemployment.

As I mentioned earlier, the deterioration in the labour market now appears to have ended, consistent with the resumption of GDP growth. Both employment levels and average hours worked bottomed out in the summer, and the unemployment rate has since been hovering around 8.5 per cent. Against this backdrop, how quickly can the labour market be expected to improve? Or, could Canada experience a jobless recovery?

Conflicting forces are at play. On the one hand, history suggests that employment growth is relatively coincident with economic growth in Canada, while improvements in the unemployment rate lag the cycle, because the more positive economic climate tends to pull more people back into the labour market.

On the other hand, labour market behaviour has been somewhat unusual during this recession. Employment held up relatively well, while hours worked fell particularly sharply. There is some evidence of what economists inelegantly call “labour hoarding” – the retention of skilled workers even if they may not be immediately needed. This suggests that employment may grow relatively slowly. Indeed, the Bank’s winter *Business Outlook Survey* reports that the percentage of firms reporting labour shortages declined further, reaching its lowest level since the series began in 1998. With the scale of restructuring required, there may be reluctance to add personnel.

Canada is not the only country with large-scale restructuring. In the United States, the unemployment rate has jumped sharply, higher than the decline in GDP would have traditionally suggested, or by about 1 to 1.5 percentage points.[9] At 10 per cent, it exceeds that of Canada – the first time this has occurred since August 1981.[10] As in Canada, there is substantial underemployment and rising long-term unemployment.[11] In addition, American job losses are unusually high in small and medium enterprises (SMEs) while they have been proportionally lower in Canada, where SMEs have been supported by relatively strong domestic demand. Unlike Canada, however, U.S. productivity growth has surged, and wage growth has slowed. The net result is lower unit labour costs, which have boosted competitiveness and should, ultimately, encourage job creation.

Canada’s productivity record is puzzling. The flipside of the apparent labour hoarding is that Canada’s productivity growth fell in the latest recession – something that has not happened in any recession in the past three decades.[12] Moreover, in sharp contrast to the United States, Canada’s productivity performance was abysmal over the decade prior to the recession.

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[9] Kimberly Beaton, “Time Variation in Okun’s Law: a Canada and U.S. Comparison,” Bank of Canada Working Paper, forthcoming.

[10] Moreover, when the Canadian unemployment rate is adjusted to match U.S. concepts, this would typically lower the Canadian unemployment rate by about a percentage point.

[11] For example, the U.S. measure, published by the Bureau of Labor Statistics, which includes discouraged workers plus marginally attached workers, stood at 11.4 per cent in December 2009.

[12] See Philip Cross, “The changing cyclical behaviour of labour productivity,” *Canadian Economic Observer*, January 2010, Statistics Canada.

Some of this undoubtedly reflects the restructuring of industries and the reallocation of capital and labour to new industries. Some may reflect longer-tailed resources investments. There remains the possibility that firms have not yet anticipated intensifying global competitive pressures.

While the Bank does not entirely understand why productivity growth has been as slow as it has been, we do understand the consequences. Slower productivity growth means that the rate of potential growth – the speed limit, if you will – of the Canadian economy has fallen. This has implications for both the growth of Canadian living standards and the conduct of monetary policy.

To be more specific, the Bank's working hypothesis is that trend labour productivity declined by 0.2 per cent last year, will rise by only 0.2 per cent this year, and by a still-modest 0.9 per cent in 2011. The combination of slower productivity growth and demographics could mean that the rate of potential growth for the Canadian economy will be closer to 2 per cent going forward than the more than 3 per cent average rate we enjoyed in the first half of the past decade and the latter half of the 1990s.

If this differential were to persist over a decade, the cumulative loss of income would be almost $30,000 for every Canadian.[13]

Inflation outlook

The performance of the labour market and productivity growth will be important influences on monetary policy going forward. In spite of the large amount of excess supply in the economy, core inflation has remained quite close to 2 per cent since the beginning of 2009. This stickiness of core inflation is likely related to the resilience in wage growth relative to the underlying trend in productivity. Although wage growth in Canada remained high through the recession, it has decelerated in recent months, causing the gap between wage growth and measured productivity to begin to narrow. This slower growth in the cost of labour is a factor that should continue to moderate overall pressures on core consumer price inflation.

With wage growth expected to stay at the more moderate levels seen recently, and with excess supply being gradually absorbed, both core and total CPI inflation are expected to return to 2 per cent in the third quarter of 2011. The Bank judges that medium- and longer-term inflation expectations remain well anchored to the 2 per cent inflation target.

Conclusion

To conclude, recent events were a watershed. The global economy that emerges from the recession will be different than the one that led into the crisis. A powerful and sustained restructuring of the global economy has begun. Canadian business will need to develop new markets as the traditional advantage of relatively open access to U.S. markets becomes less valuable. To seize new opportunities, our productivity levels must improve.

In the face of these challenges and the ongoing uncertainties about the global outlook, the credibility of macroeconomic policy is essential. One constant is the Bank's unwavering commitment to price stability. The single, most direct contribution that monetary policy can make to sound economic performance is to provide Canadians with confidence that their money will retain its purchasing power. That means keeping inflation low, stable, and predictable. Price stability lowers uncertainty, minimizes the costs of inflation, reduces the cost of capital, and creates an environment in which households and firms can invest and plan for the future.

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[13] As expressed in 2009 dollars.