Paul Jenkins: Beyond recovery – sustaining economic growth

Remarks by Mr Paul Jenkins, Senior Deputy Governor of the Bank of Canada, to the Economic Club of Canada, Toronto, 29 March 2010.

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Good afternoon. It is a pleasure to be here.

John Maynard Keynes said the objective of "analysis is … to provide ourselves with an organized and orderly method of thinking out particular problems …. This is the nature of economic thinking."[1]

This is very much the tradition of the Economic Club of Canada, which offers an important forum for analysis and discussion of economic issues, certainly those we have had to address since the onset of the global financial crisis. The Bank of Canada has offered its analysis and perspective on these issues, especially global and domestic developments, the policy actions needed to address the situation, and how best to position the Canadian economy to the benefit of all Canadians over the medium-to-longer term.

In the wake of the global financial crisis and the "Great Recession", economic recovery is under way, supported by exceptional monetary and fiscal stimulus. In many countries, however, large output gaps remain and, given the need to repair the balance sheets of households and financial institutions in these countries, the return to full resource utilization will be protracted.

What I'd like to discuss today is the economic environment *beyond* recovery. I'll set the stage by discussing, in general terms, the kind of global economic landscape we're likely to see five to ten years ahead. Then I'll look at several important areas of public policy that will help to shape that outcome and promote sustained economic growth. Finally, I'll focus on some of the challenges and opportunities that a significantly different global economic landscape will pose for Canadian business.

A changing global economic landscape

The global economic landscape will change considerably over the coming decade. To get a sense of what it may look like, it's useful to consider both the developments that are required for global economic growth to be sustained, and the likely impact of the powerful trends that have been shaping, and will continue to shape, the world economy.

It is clear that, as a nation, Americans need to save more and rebuild household sector wealth. For too long, the U.S. economy has been consuming more than it has been producing. This means that, in the future, more U.S. economic growth must come from net exports – a combination of higher exports and lower imports. Consumer demand will be a relatively less important source of growth. China, on the other hand, will need to rely more on domestic demand as the engine of growth. This rotation of global demand is needed as part of the solution to the global (current account) imbalances that were a significant part of the genesis of the financial crisis. Without this rotation of demand, resources will not be fully utilized, and global economic growth will be neither as strong, nor as sustained, as it could be.

In addition to these requirements, powerful forces are changing the economic landscape. One is the difference in the growth rates of potential output (the rate of growth that can be

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[1] J. M. Keynes, *The General Theory of Unemployment, Interest, and Money* (London: Macmillan / St Martin's Press, 1936; reprinted 1970), p. 297.

sustained over time without inflationary or deflationary consequences) that we are likely to see over the next five to ten years. For the major industrial economies, that rate of growth of potential output is estimated to be between 2 and 2 1/2 per cent. For the major emerging-market economies, the rate is estimated at between 5 and 8 per cent.[2] Much of this difference can be attributed to the fact that emerging-market economies have "catching up" to do – by combining labour and more intensive use of capital in production – and to the fact that they have a large and growing pool of labour to draw upon.

This rotation of demand and the differing rates of growth of potential output will have significant implications for trading patterns and investment flows. While it's not possible to be precise, and it depends on whether one uses market or purchasing-power-parity exchange rates, major emerging-market economies will likely account for over 55 per cent of global output by 2020, compared with about 45 per cent today.[3]

To be sure, there are many variables and uncertainties at play that will affect how the global economic landscape will look ten years out. Some refer to these uncertainties as the "known unknowns". But, one thing seems clear – the economic landscape ten years from now will be significantly different from that of today.

An important task for public policy will be to shape that outcome – remove some of the unknowns – for the benefit of everyone. On the heels of the global financial crisis and the Great Recession, one element of that task is to restore trust in markets, particularly financial markets. Trust is needed if financial markets are to price assets correctly and allocate capital efficiently. More broadly, a price-based system remains the most efficient way to allocate resources and generate growth that is led by the private sector. The reality is that for sustained growth to take hold, private sector demand must become the primary source of that growth. Public policy has an important role to play in supporting such an outcome by establishing coherent medium-term policy frameworks that will guide expectations and reduce uncertainty.

The role of public policy

I'd like to discuss three areas of public policy that will contribute to this goal. Let me start with *financial sector reform*.

A stable, efficient financial system is a cornerstone of a healthy and dynamic economy. Policy-makers are currently at an important stage in multilateral discussions about fundamental reform of the financial sector. The core of the G-20 reform proposals is aimed at:

- increasing the amount and quality of bank capital;
- introducing complementary leverage caps;
- increasing levels of liquidity;
- mitigating procyclicality;
- improving over-the-counter derivatives markets; and
- developing internationally consistent contingency and resolution plans for systemically important institutions.

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[2] Within the G-20, these economies include Brazil, China, India, Indonesia, Mexico, and Russia.

[3] Taking a longer perspective, in two decades the emerging-market economies will account for about two thirds of global output, compared with about one third in the mid-1980s.

This is important work. The objective is to make the financial sector more resilient through *better* and *more effective* regulation – not more burdensome regulation.

The second area of public policy receiving attention is *fiscal consolidation*. While the recession made it necessary for governments to step in and provide considerable economic stimulus to offset a decline in private spending, sustained growth requires that this stimulus be removed as private spending gains strength. Another way to think about this is that the savings being generated in economies need to be funnelled back for use by the private sector. The IMF estimates that "government debt for advanced G-20 countries [will] reach 118 per cent of GDP on average by 2014", compared with a pre-crisis level of about 78 per cent.[4] For 2010, the combined fiscal deficits of these countries is estimated at nearly 9 per cent of GDP.

One important factor will be clear guidance from governments about the means and the timing of fiscal consolidation. Given the size of the deficits, tough choices will need to be made. Clear communication in this regard can help to manage market expectations and reduce uncertainty.

The third area of public policy concerns the *openness of markets*. One lesson *not* to be drawn from the global financial crisis is to impose controls on the movement of goods, services, capital, and labour. Protectionism and controls are detrimental to everyone. As a trading nation, we understand that. The focus must be on opening markets and removing barriers to trade and capital flows so that all can participate in the changing global landscape. This focus is equally important for our internal markets. A renewed push is needed to remove barriers to internal trade in Canada. The goal is to have the most efficient allocation of resources possible to enable us to capitalize on the opportunities of a new global economic order.

Let me conclude this section with a few additional thoughts on what this changing global landscape means for the major emerging-market countries. These countries have achieved considerable successes in recent years. They responded in a forceful and timely manner to the financial crisis, and they have been the strongest-growing regions in the global economy. Building on these successes, these countries should have the confidence to allow market parameters to play a more active role in their economies. Doing so would include greater exchange rate flexibility to allow relative price signals to contribute to rebalancing and sustaining global economic growth, thus strengthening the global trading and international monetary systems. Indeed, another thrust of the G-20 process is mutual recognition of the need for a collaborative effort with regard to policy actions on those fronts I have just been discussing – financial, fiscal, openness of markets, and exchange rate – to the benefit of all.

Let me turn now to the private sector in Canada, and discuss some of the implications of the changing economic landscape for business here at home.

Implications for Canadian business

What will the new global landscape mean for Canadian business? I said earlier that, going forward, private sector demand must replace public support as the engine that drives sustained economic growth. This transition implies change for business, but, most importantly, beyond the transition, the new international economic order will bring many opportunities. To take full advantage of them, business will need an appetite for change.

Significant restructuring is already occurring in many sectors. The forest products sector continues to go through a difficult adjustment. In Ontario, we are all well aware of the

[4] See "The State of Public Finances Cross-Country Fiscal Monitor: November 2009". IMF Staff Position Note, 3 November 2009, SPN/09/25, pp 13–15.

challenges facing the automotive sector. More generally, Canada's export sector has had to adapt to a strong Canadian dollar, intense competition from emerging-market economies, and the shift in the relative weight in global demand from advanced economies to emerging-market economies. Herein lies one of the most important issues facing Canadian business – how best to deal with the opportunities and challenges posed by the dynamic emerging-market economies.

The strong demand in these countries for materials, finished products, and services – ranging from legal to financial to educational services – presents tremendous opportunities for Canadian business. And these possibilities offer additional opportunities – including those of developing innovative products and services, working with new partners, and optimizing the mix of global and domestic activities. In other words, the opportunities will be substantial, and they come on a two-way street, with benefits for everyone. But taking advantage of them will require a willingness to actively engage with these new markets. Make no mistake. To recognize the potential growth of these markets is to recognize the rising purchasing power of these countries and their citizens.

Encouragingly, many Canadian companies are acting now and are entering markets in emerging economies with strategic, long-term initiatives. A common thread of these initiatives is that they are taking advantage of Canada's comparative advantages, which include a stable financial system, reliable infrastructure, plentiful natural resources, and an educated, multilingual workforce.

Of course, with this opportunity comes a broad set of challenges – challenges that apply to all facets of Canadian business. These include acquiring, developing, and retaining the right people, applying technology to enhance research, operational work, and the management of value chains, addressing environmental issues, and recognizing and dealing with increased global interdependencies.

At the risk of oversimplifying, a critical element in dealing with both these opportunities and challenges is investment in modern, productivity-enhancing equipment and structures. Our track record in this regard has not been impressive, even adjusting for the cyclical factors and uncertainties of the past two and a half years. Compared with previous decades, productivity growth has weakened substantially in the past ten years. This poor performance appears to be at least partly attributable to insufficient "capital deepening" – that is, the amount of capital with which workers are equipped. Another part of the problem appears to be that capital investment is not always well integrated into the workplace.[5]

Let me expand on this last point. I'm referring here to what we call multifactor productivity. You have a computer on your desk, and the question is: Are you making full use of what that technology can do for you? Are you integrating that investment to full benefit in terms of organizational practices and producing end products? We ask ourselves these questions at the Bank of Canada, whether they relate to investments in our analytic computing capability or the handling of bank notes. They are the right questions to ask.

With our trading partners, including the United States, continuing to invest and make strong gains in productivity growth, it is all the more imperative that firms in Canada make concerted efforts to boost productivity. And from one perspective, they are well equipped to do so.

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[5] One possible explanation for this poor productivity performance lies in the shifts in capital and labour that have occurred in Canada in recent years as a result of changes in relative prices, notably, during periods of commodity-price shocks and periods of structural adjustment. For further details on Canada's productivity challenge, see M. Carney, "The Virtue of Productivity in a Wicked World", remarks delivered to the Ottawa Economics Association, Ottawa, 24 March 2010; and T. Lane, "The Canadian Economy Beyond the Recession", remarks delivered to the Canadian Association for Business Economics, Kingston, Ontario, 25 August 2009.

Corporate balance sheets in Canada are healthy. Profitability is good, with the ratio of profits to GDP back to its long-term average of 10 per cent. Leverage – i.e., debt-to-equity – ratios are low and liquidity levels are high. Corporate tax rates have declined. Absolute borrowing costs are low. And while the non-price terms for borrowing have been a restraining factor, our *Senior Loan Officer Survey* indicates that these terms are beginning to ease as the recovery takes hold. From this perspective, then, there should be little holding corporations back from modernizing their capital stock.

But there's an additional perspective, and that is the extent to which firms can access funds for making productivity-enhancing investments. The role of the financial sector is to channel savings to the real economy. Given the importance of small and medium-sized enterprises in Canada, it is critical that this sector invest in productivity-enhancing improvements. Compared with similar-sized firms in the United States, these Canadian firms rely more on individuals for financing and less on financial institutions.[6] This, to me, suggests a market opportunity for our financial institutions. As well, additional sources of higher-risk capital are needed for Canada to be successful in modernizing the economy's productive capacity through innovation and new technology. For our part, the Bank of Canada, together with financial market participants, is helping by working to make our financial system more robust through continuously open commercial paper, interbank, and repo markets, and through stronger infrastructure arrangements.[7] These initiatives provide greater efficiency in the allocation of financial capital, which benefits all sectors of the economy.

Allow me to conclude.

Conclusion

The world is emerging from the most serious economic dislocation since the Great Depression. While the global economy is on a steadier footing, the pace of change will not slow down. Indeed, five to ten years from now, the global economic landscape will be greatly altered.

Public policy has recently played an important role in helping the economy to heal. It must also play an important role in ensuring that the conditions are in place for sustained and balanced growth over the coming decade. That includes public policies that focus on creating an attractive and certain economic environment, an environment that promotes investment and innovation. Progress is being made internationally to meet the major policy challenges of our time – but work must continue until the job is done. Domestically, our frameworks for macroeconomic and regulatory policy served Canadians very well through the financial crisis, and have positioned us to move forward. But we have more work to do here at home – to further open internal markets and to strengthen our ability to address systemic risks to the financial sector that can arise from the collective actions of institutions and market participants.

For Canadian business, a rapidly changing economic landscape presents new possibilities and hurdles – chief among them, seizing the opportunities presented by emerging-market economies, and stepping up to the challenge of improving our productivity record. This should be one of the next waves of economic progress in Canada.

The Bank of Canada will do its part by contributing to sustained, solid economic performance by providing Canadians with confidence in the future value of money. An environment of

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[6] See D. Leung, C. Meh, and Y. Terajima, "Are There Canada-U.S. Differences in SME Financing?" Bank of Canada Working Paper No. 2008–41.

[7] For related comments, see, for example, M. Carney, "Principles for Interesting Times", remarks delivered to Carleton University, Ottawa, 11 March 2010; and M. Carney, "What Are Banks Really For", remarks delivered to the University of Alberta School of Business, Edmonton, 30 March 2009.

stable prices lowers uncertainty, reduces the cost of capital, and enables Canadians to plan for the future with greater confidence.

I'd be happy now to respond to comments or questions.