Mark Carney: Recent economic developments

Remarks by Mr Mark Carney, Governor of the Bank of Canada, to the Saint John Board of Trade, Saint John, New Brunswick, 20 September 2011.

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Introduction

It is a pleasure to be here in Saint John.

When I got up this morning, things had changed. For the first time, there was that sense of the turn in the seasons. It is fitting, of course, with the autumn equinox this week, but looking at the calendar doesn't dispel that wistful feeling: where did summer go? Instead of looking forward to a string of lazy, hazy days, we face the touch of frost in the air ... and the smell of fear in financial markets.

Canadians entered the summer brimming with confidence. Expecting strong sales, our businesses were full of plans to add jobs and invest in plant and equipment. Canadians themselves had a very positive view of their economic prospects. Now, in the face of alarming events abroad, some are less sure. What happened? And how should the public and private sectors respond?

What happened?

The fear currently dominating global financial markets has three causes: the deterioration in the global economic outlook, the intensification of the European sovereign debt crisis and growing questioning of the ability of policy-makers to respond.

High government debt leaves the Euro area extremely vulnerable to changes in global growth prospects and investor sentiment. These challenges are compounded by the nature of European monetary union, which demands prolonged deflationary adjustments in countries that have lost competitiveness.

The most immediate concern is growing funding pressures on European banks. Most have seen their costs of borrowing rise sharply, their access to important financial markets curtailed, and their equities trading at historic lows relative to the value of their assets.

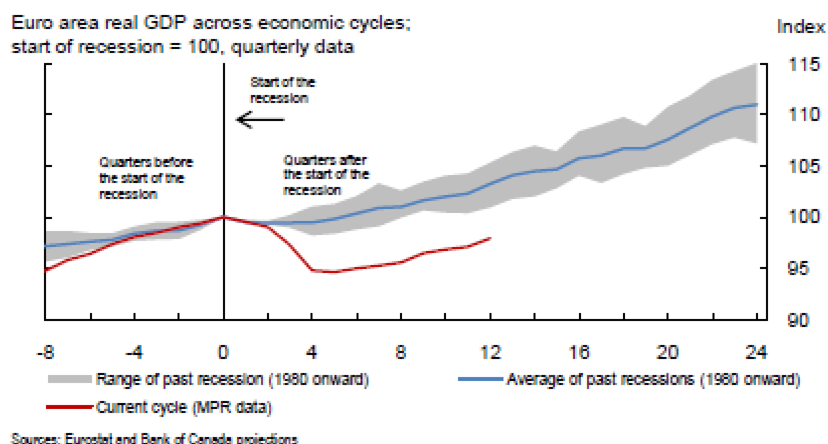
If not quickly reversed, this situation could create a damaging negative feedback loop among the banks, lending and the real economy. This would occur at a time when the European economy – the largest in the world – is already slowing dramatically.

While the immediate concern is about banks, the broader issues are the fiscal and competitive positions of a number of countries.

Most European governments have little choice but to reduce their budget deficits, despite weak private demand ***(Chart 1)***. Ultimately, Europe's problems cannot be solved by fiscal austerity alone. Any durable solution must include a series of measures to rebuild competitiveness. For example, Spain runs a 4 per cent current account deficit despite its depressed economy, and Greek unit labour costs have risen by a third relative to Germany's since the start of the European monetary union.

In the short term, the problems in Europe are being compounded by slowing global growth. In particular, the U.S. economy has lost momentum.

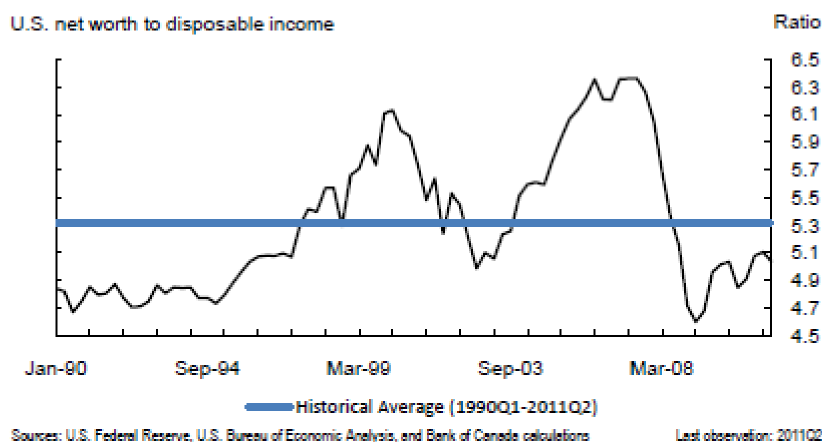
Chart 1: The European recovery is very weak



Recent benchmark revisions show that the U.S. recession was deeper and its recovery has been shallower than previously reported. What we learned over the summer does not suggest that the dynamics currently affecting the U.S. economy have changed, just that the magnitudes are much larger. In short, the housing market remains a mess, the consumer is weak, and government actions can be expected to reduce growth after materially boosting it in recent years.

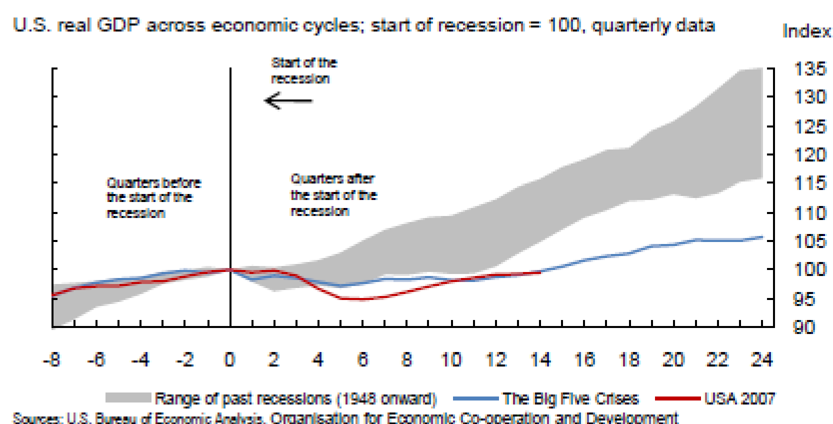
American households have experienced a major shock to their net worth, which has fallen from a peak of 6.4 times income pre-crisis to 5.0 in the second quarter of this year ***(Chart 2)***. These losses can only be recovered through a combination of increased savings and rising prices for houses and financial assets. Each will clearly take time.

Chart 2: Large drop in U.S. household wealth



Overall, the United States is in the midst of the weakest recovery since the Great Depression, and the Bank does not expect that to change at any time soon ***(Chart 3)***. In fact, the U.S. economy is tracking exactly the dreary path of other advanced economies that have experienced major financial crises.

Chart 3: Weakest U.S. recovery since the Great Depression



The Bank expects the U.S. economy to continue to grow at or below its trend rate of around 2 per cent until the second quarter of 2012. This reflects a combination of modest growth in consumption, the beginnings of fiscal drag, solid business investment in equipment and software, and relatively strong export growth. These last two factors will of course be importantly influenced by global developments.

At this stage, the Bank of Canada does not expect a recession in the United States, although the risk has clearly risen. The U.S. economy is close to stall speed, where a negative feedback loop between weak employment, consumer demand, and business hiring and investment could emerge. The possibility that markets themselves could tip the balance cannot be dismissed. Further declines in the value of financial assets could encourage higher savings and discourage corporate investment, and it remains possible that credit conditions for American firms could tighten materially.

What does this mean for Canada?

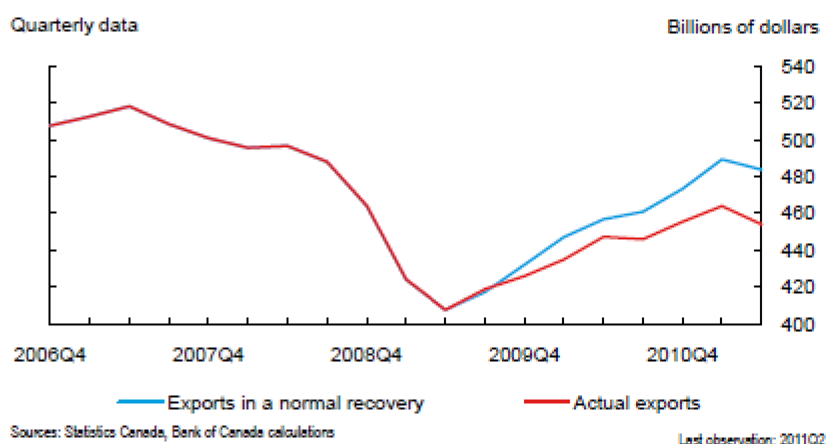
The direct impact of weaker European growth on Canada is relatively modest. However, the financial and confidence effects could be considerable. In response to uncertainties in Europe, global equity and commodity prices have fallen significantly, and financial market volatility has increased markedly.

The spillovers to Canadian financial markets have been less pronounced but are still notable. Overall financial conditions have tightened in Canada, largely due to declines in equity values. Importantly, our financial system continues to work well. Our banks have virtually unmatched access to funding and capital; credit to Canadian households and businesses remains widely available at historically low rates.

The direct impact of a renewed slowdown in the United States, our largest trading partner, is more material. Moreover, the U.S. slowdown has further hit activity in sectors, such as autos and housing, that matter for Canada. To put this into perspective, consider that if this had been an average U.S. recovery, U.S. GDP would be 2.5 per cent higher and Canadian exports would be 6.5 per cent greater, equivalent to $30 billion in additional sales ***(Chart 4)***.

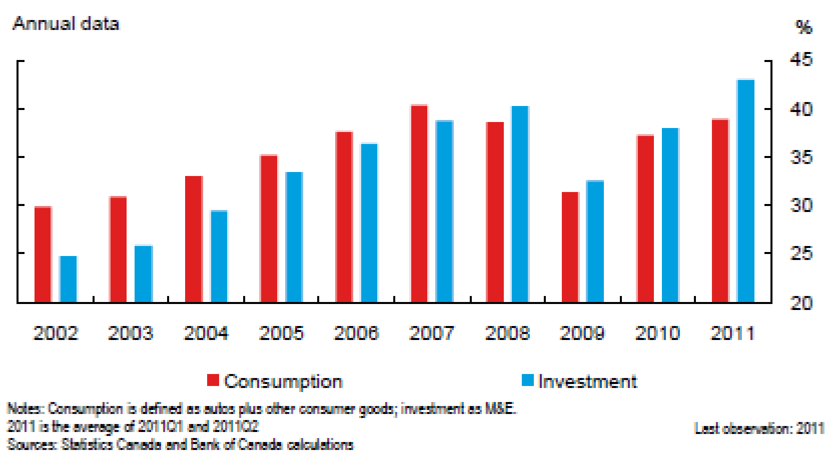
But this is not an average recovery and, now, the considerable external headwinds our economy has faced in recent years are blowing harder. Net exports are now expected to remain a major source of weakness, reflecting more modest global demand and ongoing competitiveness challenges, in particular the persistent strength of the Canadian dollar.

Chart 4: Canadian exports much lower than in an average recovery



It is worth remembering that reduced competitiveness typically means higher penetration of imports into Canada. The ratio of imports to GDP has risen 7 percentage points over the past decade. There is also some good news: over the same period, an increasing proportion of our imports is for investment purposes, rather than consumption. This indicates that an increasing share of Canada's imports is adding to the capital stock, rather than simply being consumed ***(Chart 5)***. This will need to continue.

Chart 5: Increasing proportion of Canadian imports is for investment



The Bank expects that growth will resume in the second half of this year, led by business investment and household expenditures, although lower wealth and incomes will likely moderate the pace of investment and consumption growth.

Slower global economic momentum will dampen domestic resource utilization and inflationary pressures. The Bank expects total CPI inflation to continue to moderate as temporary factors, such as significantly higher food and energy prices, unwind. Core inflation is expected to remain well contained as the growth of labour compensation stays modest, productivity recovers, and inflation expectations remain well anchored.

The risks to our economy remain largely external and are skewed to the downside.

What then must be done?

The debt-ceiling fiasco in the United States and the inability, to date, of European policy-makers to get ahead of their crisis have reduced investor confidence in the effectiveness of policy. The combination of high debt loads and unpredictable politics is toxic.

Still, it is important to distinguish between the willingness to act and the ability to address the current challenges. There is much that policy can do. The European situation is fragile but fixable; manageable if it is managed.

The European Central Bank stands ready to supply virtually unlimited liquidity to European banks. This should prevent the sort of dramatic liquidity events we saw in 2008, but it is not a cure. Banks in these situations become highly defensive. The lesson of Japan in the 1990s is that once such behaviour starts, it is hard to reverse.

The point of central bank efforts is to create a bridge. The follow-up actions must be swift and sizeable. European authorities need to move decisively to contain the crisis. Measures taken must draw private capital back in, rather than merely fund its exit.

Actually implementing announced measures will start to rebuild confidence. Enhancements to existing European funding facilities should be put in place. Financial reforms, including Basel III capital measures, should be implemented in a timely fashion. Paths for sustained fiscal consolidation should be established, consistent with the agreement reached at last year's G-20 Summit in Toronto.

But more is required.

In the Bank of Canada's opinion, what is needed now is a comprehensive capital plan for European banks, and crucially, a sizeable funding backstop for European sovereigns. The reality is that the best commitments and even the most binding legislation will not restore investor confidence overnight. As Canada learned in the mid-1990s, countries need to build a sustained track record of tangible results in order to rebuild trust. Similarly, structural policies to enhance growth have a long pay back.

Thus, European authorities must create time to re-found their monetary union based on credible fiscal arrangements and more flexible economies that can adjust quickly to inevitable shifts in internal European competitiveness. In our opinion, the existing European resources, including the European Financial Stability Facility and the European Central Bank facilities, can be used much more efficiently to create a multi-year window for these adjustments.

Just as demand must be rebalanced in Europe between countries with current account deficits, such as Spain, and those with surpluses, such as Germany, so too must it adjust globally. Under current policies, large current account imbalances can be expected to persist. Continued reliance on domestic demand in advanced economies promises disappointment. As we have seen in recent weeks, the hand-off from the public to the private sector in the United States and Europe is in danger of being fumbled. Fiscal consolidation has begun, without autonomous private demand picking up the slack because of unresolved fragilities and a barrage of negative shocks.

Rebalancing demand across economies will require the implementation of comprehensive financial reforms; open trade and capital markets; and significant changes to fiscal, structural and exchange rate policies across a broad range of countries, including major emerging markets. When the G-20 meets later this week in Washington and next month in Paris, these issues must be at the centre of the agenda.

In the face of this difficult external environment, the Bank will continue to support Canada's economic expansion by keeping inflation low, stable and predictable.

Since the crisis erupted four years ago, the Bank has demonstrated its nimbleness in the conduct of monetary policy. We reacted quickly and forcefully during the downturn. As the

Canadian recovery has progressed, we have emphasised that we would be prudent with respect to the possible withdrawal of any degree of monetary stimulus.

The Bank always takes a flexible approach. Our decisions are guided by considered analysis and informed judgment rather than mechanical rules. For example, as we have emphasised, given current material headwinds, the policy rate can return to its long-run level after inflation is projected to reach the 2 per cent target and output is projected to reach its potential.

The Bank also exercises considerable flexibility with respect to the time horizon over which inflation should be expected to return to target. In general, both the size and nature of the shocks that hit our economy can have a bearing on the appropriate targeting horizon. Over the last 20 years, the persistence of the effects of the shocks on the economy has been such that it was typically desirable to return inflation to target over a period of six to eight quarters. However, there has been considerable variation in this horizon from as short as 2 quarters to as long as 11 quarters.[1] On at least eight occasions, the Bank has extended the targeting horizon beyond eight quarters. It did so most recently in April 2009, when returning inflation to target over a longer period was warranted, given the unusually large shock confronting the Canadian economy at the time.

Just as we do not have mechanical rules for the path of policy rates, we do not outsource our monetary policy to the U.S. Federal Reserve. What happens in the United States obviously matters for Canada, but this does not mean that our rates are tied to those of the Americans. Over the two decades of inflation targeting, the overnight rate in Canada has been more than 200 basis points above, and more than 200 basis points below, the Federal funds rate. These variations reflect differences in our respective economic outlooks. Canadian monetary policy will be appropriate to Canadian circumstances and consistent with achieving price stability in Canada.

Canadians can also be assured that the Bank will take the necessary steps to ensure that core financial markets remain liquid and operating. In the event of a major systemic shock, the Bank has a wide range of tools to provide exceptional liquidity, consistent with a principles-based framework. This will help ensure that all Canadians benefit from the strength of our financial system, in bad times as well as good.

While we experience the fallout of events in Europe and the United States, Canada should also draw the lessons from these experiences. The European sovereign crisis reinforces the importance of sustainable government debt and the value of a flexible exchange rate. American difficulties underscore the risks of excessive household debt.

Should you wait out the storm?

Financial markets appear paralysed. You shouldn't be. These events are like the waves on the sea. The underlying currents – those forces that affect the long-term outlook for our businesses and economy – are much stronger. Today, the charts reveal three major currents: Canadian firms are underexposed to the fastest growing parts of the global economy; commodity prices can be expected to remain elevated relative to historic averages; and our firms are not as productive as they could or need to be.

Regardless of what happens in the United States or Europe, these challenges and opportunities need to be seized through sustained efforts here in Canada.

The world's economic centre of gravity is shifting rapidly from advanced to emerging economies. The game in the United States will be more about taking market share (something we have not been doing recently) than participating in a growing market. To put it

[1] According to projections published since 1998 by the Bank in our *Monetary Policy Report*, this is the variance in the horizon over which inflation was projected to return to the 2 per cent target.

bluntly, the U.S. economy can be expected to be relatively weak for some time as households repair balance sheets and governments wrestle with deficits. How weak depends on the choices Americans make but, given the pressures, there is limited upside.

Canada will have to look elsewhere to grow our exports. Emerging markets already account for almost one-half of the growth in all imports over the past decade. In a process that can be expected to continue for decades, emerging Asia is rapidly urbanizing. China and India are housing the equivalent of the entire population of Canada every 18 months. In parallel, a massive new middle class is being formed, growing by 70 million people each year.

Thus, even though commodity prices have eased in recent weeks, they can be expected to remain at elevated levels, supported by large, sustained demand increases from the emerging world, particularly Asia.

We will need to take advantage of such opportunities because the limits of domestic debt and demography mean that the potential growth of our economy is slowing. As the boomer generation ages, labour force participation rates will decline and hours worked will fall. The direction is clear. The question is merely one of degree.

If we do not develop new markets and if we do not improve productivity, the cumulative loss of income from slower potential growth could be almost $30,000 for every Canadian over the next decade.[2]

Conclusion

It is often said that Canada is not an island. This is true and illustrates that we are not immune to global events. Perhaps a better analogy for us today here on the shores of the Bay of Fundy is that Canada is like a ship. We can be tossed by the waves or pulled by the current, but we are still able to chart our course in even the stormiest of seas.

The challenges in the current global economic environment are significant but so, too, are the opportunities. Our corporations and governments have strong balance sheets, our financial institutions are among the most resilient in the world, and our economy can be geared to the future sources of global growth. To take advantage of these attributes, we will need continued, heavy investment to improve productivity and sustained, innovative efforts to develop new markets.

For its part, the Bank of Canada has a wide range of tools and policy options that it will continue to deploy as appropriate in order to ensure that Canadians can seize these opportunities in an environment of domestic macroeconomic and financial stability.

Fall may be around the corner, but we all know that Canadians are at their best during winter.

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[2] See M. Carney, “The Virtue of Productivity in a Wicked World,” speech to the Ottawa Economics Association, Ottawa, Ontario, 24 March 2010, available at: <http://www.bankofcanada.ca/2010/03/speeches/virtue-productivity-wicked-world/>.