Stephen S Poloz: Canada’s hot – and not – economy

Remarks by Mr Stephen S Poloz, Governor of the Bank of Canada, to the Saskatchewan Trade and Export Partnership, Saskatoon, Saskatchewan, 24 April 2014.

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Introduction

Thank you for that kind introduction, and thank you to all of you for coming today. It’s my pleasure to be here with the Saskatchewan Trade and Export Partnership. I applaud your efforts to develop exports from this province to the rest of the world – Canada’s economy needs those exports.

From my vantage point at the Bank of Canada, I take a broad view of the Canadian economy as a whole. But, depending on where you work or where you live, your sense of how well the economy is doing will vary. From one region of Canada to another, from one sector of the economy to another, we are seeing fundamental differences in the demand for our products, in employment, in wages and in housing. In fact, we are seeing markedly different rates of economic growth. Some sectors and some regions are hot – and some are not.

This shows up most tangibly in employment and housing. In places like Fort McMurray, it’s fairly easy to find a job, but hard to find a place to live. In other cities, the reverse is true.

In the time I have with you today, I’d like to talk about what’s hot and what’s not – and the forces fuelling the economy’s heating and cooling systems. My job today is to pass on some of the Bank’s analysis so that you can use it to make informed financial and economic decisions for yourselves and your families, your businesses, and your futures.

What’s hot? Oil

One of the most important forces powering Canada’s economy today is the long-term strength in global prices for resources. For Canada, oil stands out. We have the world’s third-largest reserves of crude oil. And we’re number one in potash production. This means money in our pockets.

In technical terms, it is a positive terms-of-trade shock. In non-technical terms, it’s a gift. As the value of the resources we export goes up, and as the value of the products we import either remains low or rises more slowly – or, as our terms of trade improve – more wealth flows to Canadians.

Let me put it this way. You’ve got a box of old hockey cards in the basement, right? Everybody does. What if in that box you’ve got a Chris Kunitz card from his rookie days? Hey, now that the Regina native is an Olympic gold medallist and two-time Stanley Cup winner, that card is suddenly worth a lot – and you have the incentive you need to go dig it out of the basement.

It’s the same thing with a terms-of-trade shock. Since 2002, we have enjoyed the benefit of an almost 25 per cent rise in Canada’s terms of trade. With the average world price of oil over the past decade more than double that of the previous three decades, Canada’s resources are suddenly worth a lot – and we have the incentive we need to go dig them out of the ground.

That’s what’s been happening. Higher oil prices have stimulated oil production in Canada, magnifying the benefits from the improvement in the terms of trade. This is particularly true of Canada’s vast oil sands, where the higher prices have made them economically viable.

To step up production requires more workers and more money. Where do they come from? What draws them in? The economy has natural market mechanisms that help. With the higher prices these sectors command on the world markets, profits, job markets and wages heat up, attracting more investors and more workers. As people earn more, they spend more and, as this work force grows, they need more of everything – from Tim Hortons to pickup trucks. This leads to more jobs and higher wages in other sectors and other regions of the economy, so everyone benefits.

People move to where it's hot

As a share of GDP, investment in mining and oil and gas extraction has doubled since 2002. As companies step up their investments, they set off a chain of events that draws people in. Over the past ten years, about a quarter of a million people, net – roughly the population of Saskatoon – have moved from other provinces to Alberta. Last year alone, net migration to Alberta from the rest of Canada totalled nearly 45,000. Saskatchewan, too, has had more people move in than out over the past year. Between 2006 and 2011, about one in every five Saskatchewanians was either a newcomer or had moved a long distance within the province. For all of Canada's workers, this is a sea change.

While Alberta and Saskatchewan may be net recipients of people, there is still significant gross movement of people into and out of the "cooler" provinces and sectors. The fact is, lots of jobs are being created all over the country, demonstrating the economy's ability to respond to changing circumstances.

People are crossing the country not just for the jobs, but also for better wages. No matter how you cut the data, they consistently show that workers in Alberta, Saskatchewan, and Newfoundland and Labrador have seen their wages go up faster than anywhere else in Canada in recent years.

Interestingly, in part because of this movement of people, gaps in the unemployment rates among the provinces have not widened in response to the terms-of-trade shock; rather, they have actually become smaller than they once were. The growth in job opportunities in hot areas is almost matched by a net migration of workers out of provinces where opportunities are less plentiful. Canada's labour force is demonstrating remarkable flexibility, as workers from across the country move to find good jobs and good pay.

However, this is not to say it's easy. In places where it's hot, they are scrambling to keep up with the demand for housing. Here in Saskatchewan and next door in Alberta, many more houses proportionately are going up than elsewhere in Canada. Further, the cost of maintaining a home in these provinces has increased by far more than anywhere else.

For people outside the hot spots, it is a really big decision to move across the country. The people moving to the hot economies are *leaving* other areas – of both the country and the economy – and they are taking income and potential with them. This upheaval can be difficult for the regions and sectors that are losing workers. For families, the long-distance relationships it creates can be tough.

In the long run, however, we are all better off with a positive terms-of-trade shock. While different regions and sectors adjust differently, and while these adjustments can be painful, they allow us to maximize the benefits of our rich energy endowment – and ultimately everyone gets the gift. Overall, Canada's gross domestic income (GDI), a measure of the purchasing power of all income generated by domestic production, is approximately 7 per cent higher than it would have been without the improvement in the terms of trade since 2002.

Yes, when we break this down by region, big benefits are accruing to the three oil-producing provinces. But those who suspect GDI is falling elsewhere will have to think again. Rather, *everywhere* in Canada, GDI is higher than it would have been without the improvement in our terms of trade.

Where the terms of trade go, the loonie follows

For Canada as a whole, where the terms of trade go, the loonie follows. International investors buy good-news stories and, when they buy Canada's, the value of the Canadian dollar goes up. As a consequence, our terms of trade and the dollar move together, although not necessarily always in sync.

It's like walking a dog on one of those leashes that stretch out and snap back. You might hope he'll stick by your side, but in reality the dog is always off in all directions. By the end, your respective tracks zigzag all over the place, much like an economist's chart. But when you leave the park, you're still together. That's how the relationship between the terms of trade and the dollar looks: it's loose, but dependable.

It is also how the gift of a positive terms-of-trade shock gets spread even further. A stronger dollar gives the whole country greater purchasing power on global markets by bringing down the Canadian-dollar prices of imported goods and services. That means cheaper televisions, cheaper trips, cheaper tools. That's good for Canadian consumers and for companies that buy machinery and equipment. Yes, it is true that, for some businesses, the stronger dollar also reduces their ability to compete in world markets – I'll speak more about that in a moment.

It is important to note that the terms of trade are not the only thing that affects the exchange rate. Other forces, of course, are important, in particular the U.S. dollar. In the post-crisis period, the U.S. dollar tended to be weaker against many other currencies, including ours. But in recent months, with the U.S. economy regaining its momentum, the loonie's strength has diminished, coming down from its post-crisis peak.

What's not hot? Non-energy exports

So far, I have been focusing mainly on the hot side of Canada's economy. But let's look at where growth is cooler – in the manufacturing sector. Here, the story is not so cut and dried.

As I mentioned, the strengthening Canadian dollar in response to an improvement in the terms of trade contributes to the competitiveness headwinds faced by non-energy exporting companies, especially manufacturers. Added to this was the pain inflicted on manufacturers across advanced economies by the Great Recession that followed the financial crisis.

Here in Canada, the crisis lowered the temperatures of both the energy and manufacturing tracks of our economy. But due in part to the magnitude of the hit felt south of our border and to the severe impact felt by the U.S. sectors important to Canadian manufacturers – including its residential housing sector and auto production – the crisis was particularly hard on our manufacturing exporters. Many manufacturers and manufacturing jobs simply disappeared. For the sector as a whole, the recovery has been a long time coming.

Together, the two shocks – the terms-of-trade shock and the crisis – have walloped Canada's manufacturers. Now, the world recovery is beginning to get under way, which will relieve the pressure of the shock of the crisis. However, the forces related to the changing terms of trade will continue to be felt, even as the global recovery proceeds. One shock is going away, but the other continues.

Competitiveness challenges have prompted many Canadian manufacturers to become more productive. Some have streamlined their activities, introduced new products and services, entered new markets, and invested in cost-saving technologies. Others have outsourced product fabrication, but invested in product development and sales and service for new markets.

We have seen gains in productivity among those manufacturing subsectors in which Canada has natural advantages, including primary metals, wood products, paper, and food. Since 2002, the greatest increases in manufacturing output per worker have occurred in these industries.

We all know Canada's is an export-driven economy. Growth since the crisis has been fuelled by policy, not natural forces. We need our economy to shift gears and for exports to lead again.

The importance of manufacturing to the economy and, in particular, manufacturing exporters – and the growing wedge between our export performance and foreign demand – led the Bank to dig a little deeper to better understand the dynamics of what's happening.

To do that, we broke down the non-energy export sector into 31 subsectors and investigated at this more detailed level. We are discovering that, for many of these subsectors, exports have been behaving broadly in line with the fundamentals of foreign activity – or even better. For them, business is heating up.

Subsectors that are expected to thrive as U.S. investment picks up include machinery and equipment, building materials, commercial services, and aircraft and aircraft parts. Other strong subsectors that are poised to heat up include pharmaceuticals, plastics, metal products, and travel and tourism. Some of these subsectors are expected to benefit from both the recent decline in the Canadian dollar and the stronger U.S. activity. Taken together, these subsectors constitute about half of Canada's exports. So we are hopeful that, as their temperatures rise, these industries will help drive the recovery in Canada's exports.

Other subsectors, however, are still coping with competitiveness challenges, which have been developing for a long time and weigh on their ability to benefit from stronger growth abroad. These include auto and truck makers, food and beverage suppliers, and chemicals. Because their issues are longer-term, the recovery for these groups will be slower, even as they could be helped by the recent decline in the strength of the Canadian dollar.

The Bank's analysis has given us a more granular interpretation of the export picture – and gives us more hope for the recovery of our non-energy export sector. However, it also implies that the wedge we've observed between exports and foreign demand persists to some degree. While there is more restructuring of the Canadian economy in store, we expect a gradual convergence between the growth rate of Canada's exports and that of foreign demand.

The Bank is looking to industries that are out in front in terms of their knowledge, technical expertise or production advantages to lead the growth in Canada's non-energy exports; for example, some of those companies supported by Innovation Place here in Saskatoon. We are looking to industries that have posted solid performance over the past decade and, frankly, industries of the future that we may not even be able to currently identify. Chances are, big bursts of growth will come from brand-new companies with brand-new products and services. But this process will take time; we need to be patient.

In order to achieve a *sustainably* stronger profile of export growth, we cannot rely solely on the U.S. market. There is no doubt that an improving U.S. economy is good for Canada. However, the growth potential of emerging-market economies is projected to be about four times that of the world's advanced economies. Ultimately, in addition to capitalizing on the stronger growth of these markets, diversifying our export markets will help reduce the risks associated with weakness in one export market. We can do this now, but as our various free-trade agreements fall into place, we will be able to do so even more effectively.

Overall, we remain hopeful that rising global demand for Canadian goods and services, combined with the continued high level of oil prices, will stimulate business investment in Canada and shift the economy onto a more sustainable growth track.

Consistent with this view, manufacturers interviewed by the Bank for our spring *Business Outlook Survey* indicated that, in an effort to improve competitiveness or to create opportunities for growth, they are planning to increase their investments in machinery and equipment. Such intentions are somewhat more prominent among small and medium-sized firms and among export-oriented firms. Statistics Canada's recent survey of private and public investment intentions also shows that manufacturers across a broad range of subsectors are planning to increase investment. I’m encouraged by these intentions.

With Canada’s stronger terms of trade, with our healthy business environment, with our ability to innovate, the future of Canada’s manufacturing sector is bright. Just as your favourite maple tree looks different every spring, the sector will evolve, at least on the surface. For instance, we can expect some parts of the manufacturing process to move offshore to lower-cost venues. In this respect, manufacturing is not just fabrication. Of course, it involves much more. Prior to fabrication, there’s research and development and design. Pre- and post-fabrication activities are high value-added services that reward skilled workers with high wages. At the same time, our rich resource endowment makes Canada a natural place for manufacturers of food, fabricated and primary metals, and forestry products.

Hot or not: Where does monetary policy fit in?

How does monetary policy fit into this? In effect, we make sure the big picture is balanced and we let these forces work themselves out beneath the surface. Our contribution is to keep inflation on track. However, even though monetary policy does not address sectoral or regional issues and, instead, is designed for the economy as a whole, the analysis I’ve described here feeds critically into our policy decision making.

Our forecast is that, as a result of higher consumer energy prices, total inflation will rise in the next few quarters. These increases will have, by definition, transitory effects on trend inflation and in a year from now, they will come out of the numbers. In the meantime, what is crucial to the underlying inflation story is that we start from a low inflation rate. And that’s why we say that the downside risks to inflation remain important – because they would have the potential to push inflation significantly further away from our 2 per cent target. If we ask ourselves where those risks might come from, obviously, our story hinges critically on the outlook for our exports.

We already have what looks like a soft landing emerging in housing, so it is crucial that at the same time there is a pickup of momentum in our exports, which we believe will then be followed by a pickup in business investment. Those two shifts will put our economy on a sustainable growth track.

However, if, for some reason, the export recovery were less than we’re predicting, then total inflation, having gone up to target, will simply drift back down to converge with core inflation at perhaps around 1 per cent, because the output gap will be just as big as before.

Either way, it should be clear that we are still a long way from home, as it will take until early 2016 to get underlying inflation back up to 2 per cent. Our economy has room to grow. And, when we do get home, there is a growing consensus that interest rates will still be lower than we were accustomed to in the past – both because of our shifting demographics and because, after such a long period at such unusually low levels, interest rates won’t need to move as much to have the same impact on the economy.

Last week, reflecting our analysis, we maintained the target for the overnight rate at 1 per cent.

Conclusion

It’s time to wrap up. We can’t be 100 per cent sure that oil prices will stay high indefinitely. We have a forecast, but the circumstances can obviously change. What’s crucial is that the Canadian economy maintain its ability to adapt to shifting temperatures. Diversifying our export markets is important to future growth and resilience.

Just as when you travel from one part of Canada to another, the weather can be dramatically different – hot in the Okanagan, bone-chilling cold in the Prairies and moderate in the Maritimes – local economies can cover the gamut from hot to not. We are fortunate that we can see these shifts in economic temperatures as they occur. The key is having an economy that is flexible enough to sustain the shocks and adjust to them smoothly. The more we know about the shocks and adjustments, the better prepared we are and the better able we are to benefit from everything this great country of ours has to offer.