Stephen S Poloz: The way home – reading the economic signs

Remarks by Mr Stephen S Poloz, Governor of the Bank of Canada, to the Greater Charlottetown Area Chamber of Commerce, Charlottetown, Prince Edward Island, 19 May 2015.

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Introduction

Good afternoon. It's always a pleasure to be here in Prince Edward Island.

The Confederation Bridge has simplified the trip since it first opened. If you come to the Island by car, you don't have to navigate the waters of the Northumberland Strait. According to the *Canadian Encyclopedia*, the shallow waters of the strait are susceptible to strong currents, tides and turbulence. Even the most skilled sailor can find it challenging to read the winds and waves, and to judge all the cross-currents.

If only the Canadian economy had a similar bridge. We've been on a voyage of rebuilding since the Great Recession. But the trip has been longer and more complicated than previous recoveries because of all the cross-currents acting on the economy. Not only are the headwinds of the global financial crisis still blowing, but now we're also dealing with lower prices for oil and other key commodities, which previously were a key growth engine for us. The implications for income and investment, and the adjustments they're causing across sectors and regions, may take years to work themselves out.

The drop in oil prices is the most recent setback for the Canadian economy, but it's not the first time we've had a shock that's had different effects from one region to another. That's what you'd expect in a large country that's rich in diverse commodities.

Certainly, people working in the lobster fishery or the mussel and oyster farming sector have seen their share of challenging periods in the past. But companies have adjusted and made quality improvements that are allowing aquaculture and the fishery to strengthen as the U.S. economy recovers. At the same time, P.E.I.'s exports are benefiting from diversification into sectors such as aerospace and biotechnology, as well as expansion into emerging markets, particularly Asia.

P.E.I.'s experience is an example of the resilience that we've seen in the past across Canada. We're expecting to see it again as the economy continues on its way home, toward natural, self-sustaining, and balanced growth at full capacity.

What I'd like to do today is talk about how the voyage is going. We don't have a bridge, so the economy can't avoid the choppy waters. However, there are signs that tell us we're headed in the right direction. It's important for the Bank to be transparent about the signs we watch, both because financial markets should make their own judgments about what we will do and because our monetary policy works better when Canadians understand what we're doing, and why.

The long voyage home

We begin the story with the Great Recession of 2008–09, which saw Canadian exports fall further than in any recession since the Second World War. Policy-makers everywhere reacted aggressively to the global turmoil. Here in Canada, governments boosted spending, and the Bank of Canada cut interest rates in steps until we reached the effective lower bound. These moves, combined with a strong financial system, gave Canada one of the best post-crisis experiences among advanced economies. It's fair to say that households did most of the heavy lifting to keep the economy growing, borrowing to buy houses and cars. We also enjoyed good growth in our energy sector with high oil prices.

But growth that relies too much on low interest rates and household spending isn’t sustainable. We kept looking for signs that a natural sequence was taking over in the economy: recovery in the United States and elsewhere would lead to stronger exports. This would spark increased business confidence, investment and employment. Ultimately, we would achieve natural, balanced growth, with exports representing a larger share and inflation sustainably at its 2 per cent target.

Exports began to recover after the recession but stalled in 2012 and 2013, despite strong U.S. growth. So, at the Bank of Canada, we did a lot of work to figure out what was going on, looking at how the drivers of exports were evolving, including the competitiveness of various sectors and the loss of productive capacity in the wake of the recession.

We looked at 31 categories of Canada’s non-energy exports and found that about half of them were underperforming relative to what you’d expect, given the state of foreign demand and the exchange rate. We further broke those weak categories into about 2,000 specific goods or services and discovered that about 500 of those had been shrinking since the early 2000s, falling to almost nothing. We were able to show that much of this drop was due to companies in these areas ceasing to operate in Canada. So, their productive capacity has been permanently lost.

But what about the other half of the non-energy export sector? Those 15 categories are expected to lead the recovery in exports, based on factors such as their ties to U.S. residential and business investment and their historical sensitivity to exchange rates. The list includes such categories as machinery and equipment, fabricated metal products, aerospace, and pharmaceuticals; in many of these, we’re seeing growth right here in P.E.I. That’s not to mention services, which includes tourism.

If you think back to last summer, the economic outlook was looking pretty positive. The export groups that we predicted would lead the recovery were starting to perform as we expected. The price of Brent crude oil was over US$100 per barrel, and the global economy seemed set to strengthen as economic headwinds were dissipating. The U.S. economy was looking especially good, and this was making us more confident that the natural progression was taking place and we were on our way to solid, self-sustaining growth.

Of course, we all know what happened next. The plunge in oil prices late in the year threw the recovery off course. It was clear that the shock would be a net negative for the Canadian economy and would be a downside risk for our inflation target, so we lowered our key policy interest rate in January.

But while it was clear that the oil price shock represented a setback, it has been no simple task to figure out how far off course it is taking us, or for how long. From the data we have seen to date, the impact began to show up in the closing months of 2014. For example, oil rig counts began to fall, and this showed up in employment statistics in the oil patch, especially in Alberta.

This impact contributed to weaker growth in housing and general consumption spending. Manufacturing faltered as we moved into 2015, partly because many inputs for the oil patch are manufactured, but also because of bad weather and a temporary slowdown in the U.S. economy. When all the numbers are in, we expect that output in the Canadian economy will have been basically flat in the first quarter.

Our view, as we set out in last month’s *Monetary Policy Report*, is that growth will rebound partially in the second quarter. While there’s still a risk that lower oil prices could have a greater impact, the signs we have seen to date lead us to believe that the impact of the shock is proving to be faster than we first expected, but not larger. Meanwhile, the positive forces we had already identified continue to build and should be buttressed by our interest rate cut and the lower dollar. By the second half of the year, we expect those positive forces to dominate the picture and have us back on track to reach full capacity around the end of 2016.

What are we basing this outlook on? For one thing, the January interest rate cut is working. In an atmosphere where many other central banks were also loosening policy, the reaction to the cut made financial conditions in Canada significantly easier. The cut will benefit households with a mortgage, though this will be partly offset by a reduction of income for savers.

Let me put this in concrete terms. Bank staff estimate that a household that has renewed a $100,000 mortgage would save about $250 in interest payments this year. That's on top of the roughly $500 that the average household will save in gasoline costs. But the really big impact is for companies with existing export contracts in U.S. dollars, which would see a bump in cash of roughly $15 billion to $20 billion over the course of the year from a three-cent drop in the Canadian dollar. They will also be in a stronger position to compete for new export contracts in the future.

Of course, I must underscore how uncertain the outlook is. In recent weeks, both oil prices and the Canadian dollar have moved higher. We will need to carefully consider these and other economic and financial developments and how Canadian companies and households are likely to react in the months ahead.

Now, let's look at the categories of non-energy goods exports that we said should lead the recovery. As a whole, this group – which adds up to more than $185 billion – grew by almost 15 per cent in nominal terms over the 12 months through March. Among industries present in P.E.I., aerospace is up by 20 per cent nationally, while machinery and equipment has risen by about 11 per cent.

Here in P.E.I., exports climbed by 22 per cent last year, with the total now exceeding $1 billion. Tourism, another industry important to both P.E.I. and Canada as a whole, also had a good year. Foreign tourism demand grew 4.5 per cent to reach the highest level in a decade. Given lower gasoline prices and the level of the Canadian dollar, we can expect further growth this year.

What about the next steps in the sequence: the increases in company investment and employment? When we spoke with executives in our most recent *Business Outlook Survey*, we heard that companies that are benefiting from stronger U.S. demand are starting to feel capacity pressures, and a growing share of exporters tell us that capacity constraints would limit their ability to meet a sudden increase in demand. These constraints suggest that companies may need to step up investment. To be sure, there is some spare capacity among the groups that we expect to lead the recovery. However, outside of the energy sector, the outlook for investment is positive.

In terms of employment, there have been some recent signs that the labour market is starting to function better. Let me give you some examples. We've seen long-term unemployment decline and more prime-age people taking part in the labour force. Employment vacancies have been trending upward since early last year, suggesting that it's getting easier to move jobs. Statistics Canada's Survey of Employment, Payrolls and Hours shows that manufacturing jobs have trended up for the past six months or so. However, the Bank's own indicator shows that there's still slack in the labour market, and we probably still haven't seen the full impact of the oil price shock reflected in the employment data.

Let me mention one other bellwether, and that's firm creation. While part of the increase in business investment will be companies adding to their own capacity, another part will be the creation of new companies.

Historically, growth in the population of companies tends to be weak when the economy is weak and stronger when the economy improves. New firms are the prime creators of new jobs in the economy. They are also linked with productivity growth, because new companies are often innovators or take advantage of innovations to exploit niches and develop new products. New companies tend to be more productive than firms that have gone out of business and can also pressure existing companies to be more productive. As such, they contribute to the growth in productivity that is ultimately key to improving our standard of living.

Recessions are painful and require adjustments. Companies, and sometimes entire industries, shut down, often never to return. But after the destruction, new ones are born that help drive the next wave of growth.

We know that we lost a lot of exporting companies during the recession. Growth in the population of companies hit a low point in Canada in 2009, similar to what took place in the United Kingdom and United States. After the recession, the number of U.K. companies started growing sharply in 2012 and the U.S. population took off in 2013. The Canadian rebound hasn't been as quick as we'd like, but recent data have been encouraging. We will continue to follow these data closely.

Of course, these aren't the only signs we're following. We look at a wide range of economic data and supplement these with various surveys. We also consult with business leaders, and our regional offices are invaluable in these efforts. All of this information helps us make our best judgment about how much slack there is in the economy or, in other words, how far we are from home.

Judging inflation

Our judgments about inflation are truly important because they get at the heart of our mandate at the Bank of Canada. It's our job to promote the economic and financial welfare of Canadians, and the best way we can do that is to provide an environment of low and stable inflation. Why? Because low and stable inflation allows consumers and businesses to make decisions about the future with greater certainty. Since the Bank began targeting inflation almost 25 years ago, interest rates have been lower and economic growth has been stronger and more stable.

We know that inflation is fundamentally driven by the amount of economic slack we have. If the economy is operating below its capacity, that will put downward pressure on inflation. However, inflation is a noisy indicator. All sorts of things can affect it on a month-to-month basis. Our task of judging the underlying trend of inflation has been complicated by the events of the past year. We have the oil price shock, which is pushing inflation down, and the weaker Canadian dollar, which is pushing inflation upward. On top of these, a number of one-off factors have been affecting inflation. All of this has certainly made it more challenging to distinguish the trend from the temporary.

Because it takes up to two years for interest rate movements to have their full impact on inflation, it wouldn't make sense to respond to every wiggle in the inflation rate. Our challenge is to look through the temporary effects and aim our policy at the movements in inflation that are persistent. And to do that, we need to make our best judgment of what the underlying trend of inflation is.

We have a number of measures that we use to help us make this judgment. The most familiar of these is commonly referred to as our measure of "core inflation," which excludes eight of the most volatile components of the consumer price index and removes the effects of changes in indirect taxes. But we have several other methods, models and tools, which help us judge the underlying trend of inflation.

Next year, the Bank will renew its inflation-targeting agreement with the government. As we have been saying for months, among the issues we are looking at in this renewal is whether we should continue to highlight one measure of the underlying trend of inflation, and, if so, whether our current measure of core inflation should continue to be the main guide.

At the most recent reading, total CPI inflation was 1.2 per cent, well below our 2 per cent target. This was largely due to the drop in gasoline prices, which we treat as a temporary effect. Total CPI inflation would be even lower – quite close to zero – were it not for exchange rate effects and some one-time factors. Meanwhile, core inflation was 2.4 per cent, but it is also being boosted by exchange rate effects and some one-time factors, such as meat and communications prices.

That's a lot of moving parts, and the impact of each of these transitory forces has to be estimated; we can't just measure them. So we have to use a lot of judgment to gauge the combined impact. Clearly, these estimates are subject to a fair degree of error. But our current best judgment is that the underlying trend of inflation is somewhere around 1.6 per cent to 1.8 per cent. To get the trend moving back toward 2 per cent, it's essential that excess capacity in the economy be used up. With growth set to accelerate over the rest of the year, the underlying trend should eventually converge with total CPI inflation at the 2 per cent target when the economy returns to full capacity.

Here's the bottom line on our voyage. We're still a ways from home; we project it will take 18 months or so to get there. That's if growth turns out as we expect and we aren't hit by other storms or cross-currents on the way, whether headwinds or tailwinds. But our best judgment is that we should get home – at full capacity and with inflation sustainably at 2 per cent – around the end of 2016.

Conclusion

Let me conclude with a few words about what home will look like when we do get there. While some companies disappeared during the Great Recession, never to return, others are emerging in new industries. At the same time, the economy of the future will be shaped by demographic forces that have been decades in the making. The retirement of the baby-boom generation is affecting the economy's growth potential, which is one reason why interest rates will probably remain lower than in the past.

Recent events make it clear that we live in an uncertain world. Navigating the waters of the global economy is always challenging: you never know when a sudden storm will emerge to blow us off course. That's why we take a risk-management approach to monetary policy. We look at all the data, derived from the latest models and tools, and supplement these with intelligence from companies and survey data. Ultimately, though, we make judgments – both about the degree of economic slack in the economy and the implications for our goal of inflation control.

By being transparent about the signs we're watching, we are trying to help financial markets make their own judgments about the economy's prospects. These opinions are important because they serve as a useful check on our own analysis.

It has been a long voyage, and it isn't over yet. But you can be sure that the Bank of Canada will continue to work toward bringing the economy home, at full capacity and with inflation sustainably on target, so we can fulfill our mandate to support the economic welfare of all Canadians.

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