Carolyn Wilkins: Economic trends and monetary policy

Remarks by Ms Carolyn Wilkins, Senior Deputy Governor of the Bank of Canada, at the University of Quebec, Trois-Rivières, Quebec, 6 October 2016.

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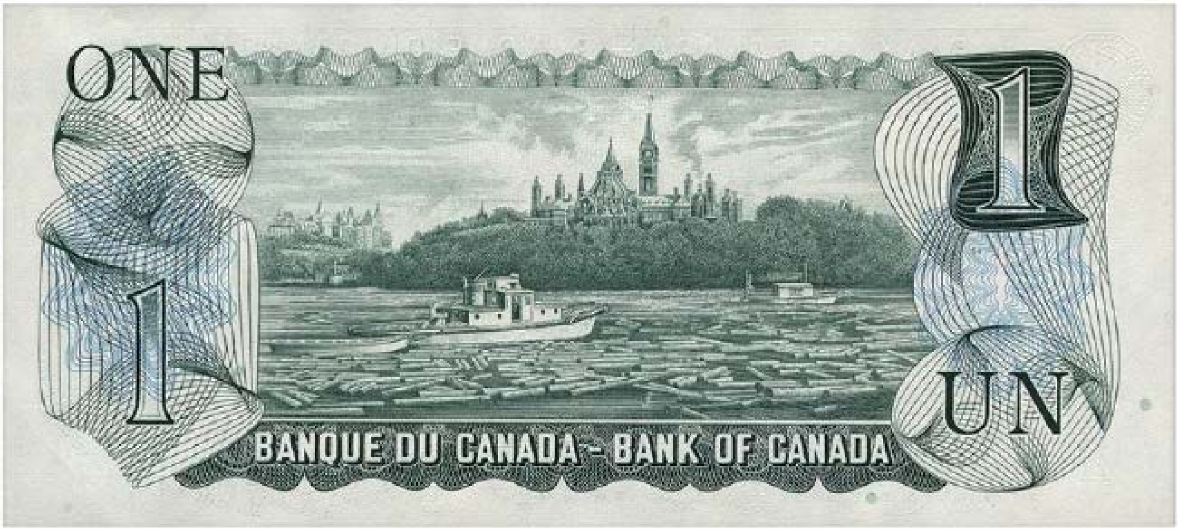
I would like to thank Eric Santor for his help in preparing this speech.

Introduction

It is a pleasure to be here in Trois-Rivières. It is a city that has a long and vibrant history. It has also gone through profound transformation. For a long time, pulp and paper mills were the economic engine of the region.

Credit: Canada. Department of Interior / Library and Archives Canada / PA-044389

Today, Trois-Rivières' economy is more diversified. You may be surprised to hear that Ottawa, where the Bank of Canada is based, was also at one time an important centre of Canada's timber trade. I am sure many of you may recall that the last one-dollar note the Bank issued even featured a tugboat amid logs on the Ottawa River.



I mention this common past not to reminisce about the good old days, but rather to marvel at how much the Canadian economy has changed over the years. Industries have risen and declined, and new ones have appeared.

These changes have at times been painful. Those who lived through hard times in the 1990s know it well. As mills closed, unemployment rose above 10 per cent. The unemployment rate in the region has fallen and is now close to the average for Québec and for the rest of Canada. Trois-Rivières has come a long way, with an unemployment rate that is below those averages. I know that the city is now counting on an expansion of its cultural and tourism sector and that your new amphitheatre has already had more success than expected.

Today, the Canadian economy continues to face pressures to adapt. Not only has it been recovering from the global financial crisis of eight years ago, it has also been affected by headwinds from the European debt crisis, fiscal consolidation in the United States and, more recently, Brexit. These events have all undermined confidence. Further, Canada is still confronting the collapse in oil prices. Remember that oil was trading at higher than $100 per barrel in June 2014, compared with around $45 now. That directly affects roughly 10 per cent of our GDP. And the prices of other commodities that are important for Quebec, such as iron ore and nickel, have also fallen significantly.

Anything that affects Canada's economy is important to us because, as you know, one of the Bank of Canada's main functions is to keep inflation low, stable and predictable. This provides the foundation for the economy to adapt as smoothly as possible to a new reality, such as a future with oil prices lower than in the past. We target an inflation rate of 2 per cent, inside a range of 1 to 3 per cent, so that families, investors and business owners can make long-term decisions with more confidence than if inflation were volatile and unpredictable.

To make the right monetary policy decisions, we need to have a good sense of what is happening now in the economy and where it is headed over the next couple of years, because growth and inflation are connected. In simple terms, inflation tends to be higher when the economy is operating at a level higher than its potential. Why? Because firms facing capacity constraints tend to raise prices by more for their products and services. And because workers tend to demand higher wages when labour is scarce. Conversely, inflation tends to be lower when economic resources such as labour and capital are underutilized, as they are today.

What I want to do now is to give you a window into how we analyze the Canadian economic situation as we seek to achieve our target for inflation. I will start by outlining the major shifts that have been affecting the Canadian economy. I will then go over the main adjustments we are watching closely as our economy returns to its potential. I will end by explaining how we incorporate all this into the decision-making process for monetary policy.

A two-track post-crisis economy

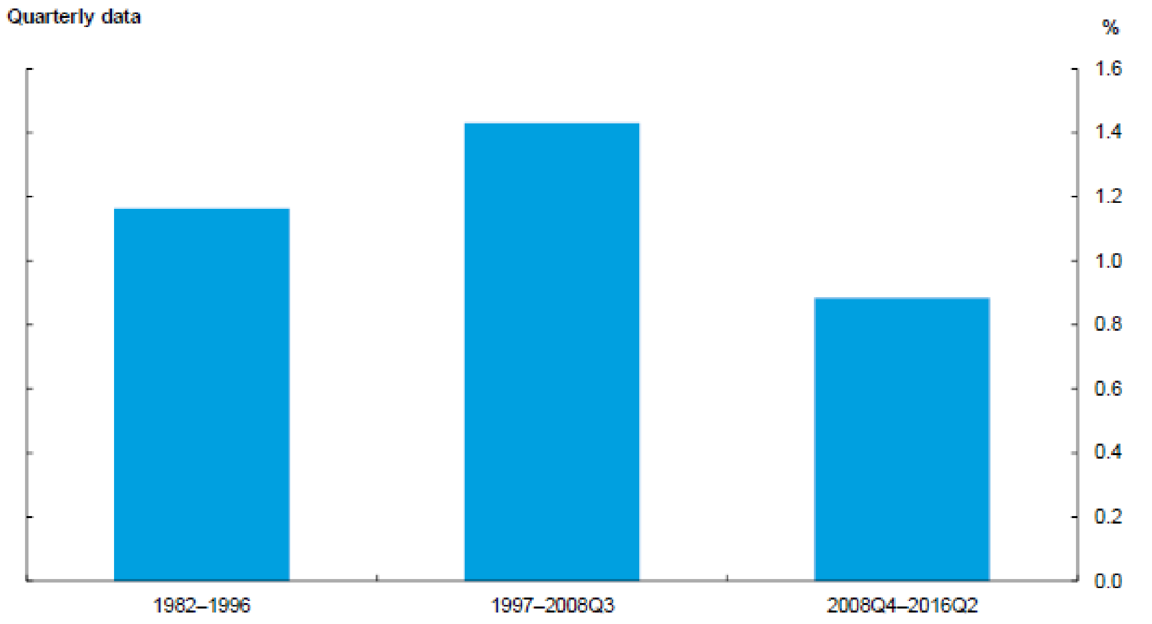
If the years since the crisis have been difficult for the Canadian economy, it is largely because of two profound shifts that are taking place at the same time.

The first shift is caused by population aging and a slowdown in productivity growth. These two factors are reducing how fast our economy can grow.

Population aging slows the growth rate of the economy's potential because it reduces the number of workers entering the labour market. As well, people work less as they get older – either by retiring or by reducing the number of hours they work. The bottom line is that companies face a lower growth rate of available workers. To give you a sense of scale: in Canada, the annual population growth for prime-age workers was just below 3 per cent in the late 1980s, compared with barely more than zero today.[1] In Quebec, this is happening a bit faster than in other provinces. At the global level, growth in the working-age population will be cut in half over the next two decades. Even China's labour force has started declining.[2] So clearly, this is a worldwide phenomenon.

At the same time, workers' productivity has been growing more slowly since the crisis began (Chart 1). Some of this slowing could be because companies are not investing as much as before to make each worker more productive. As well, the benefits to productivity growth from earlier developments in information technology are waning.

Chart 1: Labour productivity growth has slowed



Source: Statistics Canada

Last observation: 2016Q2

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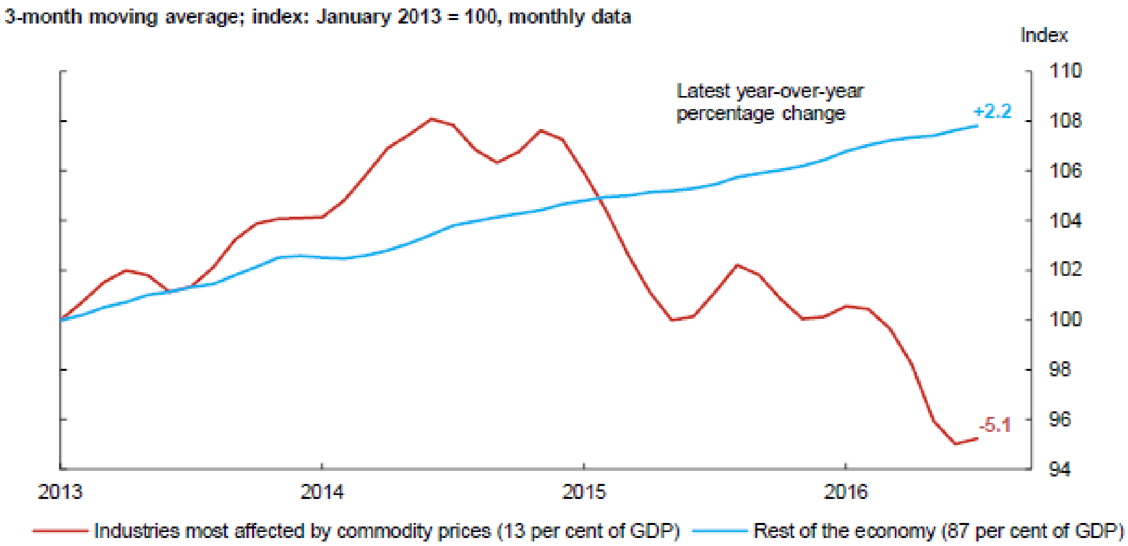
[1] Prime-age workers are workers aged 25 to 54.

[2] According to United Nations population projections of the 15–64 age group, as published in the *2015 Revision of World Population Prospects*. For access to the database, go to https://esa.un.org/unpd/wpp/.

Adapting to these underlying trends would have been a challenge at the best of times. Overall, potential output growth in Canada, as is the case in many other countries, is considerably lower than it was in the not-so-distant past. It is around 1 1/2 per cent today, compared with almost 4 per cent in 2000. That represents a lot of money, about $50 billion in foregone output in 2016. So, all things being equal, disinflationary pressures are lower because excess supply is lower than it otherwise would have been.

The second shift is the steep decline in commodity prices, especially oil, which we have seen in the past two years. The result is a two-track economy. The industries that depend on commodities have suffered a considerable downturn. The other sectors that are not directly dependent on commodities and make up about 87 per cent of our economy have made steady progress (Chart 2). This improvement is due to a more accommodative monetary policy, US economic growth and the weaker Canadian dollar.

Chart 2: Major structural adjustments are under way in Canada



Sources: Statistics Canada and Bank of Canada calculations

Last observation: July 2016

Economic models give us a framework for analyzing how the economy should be adjusting to these shifts. The framework tells us there are several interconnected adjustments that we should be seeing.

In the face of the oil price collapse, we would expect firms to cut investment spending and employ fewer workers. Over time, this drop in activity would be felt by other companies and consumers in the region.

Another adjustment concerns activity in the non-resource sector, particularly exports. We would expect the drop in commodity prices to cause the Canadian dollar to fall, which would support companies that export non-commodity goods and services. Of course, we are always looking to see how well the United States, our biggest trading partner, is doing.

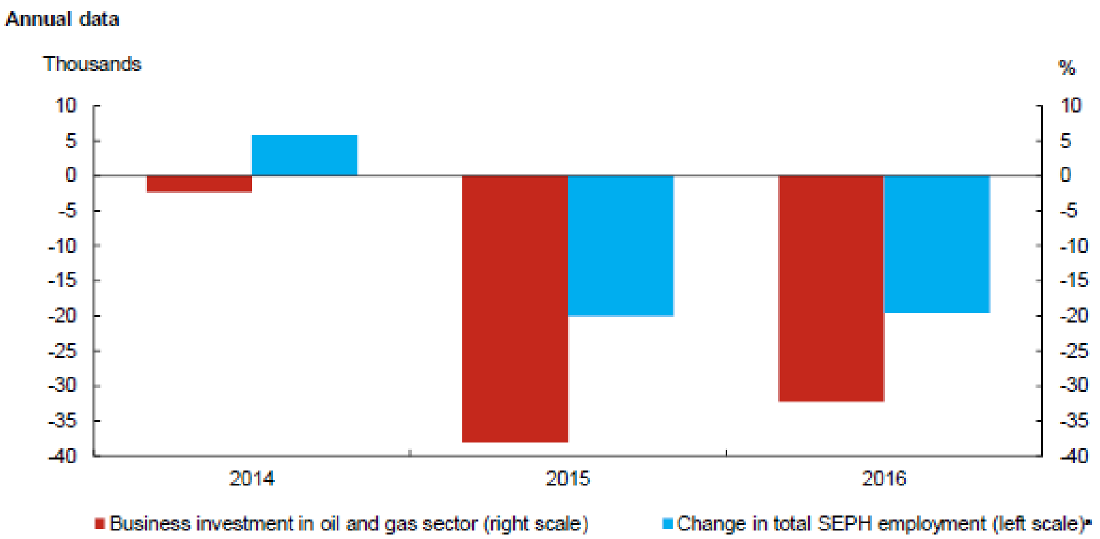
The final adjustment I will talk about relates to a further broadening in economic activity outside the resource sector. As firms see their business improve, we would expect them to invest and to hire workers to take full advantage of new-found opportunities. Government infrastructure spending would also be a contributing force.

Let us see how each adjustment is unfolding.

Stabilization in the energy sector

Adjustments in the oil and gas sector have been dramatic (Chart 3). Investment in the sector is expected to drop cumulatively in 2015 and 2016 to about 60 per cent lower than it was in 2014. And tens of thousands of jobs have also been cut. When we talk to company leaders, they tell us that the pace of the investment cuts may be easing. And while it appears that oil rig activity has troughed, it is too early to say that the cuts to investment are behind us. The adjustment in employment and wages may also continue for some time as firms adjust to the reality of lower oil prices.

Chart 3: The drop in investment in the oil and gas sector has decreased employment in the sector



a. Change in total SEPH (Survey of Employment, Payrolls and Hours) employment for 2016 is calculated using the average of employment from January 2016 to July 2016.

Sources: Statistics Canada and Bank of Canada calculations

Last observation: 2016

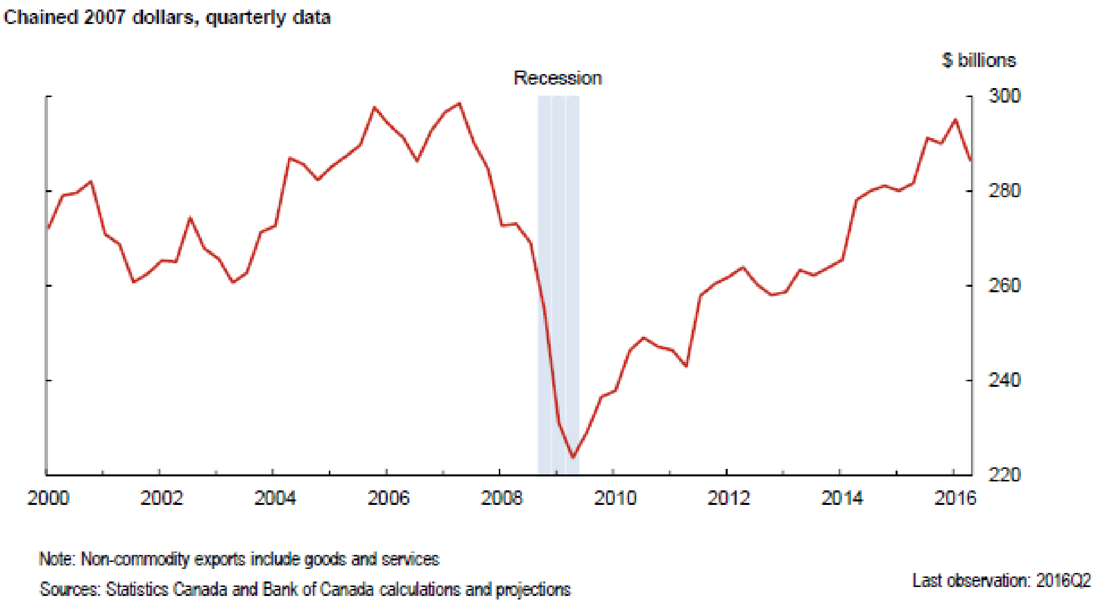
Sustained pickup in exports

As the energy sector stabilizes, we have been expecting growth in other parts of the economy to start dominating. One area in which we are looking for growth is non-commodity exports. These sectors, such as aerospace, transportation equipment, and machinery and equipment, are all important sources of exports for Quebec. Here in the region, wood products manufacturing is particularly important. Exports should benefit from two factors: solid US economic growth and the past depreciation of the Canadian dollar.

Our southern neighbour is important, since it buys around three-quarters of the goods and services we export. Now, relative to most other advanced economies, the United States has done quite well, with growth in the 2 to 2 1/2 per cent range for several years. And, let us keep in mind as well that the Canadian dollar has depreciated almost 20 per cent since the oil price shock.

Our expectations were being realized as our exports were improving. While data can be uneven, there is a clear upward trend in non-commodity exports over the past six years (Chart 4). And, generally speaking, those that have improved the most are non-commodity exports that are more sensitive to the exchange rate. We can expect the weaker dollar to support the level of exports, even though its influence on their growth rate has faded for the most part. Meanwhile, we expect US activity to recover over the next few quarters, as household spending and the labour market remain robust.

Chart 4: Non-commodity exports have been increasing steadily



Unfortunately, Canada's non-commodity exports had an unexpected setback in the second quarter. This is explained in part by weaker-than-expected US growth, particularly in investment, which is significant for our exports.

There was an uptick in July and August, which is encouraging, but uncertainty lingers. This uncertainty comes in part from the future growth of US investment. It is also possible that the effect of lower oil prices on the US economy is less positive than anticipated. It appears that the drop in oil-sector investment so far is largely offsetting the positive effects on consumption.[3]

We also cannot forget that competition effects are still playing an important role. We face stiff competition from other countries, such as Mexico, whose currency has depreciated by more than ours has. And, as Governor Poloz noted last week, some Canadian companies are growing their businesses outside of Canada to directly serve those markets.[4]

So it will take time to fully determine what is temporary and what is permanent for exports. That is why we noted in our September policy rate announcement that the risks to our inflation outlook have tilted somewhat to the downside relative to the July *Monetary Policy Report*.

Sustained non-resource growth

Further broadening in economic activity should, over time, prompt existing firms to expand capacity and new firms to be created. This should happen as non-commodity exports, fiscal stimulus and a strong service sector create new sources of growth and take up some of the excess capacity that is now in the economy.

We note that firms have not been inclined to invest in recent years. Last year, investment subtracted around 1 1/2 percentage points from growth, and we expect it to subtract another

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3 C. Baumeister and L. Kilian, "Lower Oil Prices and the U.S. Economy: Is this Time Different?" Brookings Papers on Economic Activity (10 September 2016).

4 S. S. Poloz, "The Paul Storer Memorial Lecture – Cross-Border Trade Integration and Monetary Policy," Bank of Canada Staff Discussion Paper No. 2016–20 (September 2016).

percentage point this year. The drop in non-residential investment has been largely driven by the oil price shock – the 60 per cent drop that I mentioned earlier. At the same time, the lethargy in business investment is broad-based and started before the oil price shock. For example, intellectual property investment – such as research and development – has been declining for the past four years. Businesses tell us that uncertainty about global growth plays an important role here. Weaker-than-expected exports have also contributed, since business investment and trade go hand-in-hand.

While the spotlight has rightly been on exports, I want to highlight other areas that will contribute to stronger and more balanced growth. In its most recent budget, the federal government announced roughly $25 billion of additional spending over the next two years. This includes infrastructure spending and measures for households such as the Canada Child Benefit. The effects of this stimulus will become more prominent as the year progresses.

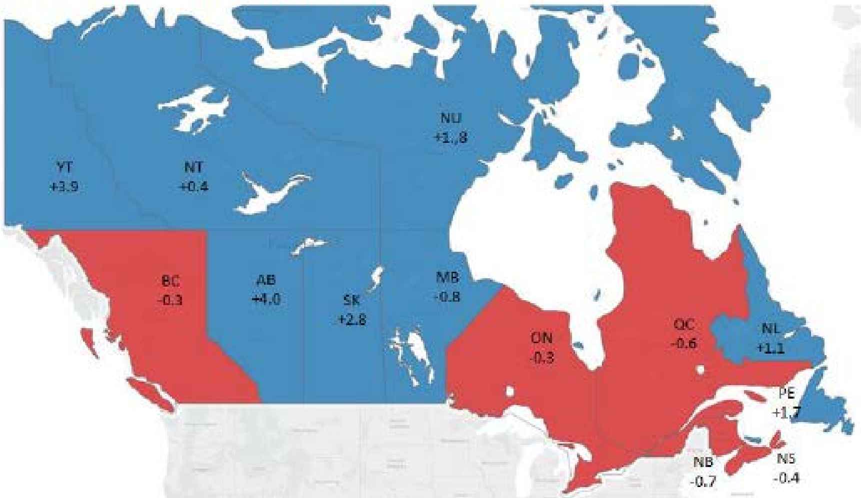
The service sector more generally has also been contributing to the stronger growth of household incomes. This is important, since services account for about 70 per cent of the economy and four of every five jobs. Some high-value-added sectors have grown quite nicely. The cultural sector is an interesting example, with more movies being shot in Canada. The air transportation sector is also improving, as new international routes are added. We export about $100 billion worth of services, or one dollar out of six from our export total. I know that tourism and professional and scientific services are two sectors that are expanding nicely in this region.

As the composition of demand and production changes, many Canadians have to make hard choices, such as whether to move to find work. It is good news that we now are seeing interprovincial migration in line with the adjustment that is needed. In fact, the willingness of people to move to regions with more dynamic labour markets has increased over the past decade and a half.[5]

This has helped keep the overall unemployment rate relatively stable at around 7 per cent despite the oil price shock, although it still varies widely across provinces (Chart 5).

Chart 5: Changes in unemployment rates across Canada since November 2014

Monthly data for the provinces, 3-month moving average for the territories



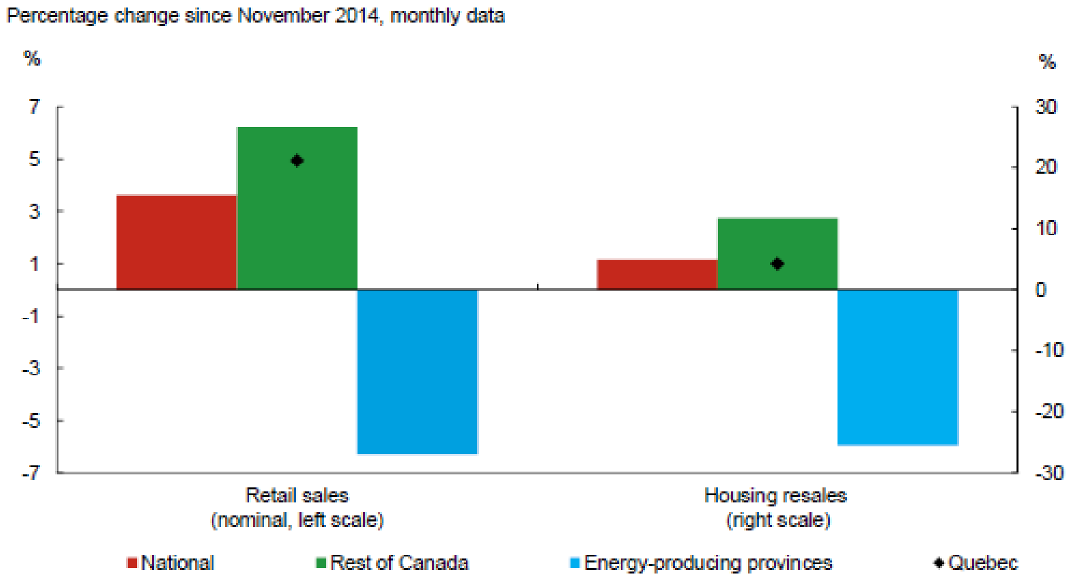
Source: Statistics Canada | Last observation: August 2016

5 D. Amirault and N. Rai, "Canadian Labour Market Dispersion: Mind the (Shrinking) Gap," Bank of Canada Staff Analytical Note No. 2016–3 (March 2016).

Moreover, there continues to be more slack in the labour market than the overall unemployment rate would suggest. This is due to modest wage growth and involuntary part-time work, as well as the number of discouraged workers.

Despite the weakness in the energy-producing provinces, nationally, the growth of household spending has held up (Chart 6).

Chart 6: Growth in national household spending has held up despite weakness in energy-producing provinces



Note: The energy-producing provinces are Alberta, Saskatchewan and Newfoundland and Labrador.

Sources: Statistics Canada and Bank of Canada calculations

Last observations: Retail sales, July 2016; housing resales, August 2016

Returning inflation to the target

Progress has been made with respect to the adjustments I have just described, but there is still material slack in the economy.

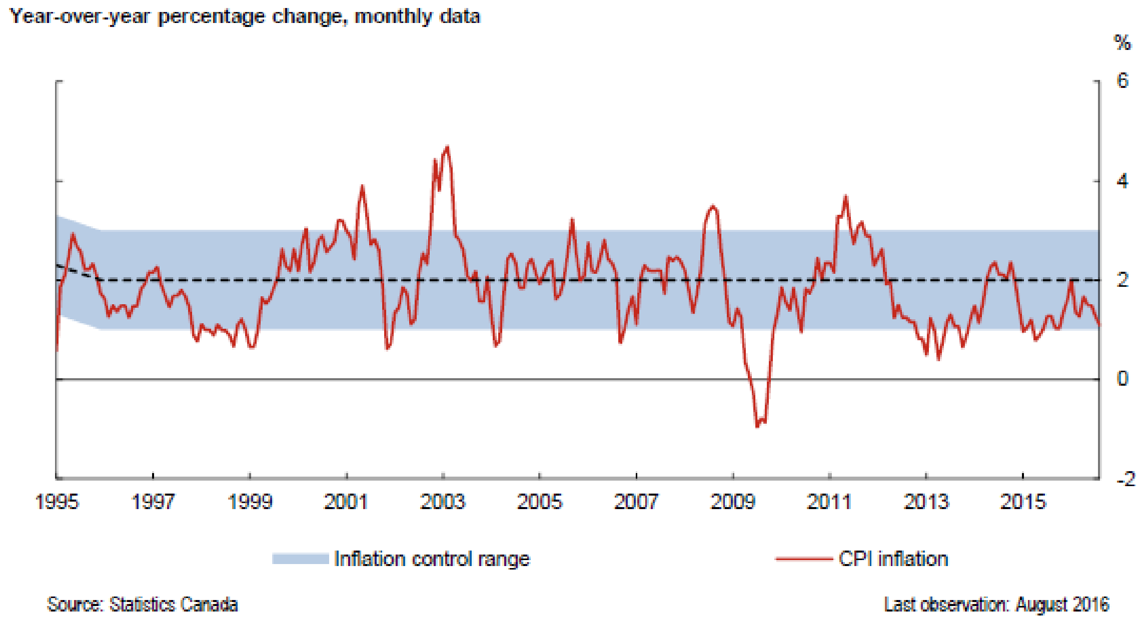
In September, Governing Council decided to leave the Bank’s target for the overnight rate at 1/2 per cent. We will revisit our projection when we release our quarterly *Monetary Policy Report*, together with a rate announcement, on 19 October. We are currently working on this.

As a matter of course, we monitor the data as they come in, but we prepare an update of our projection four times a year. This decision-making process serves us well. To achieve our policy objectives, we do our projections often enough to have a good sense of how the economy is evolving, but not so often as to become overly influenced by month-to-month fluctuations in the data. And when tragic events such as the Alberta wildfires inject volatility into the data, this longer perspective is doubly important.

As our discussions take place, we always keep in mind that the economic adjustments under way are forcing people to make difficult, long-term decisions. The one thing they should not have to worry about is whether their money will lose its value. In this context, the best contribution the Bank can make to Canada’s prosperity is to ensure that we have low and stable inflation. Empirical studies have shown that low and stable inflation helps create the necessary conditions for steady economic growth and job creation.[6]

The Bank of Canada has been successful at controlling inflation since we began targeting 2 per cent in 1995.[7] Headline inflation may be variable, but it has averaged just shy of 2 per cent (Chart 7). While it has taken time for the economy to return to its potential since the financial crisis, we have managed to keep inflation within our target range, with the exception of a few brief episodes. The monetary stimulus we are providing has been helping with the adjustment. Inflation is now in the lower half of our target range in large part because of the temporary effect of lower consumer energy prices.

Chart 7: Inflation has been remarkably stable



We are mindful that low interest rates can lead to a buildup in financial vulnerabilities. As part of our financial stability mandate, we are monitoring very closely the high level of household indebtedness and housing sector activity. We think that, over time, the measures announced by the federal government on Monday will help mitigate risks to the financial system posed by household imbalances.

Our approach to monetary policy is based on a risk-management framework. That is to say we consider both the risks to the outlook for inflation and those related to financial stability.

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6 R. J. Barro, "Economic Growth in a Cross Section of Countries," *Quarterly Journal of Economics* 106, no. 2 (1991): 407–443; S. Fischer, "Inflation and Growth," NBER Working Paper No. 1235, National Bureau of Economic Research (1983); Bank of Canada, *Renewal of the Inflation-Control Target Background Information – November 2011.*

7 In February 1991, the Government and the Bank introduced targets aimed at reducing the rate of inflation. The objective was to achieve a 3 per cent inflation rate by the end of 1992 and to gradually reduce the rate of inflation to 2 per cent by the end of 1995.

Conclusion

Let me wrap up. My goal today was to give you the Bank's perspective on the conduct of monetary policy in the current context.

Canada is going through important and complex adjustments. There has been progress, but also a few setbacks. As we said in September, with the recent setback in exports, the risks to the profile for inflation have tilted somewhat to the downside.

The Bank is providing monetary stimulus in order to meet its inflation target. The adjustments are clearly under way. But it will take time before the economy has fully adjusted to the oil price shock, the US economy strengthens and the effects of fiscal stimulus take hold.

Governing Council looks forward to providing you with an update on our outlook, as well as an interest rate announcement, in a couple of weeks.