Carolyn Wilkins: Canadian economic update – strength in diversity

Remarks by Ms Carolyn Wilkins, Senior Deputy Governor of the Bank of Canada, at the Associates of the Asper School of Business, Winnipeg, Manitoba, 12 June 2017.

* * *

Introduction

I am very pleased to join you here in Winnipeg. Thank you to the Associates of the Asper School of Business for the invitation.

I was able to get out for a run this morning at The Forks. It is a beautiful area, and I was struck by the impressive architecture of the Canadian Museum for Human Rights.

I am looking forward to visiting it this week. The museum reminds us that all people are worthy of respect and dignity, regardless of their differences. The 150th anniversary of Confederation of Canada is the perfect opportunity to reflect on the strength that comes from diversity. Just a couple of weeks ago, the Bank of Canada issued a commemorative bank note that celebrates the diversity of our nation builders and of our landscape.

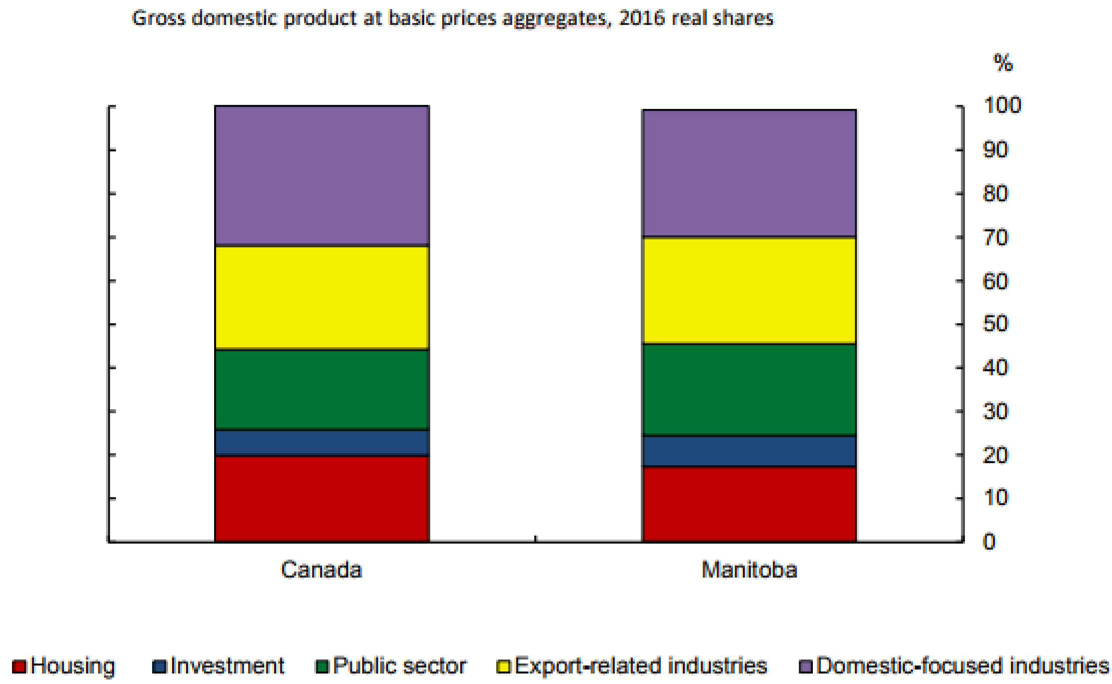
Diversity comes in many forms, and today I will speak about economic diversity and the strength that comes from having multiple sources of growth. As you will remember, the Canadian economy was hit hard by the collapse in oil prices in 2014. The adjustment to lower oil prices is now largely behind us, and we are looking for signs that the sources of growth are broadening across sectors and regions. As I will explain, the signs are encouraging.

My colleagues and I spend a lot of time poring over data to see how the economy is evolving. Data rarely tell the whole story, though, which is why we also spend a lot of time talking to people, firms, financial market participants, industry associations, labour groups and others. We do this through formal surveys on important economic issues and through outreach discussions. And, for years now, the Bank has held one of its Board of Directors' meetings outside Ottawa every year.

In fact, there is a Board meeting in Winnipeg this week, and we will have an opportunity to exchange views with local business people and other community members. We are looking forward to these discussions because this province is a vibrant microcosm of the Canadian economy.

While Manitoba has a number of unique dimensions—ranging from world-class ballet to world-class winters—it shares almost the same structure as the overall Canadian economy when it comes to sources of gross domestic product (GDP) (Chart 1).

Chart 1: GDP Components: Canada and Manitoba



Manitoba's diverse economy has been a source of strength over the past decade. Its economy has expanded by slightly more than 2 per cent a year on average since 2006. That is about half a percentage point higher than the Canadian economy overall for the same period.

As I talk about economic diversity today, I will first explain why it matters to a central bank whose main goal is to achieve low, stable and predictable inflation. I will then walk you through what key sets of information are telling us. Finally, I will outline some of the issues that we are considering as we prepare for our next economic update. This will be published in our *Monetary Policy Report* on 12 July, along with our interest rate decision.

Why diversity matters

Diversity comes in many forms. Let me mention two that relate to the Canadian economy. The first is diversity with respect to our nation's industrial structure, in other words, the range of goods and services produced in Canada. This is important because sectoral diversity makes the economy more resilient—although not immune—to shocks. It is the economic equivalent to not putting all of our eggs in one basket. Anyone who has attended business school or managed an investment portfolio will be familiar with the benefits of diversification.

Let us remember, Canada has benefited over history from its wealth in natural resources.[1] But when oil prices fell from their highs in mid-2014, the regions of Canada that rely on the oil and gas sector were hit hard. As these regions underwent a difficult adjustment process, sectors in other parts of the country were able to help absorb the slack that was created. The service sector was a primary force. That demonstrates the benefit of diversity in the Canadian economy.

Monetary policy stimulus and a lower dollar together provided critical support to aggregate demand and facilitated the adjustment of labour and capital. You will remember that the Bank of Canada reduced the policy rate by 50 basis points in 2015, to near-historical lows.

The second form of diversity—which I will focus on today—relates to the sources of economic growth. Generally speaking, while growth might bounce around from quarter to quarter, it is more likely to be sustainable over the medium term if its sources are broad-based. For example, growth in exports helps generate the income required to sustain growth in household spending without the need to borrow from abroad. Similarly, demand growth is more likely to be sustainable if matched by growth in capacity-enhancing business investment. There are also important sectoral and geographic aspects to sustainability.

While broad-based growth is desirable, it is not under the direct control of monetary policy, and it is not our objective. We target a 2 per cent inflation rate. That means that it is the outlook for overall inflationary pressure and related risks that matters most when we consider the appropriate stance for monetary policy. So even if only a few sectors were expanding enough to absorb the excess capacity in the aggregate economy, we would need to take the appropriate monetary policy action to meet our inflation target.

So let us look at how the economy has been performing recently.

Signs that growth is broadening

When we assess the extent to which the sources of growth are broadening, we look at the economy from a number of perspectives. These include the progress made in adjusting to lower oil prices, the range of industries that are growing and the evolution of the labour market. As I discuss each in turn, I will point to some signs that growth is broadening across regions and sectors, although not to the same extent.

Adjustment to lower oil prices

Let us start with the adjustment to lower oil prices. In 2015 and 2016, the starkest effects of the drop in oil prices on GDP were in business investment. Firms in the oil and gas sector cut capital spending in half, shutting down oil rigs and cancelling investment plans. Investment in the rest of the economy was also subdued, in part as a result of the weakness in non-commodity exports, especially last year. The economy kept growing, thanks to household spending, and activity was concentrated in regions where the energy sector was not as important.

Today, as we move past the adjustment to lower oil prices, we are seeing the economy pick up. A couple of weeks ago we got the national accounts data from Statistics Canada for the first quarter of this year. It was pretty impressive, with growth at 3.7 per cent. And the figures show business investment growing again. This is in large part because capital expenditures in the oil and gas sector have bounced back. That is good news. That said, investment growth in this sector is likely to moderate if oil prices stay around where they are today. More generally, ongoing uncertainty about the policies of the US administration is weighing on investment plans. And, given how business investment has declined in the past two years, we flagged it as one of the downside risks to the outlook in our April *Monetary Policy Report*.

Growth in the first quarter was also fuelled by the usual suspects—consumer spending and residential investment. However, growth in the housing sector is expected to slow from exceptionally high rates, and we are already seeing this in the most recent data on housing starts and resales. It is too early to tell how the recent housing measures introduced in Ontario will ultimately affect activity and prices in and around Toronto. In Vancouver, when similar measures were introduced last year, we saw the market cool for a period of time. But it is picking up again.

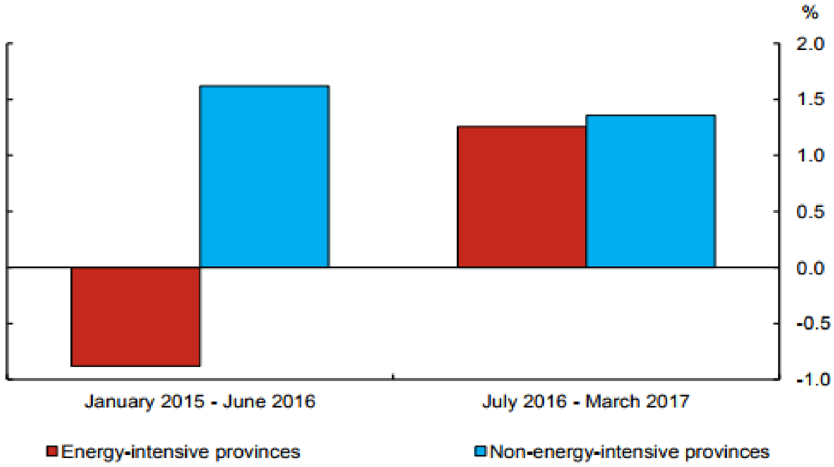
So, given we expect household spending to slow somewhat, it could surprise us and provide an unexpected boost to growth in the near term, which is another risk we mentioned in April. Higher-than-expected spending, if funded by credit, could add to the vulnerabilities in the household sector. We have been monitoring these for some time and highlighted them in last week's *Financial System Review*. In this regard, the recent policy measures taken by federal and provincial governments are welcome.

If there was one disappointment in the first-quarter figures, it was exports. We actually saw a decline of exports of services, which had been performing very well. At the same time, goods exports were flat. We have been working hard to understand the forces behind the data.

Stepping back from the quarterly data, there are other signs of adjustment. We see indications that demand in energy-intensive provinces is strengthening, after having fallen in 2015 and the first half of 2016. You just need to look at motor vehicle sales and housing resales (Chart 2).

Chart 2: Growth in major purchases

Weighted average monthly growth in motor vehicle sales and housing resales, by province, January 2015 to March 2017

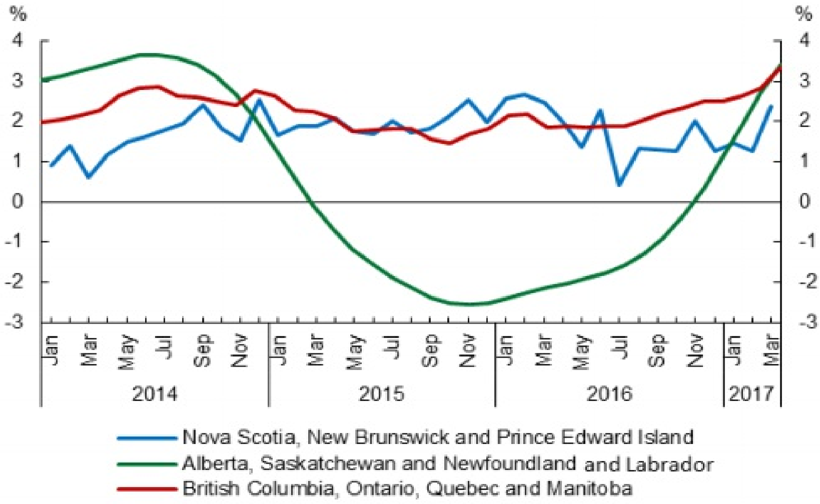


Sources: Statistics Canada and Bank of Canada calculations Last observation: March 2017

One challenge we have when assessing the geographic diversity of growth is that it takes longer for provincial data to be published—this year's data on growth by province will not be available until well into 2018. That is why Bank of Canada staff recently developed models to get a timelier read on provincial GDP.[2] These models point to a broadening in provincial activity this year, in contrast to the lopsided growth we have seen over the past couple of years (Chart 3).

Chart 3: Regional responses to the 2014–16 oil price shock

Monthly activity index, year-over-year percentage change, monthly data



Sources: Statistics Canada and Bank of Canada calculations Last observation: March 2017

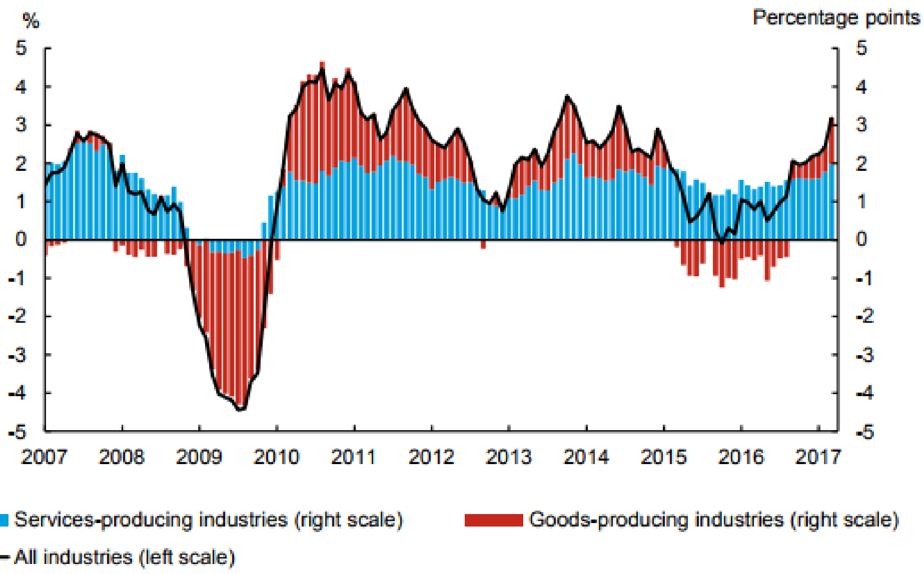
We also see a regional broadening of demand in the results of our most recent *Business Outlook Survey*. This survey asks 100 businesses every quarter about things like sales, employment and investment intentions. Executives across the country responded more optimistically about their future sales and their investment plans than they were just a few quarters ago.

Range of growing industries

We also see a broadening when it comes to growth across industries (Chart 4).[3] We can see the adverse effect the oil price shock had on goods production in 2015 and the first half of 2016. The fact that growth was positive overall was due to a resilient service sector. As the oil and gas and related sectors stabilized, the goods sector as a whole started contributing again.

Chart 4: Activity in goods industries has turned positive, notably with a firming in the oil and gas extraction industries

Contribution to year-over-year percentage change, monthly data



Sources: Statistics Canada and Bank of Canada calculations   Last observation: March 2017

What is encouraging is that this growth is not being driven by just a few key industries. The data show that more than 70 per cent of industries have been expanding—a rate we have not seen since the oil price shock. That is the kind of diversity that helps support strong and sustained overall growth.[4]

When we think about the main drivers of economic growth, many of us picture industries like mining, motor vehicles or aerospace. While these sectors still matter a great deal to the economy, many service industries are increasing in importance. Computer systems design and related services have been growing nearly 10 per cent in the past year. This sector is now as big in Canada as motor vehicles and aerospace combined. It is not all about computers—more areas of the service sector, such as financial services and air transportation, are engines of growth. This is helping to support the household spending we have seen.

Labour market developments

Let me turn now to labour markets. Developments here are largely consistent with the evolution of economic activity I just discussed. It is not surprising that job growth in the past couple of years had been concentrated in services, offsetting significant losses in goods employment. Jobs in goods-producing industries are now on the rise, and the share of sectors adding workers is growing.

Some sectors stand out. The technology sector has been creating a lot of jobs, many of which are very well paid. Other sectors that have seen strong job growth include finance and insurance, health care and education.

As sources of growth become more diverse, gains in employment are spreading across the country (Chart 5). Now, we know that the adjustment in the labour market is still under way in some regions, and this is difficult for many people and their families. Alberta and Newfoundland and Labrador, in particular, have not recovered all the jobs lost in the aftermath of the oil price shock.

Chart 5a: Change in total employment by province from January 2015 to September 2016

Thousands of persons, change in employment

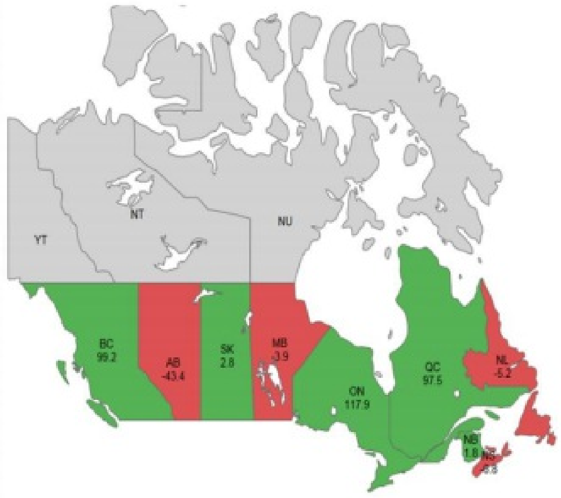
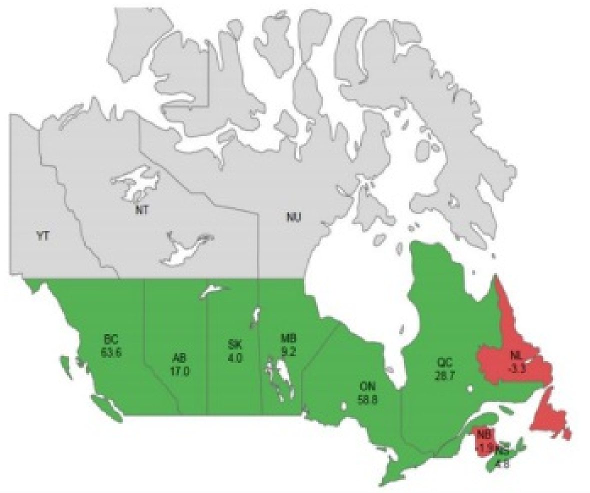


Chart 5b: Change in total employment by province from October 2016 to May 2017

Thousands of persons, change in employment



Sources: statistics Canada and Bank of Canada calculations

Taking care of business

Being able to judge the sustainability and evolution of growth is critical for a forward-looking central bank that targets inflation over the medium term. To meet this objective, we use our policy interest rate to stimulate or slow economic activity, depending on how we judge the evolution of inflationary pressures. Once inflation reaches our target, maintaining it there requires growth to be sustained at the economy's speed limit—what we refer to as "potential output growth." Low, stable and predictable inflation, in turn, allows people to make financial decisions with more confidence.

Monetary policy actions influence financial conditions and economic decisions right away but can take as long as two years to have their full effect on inflation. To ensure that inflation gets back to target on a sustainable basis, we must consider not only current economic conditions but also how they will evolve. If you saw a stop light ahead, you would begin letting up on the gas to slow down smoothly. You do not want to have to slam on the brakes at the last second. Monetary policy must also anticipate the road ahead.

Right now, slack in the economy is still translating into inflation that is below our target. Headline inflation stood at 1.6 per cent in April, in part because of the transitory effects of competition among food retailers. We look at several measures of core inflation to see past the transient volatility in headline inflation.[5] These measures have drifted down in recent quarters and range from 1.3 to 1.6 per cent. This is consistent with the lagged effects of excess supply in past quarters.

Other indicators also point to ongoing spare capacity. We have seen moderate growth in wages, and the number of hours that people work has only recently picked up, although employment growth has been strong. Our base-case projection in the April *Monetary Policy Report* was for the output gap to close sometime in the first half of 2018 and inflation to return sustainably to target around the same time.

We are in the process of doing our next projection, which will be released in July. We will digest all the new data since the April Report and update our assessment of inflationary pressures. We will also look at how the main risks we highlighted in that report have evolved. I have already mentioned the risk of slower investment growth and the risk of stronger growth in household spending. We also underscored the risk that even stronger growth in the United States could lead to a big jump in business confidence, igniting “animal spirits” as John Maynard Keynes would have put it. And, given that we do not know how much capacity might be rebuilt as the economy expands, we pointed to the possibility that potential growth may be stronger than assumed in our base-case projection.

We are all acutely aware of the uncertainty around the policies of the US administration—whether it is about trade, tax or the regulatory environment. We already factored in some of the effects of that uncertainty in our April outlook. Until we get more information, it will be difficult to gauge the impact of any proposed policy changes more precisely. This will likely remain an important uncertainty in our projection, but life goes on and decisions must be made in the meantime.

Our judgment on the appropriate stance of monetary policy will continue to be based on the outlook for inflation and on the full range of risks—both upside and downside—to that outlook. An important aspect of our inflation assessment is that the economic drag from lower oil prices is now largely behind us. And the 50 basis point reduction in our policy rate in 2015 has facilitated this adjustment. As growth continues and, ideally, broadens further, Governing Council will be assessing whether all of the considerable monetary policy stimulus presently in place is still required.

Conclusion

Time to wrap up.

There are still risks to the Canadian economic outlook. That said, when you look at the economy from different perspectives, there is reason to be encouraged. Growth has been robust in recent quarters. As we celebrate Canada’s 150th birthday and the strength that comes from the diversity of its people, we are seeing the benefits of its economic diversity as well.

The strengthening economic activity in regions and sectors that rely on energy is working to diversify the sources of growth across the country. And, while there is still room for improvement in the labour market, stronger growth is translating into job gains across a wider range of regions and sectors.

At present, there is significant monetary policy stimulus in the system. As we work toward our interest rate decision on 12 July, we will be focusing on the data and talking to many people like you to get a better sense of what is happening on the ground.

One thing that remains clear is the Bank’s commitment to achieving its inflation target so that Canadians can make their financial decisions with more confidence.

---

1 S. S. Poloz, “Riding the Commodity Cycle: Resources and the Canadian Economy” (speech to Calgary Economic Development, Calgary, Alberta, 21 September 2015).

2 T. Chernis, C. Cheung and G. Velasco. “A Three-Frequency Dynamic Factor Model for Nowcasting Canadian Provincial GDP Growth.” Bank of Canada Staff Discussion Paper No. 2017–8 (June 2017).

[3] The goods sector includes oil and gas, mining and manufacturing, while the service sector includes trade, transportation, digital and professional services, health care, education and public administration.

[4] To examine the breadth of activity over a given period of time, we constructed a diffusion index that includes the 22 subcomponents of GDP at basic prices and measures the proportion that are growing. This index has been increasing since the third quarter of 2016.

[5] The measures are CPI-median, which is based on the price change located at the 50th percentile (in terms of the CPI basket weights) of the distribution of price changes; CPI-trim, which excludes CPI components whose rates of change in a given month are located in the tails of the distribution of price changes; and CPI-common, which tracks common price changes across categories in the CPI basket.