Stephen S Poloz: Turbulent times for trade

Remarks by Mr Stephen S Poloz, Governor of the Bank of Canada, at the Baffin Regional Chamber of Commerce (BRCC) and the Nunavut Mining Symposium (NMS), Iqaluit, Nunavut, 1 April 2019.

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Introduction

It is an honour and real privilege to be here in Iqaluit, the territorial capital, today: Nunavut's 20th birthday. Over the past two decades, Nunavut has become a real destination, proud to demonstrate its culture, traditions and values to the rest of Canada, and to the world. There is tremendous potential here and I look forward to watching you continue to achieve it. So, happy birthday!

I'm here today to talk about trade. Canadians have always understood trade, because we have to. Without trade, Canada would never have become a nation of more than 35 million people with a modern, diversified economy. And as people here know well, trade will always be absolutely vital to the future of the North.

Back in the 1860s, when the United States imposed tariffs on our exports, the provinces reacted by uniting in Confederation. In effect, we chose to grow our national economy by building infrastructure and increasing interprovincial trade. Since the 1940s, though, Canada has consistently advocated for more liberalized international trade, even while allowing interprovincial trade barriers to persist, or even to increase.

Our dependence on international trade makes recent developments on this front very worrisome. The United States has imposed tariffs on steel and aluminum imports from many countries, which, in turn, have placed countermeasures on a wide range of US products. The United States is engaged in a trade war with China, and extensive measures have been taken on both sides. NAFTA has been renegotiated, but the new agreement still needs to be ratified. Europeans are waiting to see whether the United States will make good on its threat to impose tariffs on their auto exports.

In short, there has been a significant increase in uncertainty around the future of the global trading system. This is having an impact on business confidence worldwide. Data from 47 countries—representing more than 80 per cent of the global economy—show that exports and business investment slowed sharply late last year. If a company cannot rely on international trade rules, it is not going to make investments to expand capacity and fuel economic growth.

Canada's economic growth slowed late last year, and this weakness is extending into 2019. Part of this is due to developments in our oil sector and in our housing sector, but the broader effects of trade uncertainty on investment are clearly there. Fortunately, our economy also has areas of strength that are providing a cushion. Some services exports have been growing strongly. More than 350,000 jobs were created over the past year. Indeed, labour income grew by almost 5 per cent in the fourth quarter. The data are currently giving us a mixed picture and need to be carefully monitored. But the deeper question we face is whether Canada can continue to thrive as a trading nation.

Trade and globalization

To address this question, we need to put recent trade developments into context. Trade growth has generally fallen short of expectations since the global financial crisis a decade ago. To understand this, we must first understand why international trade grew so rapidly in the years before the crisis.

International trade began to accelerate during the 1990s as companies took advantage of opportunities provided by new technology and trade liberalization. Many firms found efficiencies by breaking down their products into components. This allowed for unprecedented levels of manufacturing specialization, with components sourced from wherever in the world it made the most sense.

Instead of a domestic assembly line, you had a complex international value chain. A final product, like a car made in Oshawa or a cellphone assembled in Mexico, might have contained many components that were traded internationally several times. Then the final product was exported, too. This is why international trade rose relative to gross domestic product during this period. As economists would put it, the trade intensity of goods increased.

Global trade really took off after China joined the World Trade Organization in 2001. With a massive supply of low-cost labour, China became key to many companies' value chains, and trade intensity grew even further. This gave rise to concerns that all manufacturing would move to developing economies. But there was always a natural limit to this offshoring process. A manufactured product can be fragmented only so far, and some pieces require more labour than others. This is what determines where best to produce each component.

A manufacturing process that requires many workers and only a bit of machinery can often be made cheaper by moving it to a country where wages are low. But a process that has a lot of complex machinery and relatively fewer workers is much less likely to move to a lower-wage country. Importantly, companies must also take into account the relative productivity of workers in various countries. In other words, even if workers are paid more in one country than another, they may be more productive, giving them a comparative advantage over less-productive, lower-paid workers elsewhere. It is this complex balance of factors that leads to a natural distribution of value chains around the world.

Furthermore, economies never stand still. In China, for example, globalization has led to a steady increase in wages. And this reduces the incentive for firms in advanced economies to move production there, even if that production is labour-intensive. At the same time, advances in technology have allowed firms to automate manufacturing more. This means a higher capital intensity, which also reduces the incentive to move production to lower-wage countries.

In short, these trends have made the cost of labour less of a factor in deciding where to locate global value chains. Indeed, some companies have moved production back to advanced economies, a process called reshoring. Often the motivation is to have production located closer to the ultimate customer, an action sometimes called nearshoring. Or, it may make more sense to locate closer to the source of raw materials.

For various reasons, then, we have seen some global value chains become more simplified and a reversal of some of the fragmentation of manufactured products we saw 20 or 30 years ago. As a result, components are crossing fewer borders in the assembly process. Trade intensity has eased, and we see a slowing of trade growth around the world.

A detailed study published earlier this year by the McKinsey Global Institute sheds light on these developments. McKinsey looked at 23 different industries across 43 countries over 22 years. It found that many goods-producing value chains are becoming less trade-intensive as they locate closer to their customers. And as emerging markets like China develop and consume more of what they produce, companies are building more domestic value chains.

The bottom line is that the evolving nature of globalization is contributing to slower growth in international trade. This is true for the global economy generally, and for Canada specifically. That said, there are other factors specific to Canada that have been holding back trade in recent years. They include a loss of exporting capacity in certain sectors and competitiveness challenges in others. I will come back to this later.

The seen and unseen growth of services

First, though, I want to broaden our discussion of trade. So far, I have been describing trade as shipments of tangible goods. This is how most people think of it, and my story about globalization and value chains clearly envisioned a complex product, like a car or a smartphone.

Tangible goods also include products like oil, nickel, canola, pork or lumber. We sell over $500 billion in merchandise to the world each year. Natural resources and agriculture will always be an important base for our economy, as the folks here today from the mining sector know full well. Despite recent difficulties, energy products remain our number one export category, at over $80 billion per year. We can continue to find new customers for these products and grow those businesses over time.

But, as we just saw, economies are constantly evolving. Growth in Canada's economy, which was based on trade in natural resources in its early years, is now driven mainly by service industries. Roughly 80 per cent of Canadians are now employed in services, and trade in services has been growing at a much faster pace than goods. Today, we sell about $120 billion per year in services to the world.

For example, Canada is a world leader in the mining services sector, with almost 4,000 companies providing engineering, environmental and other professional services. These categories had exports worth about $12 billion last year. Canada has long been an important exporter of financial services—last year these totalled about $13 billion and supported many well-paying jobs in Canada. Tourism exports are worth around $25 billion per year. This category includes exports of education services to visiting students—valued at about $8 billion annually. And on the cutting edge, Canada is becoming known as a global heavyweight in video games, employing more than 21,000 Canadians, with above-average salaries. Many service sectors saw exports growing at near double-digit rates or faster, including financial services, the telecom, computer and information sector, intellectual property and tourism.

As large as these numbers sound, services trade is difficult to track and probably underestimated. For example, many manufactured products include a large services component that is buried in the price. By some estimates, as much as 30 per cent of the value of goods exports is actually created through services.

Consider a smartphone. The parts and labour needed to assemble it might constitute less than half of what the consumer will eventually pay for it. Most of the difference represents the cost of all the software that is loaded on the phone.

Here is another example. Many companies today purchase back-office computing services on the cloud. Previously, a company may have invested in equipment and software and hired specialized staff to perform these functions. By purchasing cloud services, the company saves those expenses and boosts its productivity. This is clearly positive for the economy, yet our conventional statistics show a drop in investment and in trade.

Resolving the mixed picture

I mentioned before that many countries have seen a slowdown in trade and investment, mainly in response to trade uncertainty. At the same time, many countries are seeing strength in their labour markets. It is worth considering whether the shift in economic growth toward technology and services is playing a role.

In Canada, the job market appears to be in great shape. The unemployment rate is near historic lows and the participation rate of prime-age workers—those

25–54 years old—has never been higher. The number of working Canadians increased by a healthy 2 per cent over the past 12 months. And a sectoral breakdown shows this growth is being driven by several key service industries.

Start with the professional, scientific and technical worker category. This includes programmers and software engineers. More than one million Canadians work in this category, which grew by 7 per cent over the past year.

Then there are categories like education, health care and public administration. Together, these industries employ about 5 million Canadians. Including two more sectors—transportation and warehousing, and business and other support services—brings us to more than 8 million Canadians—that is about 45 per cent of the workforce. The weighted average of job growth among these categories was 4.6 per cent over the past year, more than double the rate of the entire economy. This is behind the strong increase in labour income we have seen.

These data suggest that the mixed picture offered up by the Canadian economy today reflects some important structural changes beneath the surface. In particular, our oil sector continues to adjust to global oil prices of around US$50–60 per barrel. It is important to remember that only five years ago it was a widely held view that oil prices would remain far higher than that. Plans were made, investments were deployed, and it will take time for the sector to adjust fully. The situation is made more complicated by capacity constraints for oil exports. When the dust settles, oil will remain a very important sector for the Canadian economy. But the adjustments are weighing on investment, exports, and wage performance.

Technological advances may also be prompting similar adjustments for a wide range of economic sectors. Automation puts certain jobs at risk—from manufacturing to financial advising—holding back wage increases and inflation. But it also creates new jobs for those who write the software or maintain that advanced technology, and those wages rise rapidly. The people earning those wages spend them on all sorts of goods and services, creating demand in traditional sectors including construction, transportation, maintenance and so on. As these adjustments proceed, there are now more than 500,000 job vacancies in the Canadian economy. Judging what all this means for the outlook for inflation is of course a challenge for us.

The risks posed by trade wars

But that challenge pales in comparison to the one posed by the possibility of a global trade war. We have been highlighting this risk to the outlook for the past two years. At the same time, we have said that the global economy could get a significant lift if trade peace were restored.

The likelihood of trade peace breaking out seems to fluctuate almost daily. Even so, the global economy has been dealing with heightened uncertainty over trade policy for an extended period now. Over that time, some business investment decisions have been scrapped entirely or made in a distorted situation. Even if the uncertainty lifted completely tomorrow, these decisions could not be reversed, and some of the damage done over the past two years would remain.

People who advocate for protectionism through tariffs tend to miss a basic point. When a country imposes tariffs on imports, those tariffs are paid by its own consumers and companies. A few people involved in the protected industry might benefit from the tariffs, but the economy is worse off overall.

Bank of Canada staff analyzed the impact of the trade actions that have already been taken. They have found that the various actions will lower economic output while raising prices. In other words, a trade war is stagflationary. Of course, it is possible that unilateral tariffs will boost production in the economy that imposes the tariffs, but that is usually a temporary effect, as the impact on consumer purchasing power affects everyone. More importantly, a unilateral tariff rarely stays unilateral for long. Companies facing tariffs on their exports will appeal to their own governments to level the playing field by applying countermeasures. Such retaliation is understandable, but in the end, the global economy will be worse off, and so will many innocent bystanders.

Opportunities and adjustments

It is possible that we will have to deal with frictions in the global trading system for some time yet. Even so, as we said in January, we expect that both exports and investment will return to positive growth later this year. Since the start of the year, the labour market has continued to show strength. The adjustments underway in our oil sector will eventually be completed. And firms tell us that they need to make new investments, and the recent rules around capital cost allowances are likely to speed that up.

The Bank's role in this process is to maintain a predictable environment for decision making. We have learned from experience that keeping inflation low, stable and predictable is the best contribution we can make to Canada's economic welfare. Crucially, our inflation-targeting framework includes a floating exchange rate that helps our economy adjust to external shocks. We only have to look back a few years for an example. Following the oil price collapse of 2015, movements in the exchange rate helped to offset the loss of jobs in the oil sector by boosting exports in other sectors.

In addition to the solid economic base that comes from our natural resource sectors, we have numerous advantages we can use to create new economic growth. Among other things, we have a well-educated and diverse workforce that is growing through immigration. And, we have trade agreements like the Canada-United States-Mexico Agreement, the Comprehensive Economic and Trade Agreement with the European Union, and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership. These agreements should help to buffer us from some of the negative trade developments I mentioned at the beginning.

Another possible buffer lies right here at home. Recall that when the United States turned protectionist in the 1860s, we responded by uniting our own economic clout through Confederation. In today's trade-uncertain world, it is even more important that we continue to make progress in promoting trade among our own provinces and territories. And enhancing economic links between North and South is even more urgent, given the growing risks around climate change. You are already feeling the impact of climate change here, and it will affect almost every aspect of life in the North. Lowering barriers to trade could certainly help mitigate these economic impacts.

The good news is that trade in services among the provinces has been growing rapidly over the past 10 years and is already larger than interprovincial goods trade. The bad news is that goods trade between provinces has basically been stagnant for a decade.

To make this point concrete, Bank staff estimate that Canada's potential economic growth would increase by about 0.2 percentage points per year, or about $4.5 billion, if interprovincial trade barriers were lowered. This would include harmonizing regulations on all manner of things. In a time of slow economic growth, that is too good an opportunity to pass up.

Conclusion

It is time for me to conclude.

Clearly, there are challenges in the Canadian and global economies that we need to manage. But there are clear signs that Canada is adjusting to the challenges. After taking into account the economy's structural adjustment to lower oil prices that is still going on, we can see many areas of encouraging economic growth. These are both traditional and cutting-edge, and are export-oriented. Canada's portfolio of trade agreements should serve us well as this story unfolds, despite the uncertainties the world faces today.

That being said, it is clear that the global economy is performing less well than we believed only a few months ago, and Canada is feeling the effects. In addition, our housing sector is taking longer than previously expected to digest the combined effects of stricter mortgage guidelines and higher interest rates.

That is why we said at our last interest rate announcement in March that the economic outlook continues to warrant a policy interest rate that is below the neutral range, to help the economy work through this downshift in growth and keep inflation close to target. Recent economic data have been generally consistent with our expectation that the period of below-potential growth will prove to be temporary.

Our next interest rate announcement and *Monetary Policy Report* will be released on April 24, and I can promise a fuller analysis at that time. For now, let me thank you for your kind attention, and for your wonderful hospitality here in Iqaluit.