Remarks
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Economic Progress Report: Investing in Growth

Introduction

It’s a pleasure to be in Calgary to provide an update on the Canadian economy and to discuss the decision we made yesterday to leave our key policy rate unchanged. I’d like to thank the Calgary Chamber of Commerce for the invitation.

There is certainly a lot to talk about regarding the outlook. There’s the trade war between the United States and China. And, here at home, there are the challenges of operating in the oil and gas sector as well as delivery constraints affecting a broader range of products. It’s fair to say that Alberta and other energy-intensive regions have been on an economic roller coaster over the past few years. This has led to painful adjustments for many of you here and has also weighed on Canada’s bottom line.

Seen from a macro perspective, nonetheless, Canada’s economic performance has been relatively solid. That’s the perspective that we, as central bankers, need to take to meet our inflation objective. For much of the past couple of years, the Canadian economy overall performed near full capacity. The unemployment rate fell to historic lows while wage growth improved. In this context, Governing Council raised the policy rate during that period toward a more normal setting. Inflation is currently at around 2 per cent, and our core measures have been hovering around this level for a while.

Unfortunately, several developments at the end of 2018 and beginning of 2019 have set us back. As you here in Calgary know all too well, there was the drop in oil prices last autumn and ongoing transportation constraints. Escalating tariff actions by the United States and China, and related tensions, have undermined trade and business investment. And housing, a linchpin of the recovery since the crisis, slowed sharply.

We said in our April *Monetary Policy Report* (MPR) that these developments have led to a detour for the Canadian economy. We projected much softer

I would like to thank Russell Barnett and Lori Rennison for their help in preparing this speech.

growth in the first half of the year, before a pickup over the rest of 2019. We won't do a new forecast until our next report in July, but the data we have so far suggest that our April view is largely on track.

I'm going to talk about why we continue to expect a pickup in growth. And I'll highlight the main points of discussion among Governing Council members that led to yesterday's decision.

Let me first spend time on the outlook for business investment since it's a critical piece of our forecast. Investment is at the core of productive businesses no matter what region or sector you are operating in. It's also the foundation of vibrant, sustainable economic growth. Our living standards depend on it.

Why investment matters to living standards

So, how does business investment influence our standard of living?

Investment makes workers more productive by increasing the capital that they have to work with. You can clear your driveway faster with a snowblower than with a shovel. And new investments typically harness the latest technology, which further boosts the productivity of workers and firms. The energy industry uses fibre optic monitoring to keep pipelines and other critical assets performing as well, and as safely, as they can.

This type of investment, while involving some risks to the business, can have major payoffs in terms of greater competitiveness. It can also have payoffs for Canadian workers. Higher productivity growth means stronger growth in wages and incomes.[1] And the economy overall can grow faster without causing inflationary pressures to build.

There's nothing like a few numbers to illustrate a point. The scope for the Canadian economy to expand without causing inflation—potential output growth—has averaged just under 2 per cent over the past 15 years. Around half of that has come from growth in the labour force. At the same time, steps by firms to increase their productivity through investment, a process known as capital deepening, have also been vital to potential growth. In fact, capital deepening has accounted for around 0.6 percentage points of potential output growth per year.[2] Up until 2014, about one-third of this came from investment in Alberta.

Thanks to this capital deepening, gross domestic product (GDP) in 2018 was some $177 billion higher than it would have been. That's almost $5,000 per Canadian, and that's a benefit we should receive every year going forward.

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[1] For more detail, see "Making Cents of Wages," an article published earlier this year in *The Economy, Plain and Simple*.

[2] The remainder comes from growth in total factor productivity.

Global and Canadian economic context

Investment is incredibly important to all of our bottom lines, although what goes into the decision to invest varies across firms. There are nevertheless a couple of common elements to build on. The most obvious is the current economic context, both globally and in Canada, as it relates to future sales and financing costs.

This context for investment, and global economic prospects more generally, is obviously heavily influenced by developments in the two biggest economies in the world. The trade war that the United States and China are waging is damaging not only their own prospects, but also those of the rest of the world.[3]

Now, we had been expecting the global economy to slow last year. The US economy was growing at nearly 4 per cent heading into the second half of 2018, well above its non-inflationary speed limit. We knew that the combined effect of interest rate hikes and the fading impact of tax cuts would bring US growth to a more sustainable pace. Some other central banks, including the Bank of Canada, were also taking steps to bring monetary policy settings toward more normal levels. And in China, financial regulations were tightened to slow borrowing and support financial stability.

The trade environment, however, has made the global slowdown worse than had been expected. It has undermined business sentiment and held back investment decisions in dozens of economies, including Canada's.[4] The slowdown in investment has weighed on global trade as well, as firms put off the spending that is needed to increase their capacity to export.

Our April forecast estimated that trade uncertainty, including uncertainty with respect to the ratification of the Canada-United States-Mexico Agreement (CUSMA), would cut the level of business investment in Canada by about 2.5 per cent by the end of 2021. We also estimated that it would cut the level of exports by 1.2 per cent.

Overall, we said growth in Canada will slow to 1.2 per cent this year from 1.8 per cent in 2018. Slower growth isn't all about trade uncertainty and the global slowdown. This outlook also takes into account the effect of lower oil prices and transportation constraints in energy-intensive regions. Growth excluding these energy-related factors would be 0.3 percentage points higher. The outlook also accounts for the housing slowdown, which has been deeper and more prolonged

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[3] Recent Bank of Canada research shows that, in the long run, protectionist policies between two countries can have a significantly negative impact on growth in each country—particularly when the policies disrupt trade in production inputs. See Y. Imura, "Reassessing Trade Barriers with Global Value Chains," Bank of Canada Staff Working Paper No. 2019-19 (May 2019). For more analysis on trade wars, see K. B. Charbonneau and A. Landry, "The Trade War in Numbers," Bank of Canada Staff Working Paper No. 2018-57 (November 2018); and Bank of Canada, "The potential impact of US–China trade tensions," Box 1, *Monetary Policy Report* (October 2018).

[4] Based on a measure of global gross fixed capital formation, aggregate data from 48 advanced and emerging-market economies, accounting for about 84 per cent of global GDP by purchasing-power-parity weight. See Bank of Canada, Chart 2, *Monetary Policy Report* (April 2019).

than expected, particularly in the greater Vancouver and Toronto areas. I'll get to that later.

Given these developments both in Canada and globally, it's no surprise that policy-makers responded. Since the beginning of 2019, the US Federal Reserve and other central banks have signalled a slower path back to normal monetary policy settings. And China has announced stimulative fiscal and monetary policy measures. Global financial conditions have eased and market sentiment has improved as a result. This has helped boost the prices of oil and other commodities so far this year. And it's one of the reasons why our April MPR called for a firming in the global expansion later this year.

The wild card, of course, is the trade war.

How costly are trade wars for the global economy? In April, we said tariffs over the past two years and trade policy uncertainty would chop 0.4 per cent from global GDP by the end of 2021—that's about US$350 billion. While this can only be a rough estimate, we know it matters more for trade-dependent economies like Canada's.

Where investment will come from

So, where does this economic context leave the outlook for Canadian business investment? We expect it to expand gradually overall, led by firms outside the oil and gas sector. It should be strongest in areas where companies have confidence in future markets and sales and need to invest to expand capacity or to become more productive. Attractive financing costs like those we see today, as well as recent incentives put in place by the federal and some provincial governments, are also key ingredients.[5]

According to businesses that responded to our spring Business Outlook Survey, investment plans are still healthy in most regions. This is particularly true in services industries, such as information technology (IT), where demand is solid. Recent data suggest that investment in the non-energy sectors has started off the year in positive territory.

Investment in IT and digital technologies has been particularly strong in Canada and around the world for several years now. Digital economic activities, in fact, make up about the same share of nominal GDP in Canada as mining, oil and gas combined.[6] And the third-largest digital economy in per capita terms is in Alberta. Digitalization isn't just transforming services-oriented sectors; it's transforming resource and goods-producing sectors too.

Data-driven farming on the Prairies is a good example, as farmers work to harness big data in ways that economize on fuel and improve yields. And the

[5] For example, the new Accelerated Investment Incentive that the federal government announced in its Fall Economic Statement and programs introduced by the Ontario provincial government.

[6] For more detail, see Statistics Canada, "Measuring digital economic activities in Canada, 2010 to 2017," *The Daily* (May 3, 2019).

energy industry is using automation, artificial intelligence and machine learning to cut costs and lower emissions.

Digitalization of business activity is encouraging investment across the country in areas such as computer equipment and software, as well as communication and audio and video equipment. Growth in total investment may have lost some steam recently in Canada and elsewhere, but it has continued to rise in many areas linked to technology and intellectual property.

It's possible that some types of investment are not showing up in the statistics because they are intangible in nature. Of course, issues surrounding the measurement of intangible capital have been around for decades. For instance, computer software started to be included in investment in the 1990s.[7] Even if they're not showing up in official statistics, some types of investment are becoming more important to the global economy; technology to streamline business processes, database development or moving servers to the cloud are just a few examples.

When it comes to the energy sector, we expect the current adjustment to continue. Between 2014 and 2016, energy investment dropped by 50 per cent. In April, based on discussions with companies, we estimated that investment in this sector would drop another 20 per cent before stabilizing. Investment should average around $40 billion over the next two years—that's still 15 per cent of total investment in Canada.[8]

As spending in oil and gas stabilizes, the growing investment in other sectors will show up in the headline numbers more clearly. I'd like to emphasize that we are being prudent in our outlook. In fact, total investment as a share of GDP is flat over the projection horizon. I've been in the forecasting business long enough to know that one of the toughest things to call is when intentions will translate into investment decisions.

Structural factors affecting investment

I also don't think the trade war is the only reason for the disappointing investment in Canada and globally. Even before the latest slowdown, a downbeat outlook among firms about the strength of future demand contributed to weakness in global business investment in the years that followed the crisis.[9]

A couple of structural issues are contributing to this. The first is demographics. Population aging is limiting the growth of the workforce in Canada and many other economies. This reduces the future returns to any investment by limiting

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[7] For an excellent discussion of this theme, see J. Haskel and S. Westlake, *Capitalism without Capital: The Rise of the Intangible Economy*, Princeton University Press (2017).

[8] This assumes a constant relative price for investment in the oil and gas sector.

[9] See R. Fay, J.-D. Guénette, M. Leduc and L. Morel, "Why Is Global Business Investment So Weak? Some Insights from Advanced Economies," *Bank of Canada Review* (Spring 2017): 56–67.

the economy's potential growth rate.[10] The second issue is that the boost to world trade and investment that came with China joining the World Trade Organization in 2001 has run its course. Governor Poloz spoke about this last month in Iqaluit.[11]

These longer-term structural issues aside, Canada is trailing on a number of indicators that we know increase productivity and competitiveness.[12] Among these are investment in information and communications technology and in research and development because other countries have been investing even more than we have. And, companies across the country tell us that a number of other competitiveness issues are holding back decisions to upgrade or expand capacity in Canada. These are wide-ranging and include business costs, such as electricity, and the regulatory burden as well as uncertainty around approvals for projects. And when I'm talking with business leaders, I often hear about the costs and lost opportunities because of barriers to interprovincial trade. So, as business leaders and policy-makers, together, we have our work cut out for us.

These issues can't be resolved by central banks. Still, to do our job, the Bank of Canada needs to understand how these factors affect investment decisions. A vibrant business sector, after all, is essential to a healthy labour market and to our economic prospects.

Further details about yesterday's decision

The outlook for investment was only one of many factors that went into our interest rate announcement yesterday. As I said, there have been some encouraging signs that investment outside the energy sector has firmed up. Let me take you through the other main points of our discussion.

Naturally, Governing Council spent time talking about whether the economy was progressing as we had forecast in our April MPR. As a reminder, we projected that the economy would expand at an annual pace of just 0.3 per cent in the first quarter of the year. We also projected growth would rebound modestly to a 1.3 per cent pace in the second quarter and further accelerate later in the year. Evidence has been accumulating that tells us our story is on track. We hope to see this confirmed in the national accounts data that Statistics Canada will release tomorrow.

We've worked hard to understand some conflicting signals in the economic data. The labour market has been strong, with solid growth in jobs and steady growth in wages. We've tried to square this strength with the weakness seen in the

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[10] See R. Barnett and R. Mendes, "A Structural Interpretation of the Recent Weakness in Business Investment," Bank of Canada Staff Analytical Note No. 2017-7 (July 2017).

[11] See S. S. Poloz, "Turbulent Times for Trade," (remarks to the Baffin Regional Chamber of Commerce and the Nunavut Mining Symposium, Iqaluit, Nunavut, April 1, 2019).

[12] See, for example, the Organization for Economic Cooperation and Development's Main Science and Technology Indicators and IMD's world competitiveness rankings for 2019, including profiles for Canada and other countries.

spending side of the economy over the past couple of quarters. It turns out that this gap can be explained in large part by the behaviour of companies in the construction and oil and gas sectors, which have been key drivers of the recent GDP slowdown. Companies in these sectors have been generally keeping their employment levels fairly steady, while reducing the hours their employees work. This is consistent with firms believing that the economy has been going through a temporary soft patch, exacerbated by the brutal winter experienced in so many parts of Canada.

I should point out, though, that inventories have increased sharply because we've had continued production and strong import growth while at the same time demand has been soft. To the extent that this buildup is unplanned, it may dampen production in some sectors later this year. On top of this, there has been flooding in Eastern Canada and Manitoba and terrible wildfires here in Alberta, which reminds us that Mother Nature can be ruthless. These events are causing severe hardship to many communities. And they may add some choppiness to economic data.

Back in April, Governing Council said we would watch developments in three key areas: household spending, oil markets and global trade policy. Much of our latest discussions centred on these areas. In terms of household spending, we have seen strong growth in labour income, which is supporting consumption. Consumer confidence has firmed, and retail sales have picked up. Of course, the housing market has been a concern in many areas of the country, including Alberta. Recent data on starts and resales make us more confident that housing markets in many places are falling more in line with fundamentals. Here in Alberta, ongoing weakness in housing can be explained by adjustment over the past five years to continuing challenges in the energy sector. The greater Vancouver market, which had been quite frothy, is still adjusting. This follows changes in mortgage financing rules, past increases in interest rates, and the provincial and municipal measures aimed at discouraging speculation and foreign buyers. Weather likely affected the Toronto area in recent months, and, while we need to see more data, that market is showing signs of stabilizing.

In terms of oil, prices have recovered from last autumn's decline, production has started to increase, and profitability has started to improve. At the same time, we know that curtailments and transportation constraints continue to weigh on production. These should ease over time as rail capacity expands later this year and as Line 3 is completed. This will bring a welcome boost to the Canadian economy. We will continue to watch this closely.

This brings me to trade and the ongoing conflicts. There have been some positives lately. The US government has dropped its tariffs on steel and aluminum, and Canada has dropped its retaliatory measures. This should improve the chances that CUSMA will be ratified. Other developments are discouraging. China and the United States have escalated their dispute, and Canada has been caught in the crossfire. Further, China has imposed new restrictions that are affecting some Canadian farmers directly. On top of this, we see the potential for more friction between the United States and European Union. A big part of the Bank's work leading up to the next MPR in July will be to understand the implications of all these developments.

Of course, the trade disputes are not just a short-term concern. There are also longer-term implications for the global and Canadian economies. If some of these disputes were to be resolved, that would provide a welcome boost to the Canadian and global economies. But if the disputes were to worsen and become long lasting, the outlook would be quite different. Not only would we see weaker economic demand, but the supply side of the economy would also take a hit as companies deal with disruptions to their supply chains. Obviously, this remains a major preoccupation for us.

Governing Council also spent some time talking about prices in financial markets. Since the start of the year, financial conditions have become more accommodative in many economies, and this will help support economic growth. We talked about the signals that we should take from a very flat or, in some cases, inverted yield curve. These developments partly reflect a change in tone by many central banks and, possibly, investor appetite for long-term, fixed-income assets. They nonetheless also reflect a concern about the prospects for growth that is not reflected across other asset classes. We continue to be attentive to these signals.

Let’s not forget that we’re a central bank that targets inflation. On that front, inflation remains near 2 per cent. Some temporary factors are boosting inflation and offsetting the modest downward pressure that is being generated by excess supply in the economy. We project that these upward and downward pressures will dissipate over the projection horizon, leaving inflation close to target.

Putting it all together, recent data have reinforced Governing Council’s view that the slowdown in late 2018 and early 2019 was temporary. At the same time, global trade risks have increased. In this context, the degree of accommodation being provided by the current policy interest rate remains appropriate. In taking future policy decisions, Governing Council will remain data dependent and especially attentive to developments in household spending, oil markets and the global trade environment.