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Trends and Challenges in the Global Economy and What They Mean for Canada and Ontario

Good morning. First, I would like to thank the London Chamber of Commerce for inviting us here today. It's a pleasure for me to be back in London, given my close family ties and my years at the University of Western Ontario.

As is the case for so many cities and regions in Canada, London's economy and that of southwestern Ontario are directly affected by changes in the global economy. And, as with so many things in life, the better we understand the forces of change, the better equipped we are to deal with them.

What I'd like to do this morning is discuss some of the key trends in the global economy, as well as the challenges they present, and then talk about some of the implications for Canada and for Ontario. And because one of the main reasons that we have come to London is to hear your thoughts and concerns, I'll leave plenty of time for your comments and questions.

Macroeconomic Trends in the Global Economy

The turbulence in global financial markets, which has been with us since last August, continues to be a major focus. But rather than starting there, allow me to first step back and provide a perspective that covers the past five or six years. From 2002 to 2007, the world economy expanded strongly, growing by an average of 4.6 per cent per year, measured in terms of real GDP. The growth of world trade was even more impressive, at about 7 per cent on an annual average basis. This period of robust growth benefited most nations, and was strongest in emerging-market countries such as China, India, and Brazil. In industrialized countries, growth was also steady and solid.

What we are now confronting is a marked slowdown in global economic growth, emanating primarily from the sharp correction under way in the U.S. housing market and the associated tightening in credit conditions linked to the collapse of the U.S. subprime-mortgage market. I will come back to discuss these financial developments in a moment. But in keeping with the theme of taking a longer-term perspective, it's important to note that some slowing in global economic growth was necessary. After five to six years of nearly unprecedented growth, levels of economic activity around the globe were straining capacity limits and beginning to put upward pressure on inflation.

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These pressures can be seen in the sharp run-up in commodity prices. Compared with the beginning of 2002, U.S.-dollar prices are more than 5 times higher for crude oil, and more than triple for metals and grains. In real terms (that is, compared with the increase in overall consumer prices) the price of crude oil has more than quadrupled over this period, and is now above the levels reached in the 1970s and early 1980s.

The impact of these elevated commodity prices on consumer prices can be seen in the latest numbers on total consumer price inflation. In the United States, the United Kingdom and the euro zone, total CPI inflation is currently at 4.0 per cent, 2.5 per cent, and 3.5 per cent, respectively. Emerging-market countries are also facing rising price pressures. Core inflation, which excludes the effects of rising food and energy prices is, however, running closer to 2 per cent in industrial countries. With global economic growth slowing, it is unlikely that the higher prices of food and energy will spill over into prices and costs more generally, but this risk is something central banks are watching closely. In other words, central banks are focused on keeping inflation expectations well anchored.

Challenges in the Global Economy

With that backdrop, let me now discuss three key challenges facing the global economy and, by extension, Canada and Ontario: first, the slowdown of the U.S. economy and the associated financial turbulence; second, global trade imbalances; and third, competition from emerging-market countries.

The most immediate challenge facing the global economy is the marked slowdown in the U.S. economy. This slowdown involves several interconnected elements, and, given our close trade links to the United States, has very direct consequences for Canada.

One element is the sharp and protracted correction under way in the U.S. housing sector. This correction stems from the fact that house building had risen to unsustainable levels and from the related implosion of the subprime-mortgage market with its weak underwriting standards. Construction, sales, and prices in the housing market have fallen dramatically, and inventories of unsold houses remain high.

Another element is, of course, the financial turbulence and changes in credit markets that we've witnessed over the past eight months. Given the complexity of this situation, let me spend a little more time on it.

To understand the cause of this turbulence, it's again useful to look back over the past five or six years. During this period, a decline in inflation, together with an excess of global savings relative to desired investment, resulted in real interest rates that were low by historical standards. It was also a period, as I noted earlier, of strong, steady global economic expansion.

In this macroeconomic setting, spreads between higher-risk and lower-risk investments declined. At the same time, a variety of new financial instruments, such as new types of asset-backed securities and collateralized debt obligations, were introduced. Investors who were looking to enhance their returns were attracted to these products. This led to greater leverage (that is, debt financing) and to investors taking on risks that many clearly did not fully understand.

The link back to the United States is that many of these new, or structured, products had subprime mortgages embedded in them. Once delinquencies and defaults on these mortgages started to mount, and given the opacity of these investment products, risk premiums started to widen, market liquidity started to dry up, and credit conditions tightened. And these financial market reactions were felt globally. I will quickly add, however, that the pressures in Canadian financial markets have been less intense because of the relatively healthy balance sheets of households, firms, and financial institutions in Canada.

The entire episode, which is by no means fully played out, can be seen as an overdue repricing of risk, a recognition of losses, and a recapitalization of balance sheets. Governor Carney spoke recently about this topic, so I won't dwell on it here, but suffice it so say that these events highlight the need for change in both the private and public sectors so that markets can return to more normal functioning. In the private sector, the most pressing needs for change include greater transparency in financial products, improved risk and liquidity management, and more rational, better-aligned incentives. For our part, we at the Bank are taking steps to support the functioning of markets by expanding the list of eligible collateral that we will accept in our Standing Liquidity Facility, by examining types of term operations and term lending, and by modernizing our legislative authority to support the stability of the financial system.

The second challenge facing the global economy and Canada has to do with the large current account imbalances that exist today. In a nutshell, the United States has been running a very sizable current account deficit for a number of years, while most of the rest of the world – is especially Asia and oil-exporting countries – has been running current account surpluses. Large imbalances such as these are not sustainable over long periods, so the question arises: what needs to be done to effect an orderly resolution?

Two main adjustments are needed. First, those countries with large surpluses need to rely more on domestic demand as a source of growth, and those with deficits (mainly the United States) need to increase their national savings rate. Second, there is a need for more exchange rate flexibility. This is particularly the case for China, but also more broadly across Southeast Asia. China continues to resist exchange rate flexibility, and thus adjustment, through the accumulation of foreign exchange reserves, which now total US$1.5 trillion. I want to quickly add that greater exchange rate flexibility is in China's own best interest. It would greatly enhance their ability to manage their own economy, including dealing with their mounting inflationary pressures.

The third major challenge is the integration of China and India into the global economy. Not surprisingly, some perceive the growing economic clout of and competition from China and India as a threat, especially as both countries increasingly produce more high-value-added goods and services. But the growth of emerging-market economies represents a tremendous opportunity for Canadian businesses. We need to exploit our comparative advantages and see these rapidly expanding markets as places to do business.

So, that's a quick look at some of the trends in and the challenges posed by the global economy. Let me now turn to the home front and discuss some key economic issues facing Canada and Ontario, in light of these global developments.

Canada and Ontario in the Global Economy

These global economic trends represent significant and, in a very real way, competing or contrasting, forces shaping developments here at home. Strong commodity prices are generating a substantial boost to incomes in Canada. In economic jargon, we have had an increase in our terms of trade – the prices of the products we sell internationally are rising faster than the prices of the products we import. The resulting rise in real incomes is providing support for domestic demand in Canada, which has been showing up in rising consumption, construction spending, investment in machinery and equipment, and, more broadly, in employment gains.

At the same time, the weakness of the U.S. economy, the strength of our dollar (reflecting the increase in our terms of trade and the relative weakness of the U.S. dollar), and competition from Asia have led to flat to declining exports, especially in the manufacturing sector.

Thus, overall, what we have had in Canada is strong domestic demand offsetting a weak traded-goods sector. Monetary policy has been calibrated based on judgments about the relative strengths of these competing forces, with an eye firmly fixed on the policy objective of keeping inflation at our 2 per cent target. Currently, total CPI inflation in Canada is 1.8 per cent. Excluding the one-time effect of the January GST cut, total CPI inflation is 2.4 per cent, and core inflation (which excludes the more volatile components) is 1.5 per cent.

Staying on top of all the forces at play is an essential preoccupation of the Bank of Canada. As we said in our last policy press release a month ago, the correction in the U.S. housing sector, knock-on effects of this correction to other parts of the U.S. economy, and the tightening of credit conditions in global financial markets have led us to conclude that the risks surrounding the Canadian economy have shifted to the downside, resulting in our decision to lower our policy interest rate by 50 basis points to 3.5 per cent. We also said that further monetary stimulus is likely to be required in the near term to keep aggregate supply and demand in balance and to achieve the 2 per cent inflation target over the medium term.

With that global and national perspective, I'll now talk about some of the issues, challenges, and opportunities facing the Ontario economy.

Ontario's economy is being confronted by both cyclical and structural economic forces. On the cyclical front, we have the marked slowdown in the U.S. economy. This has had a direct impact on the province's forest products industry – from lumber, to doors, windows, and building materials generally – and on the automotive industry. But these and other industries are feeling the effects of strong structural forces. Clearly, competition from emerging-market countries is one of those forces.

Because of these cyclical and structural forces, demand has turned away from a number of products that Ontario has traditionally produced. In other words, relative prices have moved against some key segments of the Ontario economy. To draw a comparison to the national situation, one could say that there has been an adverse movement in Ontario's terms of trade. Of course, the rise in value of the Canadian dollar over the past five or six years has been an important part of these relative price movements.

At the same time, some sectors of the province's economy are benefiting from these changes in relative prices, including the mining and agrifood sectors. We must also remember that the manufacturing sector is not homogenous – the high-tech sector standing out as an example. And Ontario has strong financial services and health services sectors.

What this adds up to is the need for adjustment within the Ontario economy in response to these global forces. Adjustment is not easy. But London and its surrounding area does seem to me to stand out as an example of the importance of having the flexibility to respond and adjust to changing circumstances. Some 20 years ago, manufacturing accounted for 20 per cent of the jobs in London, compared with 14 per cent today. This decline has been more than offset over the past 20 years by employment gains in financial, business, and professional services, and in transportation and warehousing. In addition, we have seen significant investments, including in the manufacturing base of this community, in technology that supports world-class operations. The result for London over this period has been rising employment and rising real incomes.

Good macroeconomic management is certainly part of what is needed to help provinces, cities, and communities adjust to global change. This includes sound fiscal policies, policies that help to reduce public sector debt levels relative to the size of the economy. The Bank of Canada also has an important role to play. The Bank's monetary policy aims at keeping inflation low, stable, and predictable. This, in turn, helps households, businesses, and governments to read price signals more clearly, respond to relative price movements more promptly, and allocate production resources more efficiently. When relative prices move to the extent that they have in recent years, markets are essentially telling us that there has been a fundamental change in the type of products that the rest of the world wants to buy from Canada. In setting monetary policy, our job is to understand what this means for Canada's overall economic picture, which implies a focus that is national in nature and scope.

Conclusion

To conclude, the first point I wish to make is the importance of allowing market-based adjustment mechanisms to work. Markets send price signals that indicate the best way for resources to be allocated. Second, it is also important for households, businesses, and governments to take a medium- to longer-term perspective in making decisions. The global forces at play are not going to disappear any time soon.

We therefore need to encourage flexibility and adaptability in the Canadian and Ontario economies. In other words, more needs to be done to enhance the functioning of our internal markets. Policies that support flexibility can obviously help economies adjust to cyclical economic shocks. But encouraging flexibility can also have a longer-term payoff. When policies provide an environment where initiative and innovation can flourish, the Canadian economy is able to adapt to longer-term global forces in ways that continuously exploit our comparative advantages.

Thank you for your attention. I would now be happy to respond to your questions and comments.