BANK OF CANADA
BANQUE DU CANADA

Remarks by Paul Jenkins
Senior Deputy Governor of the Bank of Canada
to the Canadian Association of New York
New York, New York
6 November 2007

CHECK AGAINST DELIVERY

North America in Today's Global Economic Setting

Good afternoon. I'm very happy to be here today and to have the opportunity to address the Canadian Association of New York. The goals of the organization, as set out in your mission statement, are laudable ones. And I hope today to make a contribution towards your efforts "to disseminate information and knowledge relating to Canadian business."

In recent months, much has been said, and written, about developments in financial markets. The turbulence in global credit markets, which had its roots in developments in the market for subprime mortgages here in the United States, has been a focal point of attention for market participants and policy-makers around the world. At the Bank of Canada, we have worked hard to understand the causes of this financial market turbulence and assess the implications.

But while attention has been focused on financial markets, it's important not to lose sight of other developments and trends with implications for the real economy. So today, I want to switch the focus back on to the real side of the Canadian and U.S. economies. What I plan to do is discuss the implications of global economic trends for the evolution of the ties between our two economies. First, I want to look at how the economic links within North America have been evolving. Second, I'll talk about how trends in the global economy have been affecting those links. Then, I'll look at some of the policy implications of these evolving trends, and close with a few words about the state of the Canadian economy.

Economic Links within North America

Let me begin by going back almost exactly 20 years to the signing of the original U.S.-Canada Free Trade Agreement (FTA) in October 1987. Since this watershed event, businesses on both sides of the border have cemented the already-close economic ties that existed between our two countries. This agreement recognized the growing importance of trade for both economies. Of course, Canada does rely more on trade than the United States. But since the implementation of the FTA in January 1989, trade flows measured in constant dollars have more than tripled for both countries, and trade as a share of GDP has risen sharply. Indeed, more broadly, the volume of world trade has risen at an annual rate of 8.4 per cent since 1990, compared with an average annual rate of growth for world GDP of 3.75 per cent over the same period. It is safe to say that this tremendous growth in world trade has been far greater than anyone had expected.

Not for publication before 6 November 2007
13:05 Eastern Time

Given the close trade ties between our two economies, it is not surprising that there has traditionally been a rather strong correlation between economic growth rates in Canada and the United States.[1] Our economies have tended to move fairly closely together throughout economic cycles. So it's not hard to see how, for example, developments in the auto sector in the United States are felt almost immediately in Canada, or how swings in housing starts in the United States affect Canada's forest products industry. In the Bank's latest *Monetary Policy Report*, we noted that our base-case economic projection for the United States incorporates a 15 per cent decline in residential investment this year, and a further 11 per cent drop next year. All else being equal, our analysis suggests that this would lead to a reduction in the growth of Canada's GDP of 0.4 percentage points this year and 0.3 percentage points in 2008.

Following the implementation of the Free Trade Agreement, Canada began to send an increasing share of its exports to the United States. From 1990 to 2000, the percentage of Canadian goods exported to the United States rose from just under 75 per cent to just under 87 per cent. Of course, the original FTA turned into the North American Free Trade Agreement (NAFTA) with the addition of Mexico in 1994. And under NAFTA, Mexico has also increased the concentration of its exports that go to the United States, reaching a peak of about 89 per cent in the year 2000.

But below the surface, the story is much more interesting and complex. While the share of Canadian and Mexican exports to the United States remains higher today than before free trade, the share of imports received by both countries from the United States is not higher.[2] Further, the year 2000 looks to have been a turning point. With the accession of China to the World Trade Organization in 2001, that country and, to a lesser extent, India started to become increasingly important global players. So the share of both Canadian and Mexican exports to the United States began to decline at about that time, while both countries began to import more from outside North America.

I don't want to overstate the situation. The United States remains Canada's most important import source and export destination by far. But despite these close ties, it is clear that developments in the global economy have affected the economic links between Canada and the United States. To understand how these links are changing, it's important to understand the differences in how the structures of the U.S. and Canadian economies have been responding to recent global developments.

Global Cyclical and Structural Developments

Over the past decade, we have seen a number of economic shocks that have affected the U.S. and Canadian economies differently. Why has this happened? Part of the reason has to do with the rise to prominence of economies such as China and India. Because of their size and their growing share of world output, it is their influence, rather than the U.S.

---

[1] The IMF estimates that a 1-percentage-point decline in U.S. GDP growth is associated with a decline of 0.5 percentage points in Canadian GDP. See the IMF's April 2007 *World Economic Outlook*, page 137.

[2] Canada's share of exports to the United States rose from 72.8 per cent in 1988 to a peak of 87.1 per cent in 2002, compared with 79 per cent in the first half of 2007. Canada's share of imports from the United States rose from 65.6 per cent in 1988 to a peak of 68.2 per cent in 1998, compared with 54.5 per cent in the first half of 2007.

economy, that is increasingly shaping the global business cycle and determining the prices of traded goods, including commodity prices.

The other, related, reason why our two economies have been affected differently is, of course, the fact that commodity-price shocks result in opposite movements in the terms of trade for Canada and the United States. This means that when Canada's terms of trade have improved – that is, when Canadians receive higher prices for exports and pay lower prices for imports – the terms of trade for the U.S. economy have tended to deteriorate. And the situation has been the reverse when Canada's terms of trade have deteriorated.

What this negative correlation in the terms of trade tells us is that even though the two economies are integrated, they have very different structures that, quite naturally, respond in different ways to certain shocks. Consider both the Asian crisis of 1997–98 and the events of the past five years or so, as China and India have risen to economic prominence. Both of these events have had significant implications for the economies of North America.

In the case of the Asian crisis, we saw a marked slowdown in global economic growth, which resulted in a sharp decline in the prices for many of Canada's primary commodities. With these swings in relative prices, Canada saw its terms of trade deteriorate, while the U.S. terms of trade improved. In these circumstances, we saw a decline in the exchange rate for the Canadian dollar against the U.S. dollar. These movements sent price signals that triggered important shifts across sectors and regions of the Canadian economy. With lower commodity prices, resources flowed out of commodity-producing sectors and into sectors such as manufacturing.

But over the past five years, we have seen essentially the reverse take place. There has been very vigorous global growth, accompanied by high prices for the commodities that Canada produces. As a result, Canada's terms of trade have seen a sharp improvement, while the U.S. terms of trade have deteriorated. And the Canadian dollar has appreciated against the U.S. dollar. Not surprisingly, resources have shifted back to the production of commodities where prices have risen, and away from sectors such as manufacturing.

Economic data clearly illustrate the structural changes that have been brought about by the integration of China and India into the global economy and by the increasing competition coming from emerging economies more generally. Consider Canada's manufacturing sector. This sector expanded in terms of both its share of employment and its share of GDP, following the implementation of the original Free Trade Agreement. And, as I just noted, the sector expanded strongly in the wake of the Asian crisis. But since 2000, in the face of high commodity prices, a strong dollar, and rising competition from Asia, Canada's manufacturing sector has declined in terms of its shares of employment and output.[3]

---

[3] From 1995 to 2000, the share of manufacturing employment rose from 14.3 per cent to 15.2 per cent, while the share of manufacturing output rose from 17.2 per cent to 18.8 per cent. But by 2006, those shares had declined to 12.9 per cent and 15.8 per cent, respectively.

Policy Implications
So what are the implications of these developments for policy-makers? In answering that question, I want to make a general observation, and that is the importance of allowing market-based adjustment mechanisms to work in an economy. Markets send price signals that indicate the best way for resources to be allocated to the highest value-added activities. This implies that policy-makers should not try to impede or frustrate these market signals. And it implies that our economies will be best served by policies that promote flexibility – policies that allow economies to respond to price signals and to adapt to changing circumstances. Let me make three points about how policy-makers can encourage flexibility.

The first thing to note is the importance of continuing to promote free trade, and resisting the siren song of protectionism. We must never forget that trade – whether in goods or services – is a positive-sum game. That is to say, in the end, all countries can be winners. But if countries yield to protectionist pressures, everyone in the international community will be worse off in the end. Moreover, protectionist actions that focus on bilateral imbalances will not reduce the size of a country's overall current account deficit. If the underlying cause of that deficit is not addressed, protectionism will only result in trade flows being diverted to other countries.

But to support an open and robust global trading system, we also need to actively support a market-based international financial system. Policies that thwart market-based economic adjustments can threaten global growth and stability. That is why we at the Bank of Canada have been quite active in saying that surveillance at the International Monetary Fund should be focused on countries that are following policies that do not allow market-based adjustments to take place.

The second point I want to make is the importance of sound macroeconomic policies. I'll confine my remarks here to monetary policy. Although there are differences in approach, both the Bank of Canada and the U.S. Federal Reserve have inflation control as a fundamental goal, with that goal supported by a floating exchange rate. For an economy as open as Canada's, having a flexible exchange rate is a critical element in allowing it to pursue an independent monetary policy that is appropriate to its specific domestic circumstances. And by focusing on inflation control, both the Bank of Canada and the Federal Reserve are allowing changes in relative prices to send those clear signals that help the economy adjust to different circumstances.

Of course, it is not easy for businesses competing in the global economy to adapt to sharp movements in exchange rates. But movements in exchange rates encourage the kinds of adjustments that are necessary in response to economic shocks. In the absence of a floating exchange rate and with limited labour market mobility between Canada and the United States, the adjustment that would otherwise take place would be significantly more costly and more difficult.

The third point I want to make is the need to have structural or microeconomic policies in place that encourage flexibility and adaptability. In Canada, we have made good progress in improving the flexibility of our economy. This is evident in the way that the economy has been able to adjust to the various shocks that have come its way in recent years. Indeed, although these shocks have had different effects across sectors and regions of the country, growth in overall output and employment has remained solid, while inflation has remained low and stable, as resources have shifted to those sectors whose products have been in high demand.

But this does not imply that we should not be looking to improve Canada's structural policies. There are some priority areas in this regard. Considerably more needs to be done to enhance the flexibility and functioning of our internal markets from coast to coast. Business regulations and standards, including those for the financial sector, need to be harmonized across Canada. And, to make our labour markets more flexible, trades and professional designations should be recognized and fully transferable across the country. The Trade, Investment and Labour Mobility Agreement reached between British Columbia and Alberta is an important step in that direction. But more progress of this sort is needed in Canada.

Policies that support flexibility can obviously help economies adjust to economic shocks. But there is also a longer-term payoff that can come from encouraging flexibility. When policies provide the right environment for entrepreneurship to flourish, economies can adapt to longer-term global economic forces and continuously exploit their comparative advantages.

Consider some of the iconic firms here in the United States, and how a company such as IBM has evolved. IBM was once primarily a manufacturer of "business machines," as its name implies. But as other countries and economies developed and became better placed to manufacture goods, IBM redefined itself and used its comparative advantage to become a "business solutions" firm, offering software, consulting, and even financing services in addition to computers.

Recent Economic and Financial Developments

Let me now turn to recent developments. A little more than two weeks ago, the Bank published its *Monetary Policy Report.* In that document, we noted that growth in the Canadian economy has been stronger than projected, supported by the robust global economic expansion and strong commodity prices. Canada's economy is now operating further above its production potential than had been previously expected.

We also noted three major and related developments since the summer that have affected the outlook for the Canadian economy. First, the Canadian dollar has appreciated sharply. In the *Report*, we noted that while the dollar has been supported by firm commodity prices, and strong domestic demand, the magnitude of the recent appreciation appears to be stronger than historical experience would have suggested. The second major development affecting the Canadian outlook is the weakening of prospects for the U.S. economy, and the third is a tightening of credit conditions. Despite these tighter credit conditions, the momentum of domestic demand in Canada is expected to remain strong. But the combined effect of a weaker U.S. outlook and a higher assumed level for the Canadian dollar implies that net exports will exert a significant drag on the Canadian economy. Given these developments, the Bank revised its projection for growth. We now project Canada's gross domestic product to grow by 2.6 per cent in 2007, 2.3 per cent in 2008, and 2.5 per cent in 2009.

With the economy moving back towards balance, and with the direct effect of the stronger Canadian dollar on consumer prices, core inflation is projected to gradually decline to 2 per cent in the second half of 2008. Total CPI inflation is expected to peak at about 3 per cent later this year and then move back down to the 2 per cent target in the second half of 2008.[4]

But there are a number of upside and downside risks to the Bank's inflation projection. The main upside risk is that excess demand in the Canadian economy could persist longer than projected. The main downside risk is that output and inflation could be lower if the average level of the Canadian dollar were to be persistently higher than the 98 cents U.S. level that we assumed in the *Report*, for reasons not associated with demand for Canadian products. Given recent information, both the upside and downside risks appear to be greater than they were when we completed the *Report*.

In the *Report*, we said that after considering all factors, we judge that the risks to the Bank's inflation projection are roughly balanced, with perhaps a slight tilt to the downside. And we also said that we judge, at this time, that the current level of the target for the overnight rate is consistent with achieving the inflation target over the medium term.

Conclusion

Let me conclude. The Canadian and U.S. economies remain highly integrated, and there is every indication that our economic ties will remain strong. But developments in the global economy and the growing prominence of emerging economies have important implications for policy-makers on both sides of the border.

Indeed, while our economies are highly integrated, they have different structures, and they respond differently to shocks that are increasingly global in either nature or origin. So, it is important that policy-makers heighten their focus on the need to promote and enhance flexibility. Our economies must be able to adjust to changing circumstances. If we are successful in this effort, not only will both the Canadian and U.S. economies be able to deal with economic shocks, but we will also be able to sustain strong economic performance in North America. And that is the best outcome for Canadians and Americans alike.

[4] The projection for total CPI excludes the impact of the recently announced one-percentage-point cut in the federal GST, which would be effective 1 January 2008.