Remarks by Stephen S. Poloz
Governor of the Bank of Canada
Investment Industry Association of Canada and
Securities Industry and Financial Markets Association
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A New Balance Point: Global Trade, Productivity and Economic Growth

Introduction

The year 2016 got off to a rough start, with plenty of financial market volatility. Of course, there is no shortage of fundamental issues to worry about: another downgrade to the outlook for global growth, uncertainty about the economic transition in China, the pace of normalization in the United States, worries about Europe, worries about Japan, just to cite a few.

Financial markets have a love-hate relationship with volatility, and central bankers usually try to see through it all. But one worry I hear a lot these days hits pretty close to home—the idea that monetary policy just isn't working anymore. That's one myth I'd like to dispel right off the top.

The fact is that policy actions—both monetary and fiscal—taken in the wake of the global financial crisis prevented what would have been a second Great Depression. But many of the negative forces that were acting then are still acting now. That's why ultra-low interest rates are not causing rapid growth and inflation.

If you think monetary policy is not working, ask yourself what would happen if interest rates suddenly returned to 3 or 4 per cent. Most would agree that such a move would trigger a recession. This is just another way of saying that severe headwinds are still acting on our economies, years after the crisis, and low interest rates are keeping them at bay.

It's a bit like riding a bicycle up a steep hill. Your progress may be slow, but that doesn't mean your legs aren't working hard or that your bicycle is broken. Monetary medicine hasn't cured everything, but it is working, and it has surely saved us from the worst.

Still, as central bankers, we need to take market anxiety, and the volatility it creates, seriously, regardless of the source. Although volatility can go both ways, "market volatility" is usually code for "market declines," which can erode

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consumer and business confidence and cause a weakening in economic fundamentals.

So, what I would like to do today is address another current source of anxiety in financial markets—the striking weakness of international trade. After all, international trade is the lifeblood of the global economy. Firms, consumers and investors alike all rely on it to keep the economy growing, create and sustain jobs and deliver investment returns.

The exchange of goods and services has been happening as long as people have been able to produce more than they needed to survive, leaving them free to follow other pursuits. Expanding exchange into the international arena is the next logical step, and that is exactly how global history has unfolded.

Trade is a grand facilitator that permits people and firms to specialize and innovate. The resulting improvement in living standards continues until trade reaches a balance point in the economy where all advantages have been exploited. That balance holds until circumstances change and people react to new opportunities.

Given the central importance of trade, it's not surprising that investors are worried about what the data show. For roughly 20 years before the financial crisis, global trade had been expanding by more than 7 per cent a year—about twice as fast as the world economy. Trade collapsed in the wake of the crisis, but rebounded sharply in 2010. Since then, though, trade growth has again slowed dramatically, trailing even the tepid pace of global GDP growth.

What is behind this slump in trade? Has the link between trade and economic growth changed? Is the trade slowdown a warning of another global recession? And, if trade is central to the productivity and efficiency of companies, what does the slowdown in trade mean for productivity growth?

I hope to shed some light on these issues today, and help everyone better understand the forces that are at work.

Explaining Slow Trade Growth

Let's dig into the data a little. The post-crisis slump in international trade was initially concentrated among advanced economies, particularly in Europe. More recently, the trade slowdown has been centred in the emerging markets of Asia, including China. This has led many investors to link weak trade to the slowdown in China, and therefore in the global economy.

Recent work at the Bank of Canada and elsewhere shows that about half of the slowdown in trade growth among advanced economies in the post-crisis period can be explained by weak economic activity, especially sluggish business investment. Throughout this period, companies have been dealing with high levels of uncertainty about the prospects for the global economy, in some cases because of aggressive deleveraging. This has held back investment and, in turn, contributed to soft trade. Investment spending involves capital equipment, with inputs from many countries, and therefore is very trade-intensive. So when economic growth slows because of weak investment, trade slows disproportionately.

While advanced economies were dealing with the worst of the crisis, China's economy continued to expand. This supported demand for commodities, thereby keeping a portion of international trade flows moving. Higher prices for commodities also prompted commodity producers to make big investments and ramp up supply.

Ultimately, though, growth in China began to moderate to a more sustainable pace. More importantly, the Chinese economy has begun to shift away from investment-driven growth toward consumption, especially of services. Quite simply, this has meant less international trade. Even so, China's imports of many commodities continue to grow at double-digit rates.

So, we have reason to expect global trade to grow more slowly than in the past: first, because global investment spending is in a lull, and second, because China's economy is restructuring toward more domestic consumption and less trade. We can certainly expect global trade to pick up when the world economy gets back onto a self-sustaining growth track, with stronger business investment. Still, as I just noted, cyclical factors can explain only about half of the trade slowdown, so we have more explaining to do.

Indeed, I think we need to step back and consider the possibility that the rapid pace of trade growth that prevailed for the two decades before the crisis was the exception, and not the rule. Why would I say that? What we saw during the 1990s and 2000s was the result of the natural incentive to use trade to increase specialization, in reaction to reduced trade barriers and major advances in communication and transportation technology.

During those years, countries formed regional trading blocs through arrangements such as the North American Free Trade Agreement and the European Union. Previously closed economies, such as China, became more engaged by joining the World Trade Organization (WTO).

This combination of elements gave the natural incentive to trade a great deal more room to grow. It paved the way for companies to build global supply chains—the "integrative trade model." A factory that made a product no longer needed to be next door to the product's designers. Firms could now exploit their comparative advantage by specializing, not just in one particular good or service, but in *one part* of a good or service. The result was an explosion of specialization as markets became global and companies became more efficient.

As the Peterson Institute for International Economics put it in its recent persuasive report *Reality Check for the Global Economy*, "trade boomed during the 1990s and early 2000s in part because intermediate goods began globetrotting."

However, any trend that goes on for 15 or 20 years becomes ingrained in our expectations. We should have realized all along that this process of integration simply could not continue at the same pace forever. At some point, trade would reach a new balance point in the global economy where firms had built optimal supply chains that crossed international borders, slowing the integration process, at least for the present.

Yes, there are other structural reasons you can point to for the deceleration in global trade. A troubling number of protectionist measures have been put in place since the crisis, for example. But I believe that the most important structural factor behind the slowdown in trade growth is that the big opportunities for increased international integration have been largely exploited. China can join the WTO only once. That's not to say that further integration waves won't happen—I certainly hope they will. But if global trade has reached a new balance point, we should not fret that global export growth hasn't recovered to pre-crisis levels.

The Link Between Trade and Productivity

Even so, we need to think about what this assessment of the state of global trade means for productivity. Productivity matters to all of us because its growth, along with the growth of labour, determines the potential growth rate of an economy. We already know that demographic forces are leading to slower labour input growth in most advanced economies. Productivity growth is also slowing. This combination points to lower global economic growth in the future.

And there's more. The most important input into the equilibrium real rate of interest—what economists refer to as "the neutral rate"—is the underlying growth in economic potential. Investors are only beginning to come to grips with the implications of this downward drift in the neutral rate of interest and what it means for long-term investment returns.

Obviously, it matters a great deal whether productivity growth is likely to remain low or recover as the world economy gains traction, and that depends on how you explain slowing productivity growth.

Some have said that productivity growth is slow today because most of the truly important inventions happened years ago, and today's technological progress is more incremental. But I think a more natural place to look is at international trade, because companies that use trade to increase specialization also increase their productivity. And if that process has reached a natural limit, at least for now, then perhaps that also limits future productivity gains.

A quick comparison of experiences in the United States and Canada illustrates my point. Let's look at US and Canadian manufacturing over the past 60 years. In 1955, roughly one-third of the workforce in both countries was employed in manufacturing. As has been well documented, these shares have been declining, as they have in all advanced economies, as companies built global supply chains and shifted activities to places that can produce the same goods at a lower cost. Last year, the share of the workforce involved in manufacturing was below 10 per cent in both countries, with the US figure a bit lower than the Canadian.

Of course, today's factories are much more productive than those in 1955. US manufacturing is almost seven times more productive than it was 60 years ago, while Canadian factories are roughly five times more productive.

Those are both big numbers, but what can explain the difference? The relative size of our economies may be one factor, since there are clearly more opportunities for economies of scale and scope in the larger US economy. But also consider this: over the same 60-year period, the importance of international trade to the US economy more than tripled, while the importance of trade for Canada only doubled. Here, I am measuring the importance of trade by looking at total trade—exports plus imports—as a share of GDP.

One explanation for this difference is that Canada has always been dependent on trade. We were founded on a resource-export model, and since trade started out being very important, there is less room for its importance to grow. But, in my opinion, the basic insight here is that US companies pursued globalization and offshoring more than Canadian companies did, boosting the importance of trade to the US economy more than was done in Canada. When a company procures one slice of its value chain offshore, it does so to reduce costs. The result is that the average productivity of the domestic operation goes up. This isn't a productivity miracle; it's simply arithmetic.

US firms are more likely to be larger than Canadian firms. That means they tend to have more outsourcing opportunities. Smaller Canadian firms are more likely to be part of the global supply chain of a multinational firm and have fewer opportunities to build an integrative-trade supply chain. And, of course, if you are in a resource-extraction business, there may be few opportunities to outsource.

Ultimately, the integrative trade model is a powerful force for advancing living standards. We can see evidence of it in action everywhere. Most of us have examples in the mobile phones we are carrying in our pockets right now. It's true, of course, that the globalization of supply chains has required economic adjustments. These adjustments can be painful for individuals, and it is incumbent on policy-makers to help buffer the transition by ensuring adequate safety nets for workers and facilitating retraining and relocation. But the benefits of integrative trade shouldn't be ignored. It has meant increasing incomes for economies. It has made many products much more widely accessible to more people. And it has meant continued job growth at home.

Implications and Alternatives

My argument is that a significant part of the strong productivity performance in the two decades before the crisis was due to globalization, and that the globalization process may have brought trade in the global economy to a new balancing point. Understanding this is one thing; the question is what can be done about it.

I see at least three reasons to hope for future progress. The first is that a lot of productivity growth comes not from existing firms, who tend to be incremental about it, but from new firms. A new firm with a new product or service tends to see giant leaps in productivity as it goes from being a start-up to the "hockey stick" growth phase. A firm only makes that transition once, but an economy can reap the benefit over and over if there is a strong trend in new firm creation.

An expanding economy generally sees a pretty steady growth in the population of companies. Under the surface, there is a steady rate of firm exit too. This is Schumpeter's process of creative destruction.

So let me just point out that the growth of the population of companies slowed dramatically in a number of countries in the wake of the global financial crisis. I've been watching the Canadian and US data closely, because I'd interpret the emergence of firm creation as a strong sign that growth had become self-sustaining. In the Canadian data, firm population growth has picked up but remains slow, at around 1 per cent annually, well below pre-crisis rates. But in the United States, there has been a steady acceleration of firm population growth since 2011. The most recent figures are approaching 3 per cent annual growth, which is back to pre-crisis levels. If I am right, the US economy is due for another period of better productivity growth, and I have every reason to think that Canada will follow once we work through our adjustment to lower resource prices. A reversal of the cyclical slowdown in investment I mentioned earlier would also serve to support future productivity growth.

A second reason for optimism about productivity is that even if most major economies have exploited most available opportunities for integration, gains may still be had from improvements to existing supply chains. Economies evolve over time, and comparative advantages are not set in stone.

Consider China, which for years was the main destination for outsourced production. Today, its working-age population is shrinking. Unit labour costs have been rising quickly as the economy moves up the value chain. Now, we're seeing signs that labour-intensive production is shifting out of China and into nearby economies, such as Cambodia and Vietnam.

All of this suggests that companies and investors may be able to find ways to improve the efficiency of supply chains in many geographic areas. This will show up as a new wave of integration and global trade growth. For policy-makers, of course, this means we should be working to help initiatives such as the Trans-Pacific Partnership and the Comprehensive Economic and Trade Agreement between Canada and the European Union become a reality.

Third, nobody can predict the future disruptive technologies that would allow the global economy to take its next giant step forward. History gives us no reason to be pessimistic with respect to future technological progress.

Before I wrap up, let me make one more point. International trade, as measured by our standard global trade statistics, is not the only way for companies to exploit integration opportunities. Some companies find it more sensible to operate foreign affiliates in other countries while managing them from home. For some firms, this model effectively acts as a substitute for international trade.

And this business model has been growing, even while traditional exports and imports have been slowing. We know that sales by Canadian-owned foreign affiliates now exceed total exports from Canada, approaching 30 per cent of GDP. In other words, these foreign affiliates are almost like another Canadian economy out there, supporting jobs in Canada in areas such as research and development, engineering, design and marketing, not to mention lawyers, accountants, and executives who manage the operation from home. In the United States, foreign affiliates are even more important, with sales equalling more than 40 per cent of GDP. This is a very real sign that companies are growing, becoming more productive and creating jobs at home, whatever the official trade data show.

Conclusion

It’s time to conclude. In a world full of anxiety, my goal today was to give investors one less thing to worry about. Most of the cyclical part of the slowdown in trade should be reversed as the global economy recovers, even if that is a slow process. Furthermore, there are opportunities for progress on the structural side in terms of both trade and productivity if conditions permit another wave of global integration. Moreover, the creation of brand-new firms could be the most promising source of new trade and productivity growth.

I hope I’ve convinced you that the global economy can continue to recover, even if global trade growth remains lower than its pre-crisis levels. The weakness in trade we’ve seen is not a warning of an impending recession. Rather, I see it as a sign that trade has reached a new balance point in the global economy—and one that we have the ability to nudge forward.

As for monetary policy, the Bank of Canada will continue to work on building a positive economic environment for investors, firms and consumers. We know that sound, clearly communicated monetary policy can facilitate trade, productivity and growth. And that’s good for everybody.