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The Canadian Economy: A Progress Report

Introduction

It's a great pleasure to be here and see the Land of the Midnight Sun first-hand. The last time I was here it was mid-January, and the locals promised me I would see the northern lights—but it snowed the whole time I was here!

This time, we get to take in the natural beauty of Whitehorse in the daylight while meeting with the business leaders of the region. Visits like these supplement the invaluable work done by the Bank's regional staff, who help keep us on top of how things look to the people who actually make the economy tick.

I don't have to tell you that the Canadian economy has faced its share of challenges these past few years. Our exports plunged in the wake of the global financial crisis, and we lost many exporting companies and their jobs. The global recovery since 2010 has been disappointing and so has our export recovery. High oil prices boosted Canada's income growth and increased investment in the energy sector through 2014, offsetting some of the bad news. But over the past 18 months that growth engine, too, has throttled back.

So, today we find ourselves partway through two distinct economic narratives. First, the resource economy is going through a painful and complex adjustment to low prices—an adjustment that will mean lower levels of income, investment and employment, as well as the migration of families within Canada. This process will take another couple of years to work itself out. Second, the non-resource economy is still healing from the post-crisis trauma, moving unevenly toward full capacity—two steps forward, one step backward.

And then there are the wildfires in Northern Alberta, which devastated the town of Fort McMurray, forced 90,000 people from their homes and affected production in the oil sands. This has made a challenging situation even more so.

The one constant in recent years has been the Canadian consumer. In part supported by low interest rates, Canadian consumers have been a steady source of economic growth, particularly through the housing sector. The result?

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Canadian households are carrying near-record debt loads, and we are growing increasingly concerned about risks in some housing markets.

So, you might be wondering how Canada is really doing in the face of all these conflicting economic forces. Today I'd like to offer you a progress report. And let me say at the outset: we are making progress.

Four times a year, the Bank publishes its *Monetary Policy Report* (MPR), containing our latest projections for the Canadian economy. Our model-based forecasts are complemented by judgment, which is supported by extensive consultations with companies and other contacts. Conditional on this economic projection, we choose a path for interest rates that will keep projected inflation on target or bring it back to target over a reasonable time frame.

At the end of each MPR we highlight several risks to our forecast—issues that require the Governing Council to exercise judgment. In principle, if one of those risks were realized, projected inflation would deviate from the target, and an adjustment to policy might be indicated.

The Governing Council spends a lot of time debating and forming judgments around these risks. So, I thought it might be interesting to invite you into our forecasting tent today and talk about how we have been seeing Canada's key economic risks evolve since our last MPR in April.

The Base Forecast and Risks

For the past 18 months, the biggest issue for our forecast has been tracking how the Canadian economy is adjusting to low resource prices. In the first instance, this has meant a big drop in investment spending, especially in the oil patch. It has also meant a lower value for the Canadian dollar and two interest rate cuts during 2015.

Our forecast in April saw the Canadian economy making its way back to full capacity during 2016 and 2017—a process that would see inflation sustainably at our target of 2 per cent by late next year. Without last year's interest rate cuts, it would have taken much longer to have inflation return to target.

While the April projection was being developed, the Canadian economy appeared to be doing better than previously expected. However, our analysis suggested that we should not extrapolate that first-quarter surge in growth for the rest of the year—that some of the apparent strength represented a catch-up from a soft fourth quarter, and some other factors were probably temporary.

Accordingly, our April forecast anticipated a significant slowdown in growth for the second quarter and a decent pickup in the second half of the year, in part due to the government's fiscal plan. Several risks played an important role in these discussions; I will now discuss four of the most important and consider how well the economic data have supported those judgments since April.

Risk 1: Stronger US economic growth

We might as well start with the most obvious risk—the outlook for US economic growth, which, of course, feeds directly into our recovery narrative for Canada's non-resource economy.

When we were preparing our forecast in April, the US economy was showing signs of faster growth, but we were skeptical that it would be sustained. The fact is we had been disappointed too many times in the past. As in all such debates, however, there was a risk that we were being too conservative and would be surprised on the upside as things unfolded. This would, of course, have been welcome, because it would have meant more exports for Canada.

As it turned out, though, the first quarter in the United States was even softer than we had been expecting. US energy companies were cutting back on investment—much like they were in Canada—and US consumers slowed the growth of their spending.

But the second quarter is looking better for the United States. We're seeing renewed strength in housing and auto sales, and consumer confidence is near a post-crisis high. America's job market stumbled in the latest monthly report, but we don't think this one month of data heralds a significant downshift in growth. Besides, some moderation in monthly employment gains and GDP growth is inevitable as the US economy approaches full employment.

So, after tilting a little to the downside early in the year, the balance of risks around the US outlook now appears to be reasonably close to our view in April. A full reassessment of this risk is being done now, for our next MPR in July.

Risk 2: Stronger Canadian exports

Generally speaking, a stronger US economy will mean more export sales for Canada. But in recent years this link has proven less reliable than in the past. Accordingly, the second forecast risk that has been preoccupying us is the possibility that our Canadian export forecast would again miss the mark.

Toward the end of 2015 and in early 2016, in fact, non-energy exports started showing surprising strength. While this was encouraging, more granular analysis suggested to us that some of that strength would be temporary—in auto exports, for example—and we judged that exports would slow. Therefore, the risk we set out in the MPR was that we may have been too conservative on the export outlook—that perhaps exports would continue to surprise us on the upside.

Sure enough, exports have taken a step back in the past couple of months, validating our cautious analysis. Even so, the levels of several export categories have shown good progress. For example, exports of building and packaging materials are up 35 per cent since 2012 to levels last seen before the financial crisis. Furniture and fixtures exports are up 45 per cent over the same period and exports of pharmaceutical and medicinal products have grown by 70 per cent.

And then there is tourism. I know the Yukon government has been actively working to draw visitors, both from Canada and abroad. Land border crossings, which are how most visitors enter Yukon, are up almost 9 per cent from last year. Accommodation and food services jobs were about 15 per cent higher in March than a year ago. These trends are being replicated in many parts of Canada. Data on day trips between Canada and the United States, where people cross the border but don't stay overnight, have shifted sharply with more Americans crossing the border to shop in Canada and many fewer Canadians travelling in the opposite direction.

Given the past depreciation of the currency and our confidence in the US expansion, we expect our export sector to continue to heal. Many firms are close to their capacity limits, which augurs well for future investment spending and new job creation. So, while the whole process has been disappointingly slow and uneven, we remain confident that we have the right narrative.

Risk 3: Deeper adjustment to low oil prices

The third big source of uncertainty in our forecast is how our economy will ultimately adjust to a world of significantly lower oil prices. This basically comes down to the actions of individual firms and their investment plans, and we have managed to track this reasonably well through conversations with the firms themselves. In the energy sector, investment spending this year is expected to be about 60 per cent below 2014 levels. And, since the process began, companies have cut investment spending each quarter by more than we expected, so this has been framed as a downside risk.

We’ve seen a similar phenomenon here in Yukon, as mineral exploration spending has fallen and is expected to drop further and several mines have closed in recent years. This includes the plans for a temporary shutdown at the Minto copper mine next year.

The recent uptick in oil prices might lead some to expect an end to investment spending cuts. We are not persuaded of this, for two reasons. The first is that some of the recovery in prices is due to supply disruption that will probably be temporary, so we should reserve judgment.

The more important reason, though, is that it’s highly uncertain what price level will rebalance the oil market on a sustained basis. It certainly looks as though prices will not be returning to their old highs in the foreseeable future. Oil companies and their suppliers and service providers have found many ways to cut costs, and this is lowering break-even prices. This means that new oil supply can come back on stream profitably—especially in US shale plays—at lower prices than before, perhaps putting a lid on further price increases.

The recent pickup in oil prices is, of course, welcome, because it means a boost to Canadian income for every barrel exported. But an extended period of oil prices at recent levels is unlikely to lead to greater investment spending in the Canadian oil patch. Indeed, market intelligence suggests there is further downside risk to investment at these still-low price levels. Accordingly, this remains a potential source of downside risk to our forecast.

Risk 4: Will consumers rein in their spending?

The fourth risk we’ve been giving special attention to is the possibility that Canadian households might become more cautious in their spending. At the heart of this uncertainty is the high level of household debt. It is natural to expect that, at some point, households will rein in their spending and put more effort into paying down their debt.

There is no evidence of this downside risk so far, however. Indeed, data from the first quarter show that household spending, including big-ticket items such as motor vehicle sales and housing, has remained strong. Nevertheless, we will need to remain alert for signs that this risk is emerging.

Low interest rates and a resilient job market have certainly helped sustain consumer spending, and the tax rate changes that the government introduced at the beginning of the year may also be playing a role. We also think spending is being supported by the impact of cheaper gasoline, since the average Canadian household is spending about $600 less per year to fill their tank. On the other side of the ledger, the decline in the Canadian dollar has raised the price of a wide range of imports.

A strong consumer is, of course, a key contributor to Canada's strong housing market. However, a number of other factors are at play, as seen in the significant regional divergences in housing sales and prices. We continue to see very strong markets in British Columbia and Ontario, fuelled by strong population and employment growth, declines in energy-producing regions such as the Prairies and modest growth elsewhere in the country.

Indeed, we noted last week in our *Financial System Review* that house prices in Vancouver and Toronto have been rising at a pace that probably can't be sustained. It's possible that self-reinforcing expectations of higher prices are affecting these markets, and the risk of a decline in prices, while difficult to quantify, is growing.

Summing Up

So, after looking at those four risks, where do we stand?

I have no doubt that the growth forecast numbers will change when we do our full analysis in July, and that will have implications for our projection of inflation and our policy deliberations. But it does seem that our core forecast narratives around the US economy and around Canada's exports remain intact.

Investment plans in the energy sector, and the possibility that households will suddenly rein in spending to pay down debt, do still present downside risks that we will continue to monitor carefully. And of course, there may be a whole new set of risks to consider in July.

Impact of the Alberta wildfires

Unfortunately, there is still one major economic factor to consider that was not foreseen at all—the Alberta wildfires.

The fires were brutal. Almost 90,000 people were displaced and about 2,400 buildings, mostly homes, were destroyed. Canadians rallied to support their neighbours, as you'd expect. Insurance claims are expected to be somewhere between $2 billion and $6 billion—the largest such event in Canadian history.

It's difficult to estimate the impact of this disaster on the economy. Lost oil output amounts to around 1 million barrels per day, but since it is unclear when production will be fully restored, the cumulative loss of income remains uncertain. In addition, the vast majority of the local population wasn't working during the evacuation. From a GDP standpoint, there will be some offsets to these losses, from emergency services and the like.

We estimate that the Alberta fires will reduce annualized growth in the second quarter by about 1.00 to 1.25 percentage points. Part of this decline in GDP, stemming from the oil production shortfall, will probably be made back sometime in the third quarter, but the net effect on the level of GDP over time will depend on the pace of rebuilding, which at present is difficult to foresee.

This suggests that GDP growth will be very choppy in the second and third quarters. Growth will probably be flat or slightly negative in the second quarter and show an outsized recovery in the third quarter. That type of quarterly growth profile could yield average growth over the two quarters quite close to that set out in the Bank's forecast in April. But we will have to wait and see.

We will bring a completely new analysis to the table in July, so all these estimates are subject to change, based on these risks or new ones. Just by way of illustration, the outcome of the Brexit referendum next week poses new risks at the global level that could mean a shift in view.

Conclusion

Let me conclude. As I said at the beginning, the economic situation we face is very complicated and riddled with uncertainty. But I am confident that we are making real progress.

The global economy retains the capacity to disappoint us, but it is gradually healing. The US economy appears to be doing well, despite the usual variability in the data. Our export recovery is proving to be very uneven, but several categories are encouraging. Many export sectors are operating near their capacity limits, which augurs well for future investment and job creation. The structural adjustments to low oil and other commodity prices are clearly under way and will persist for some time yet. Financial stability risks, especially in the household sector, remain an area of concern but should diminish as the economy strengthens.

Continued patience is required, but we have the right to be optimistic. Let me acknowledge, though, that many of the macroeconomic processes that economists talk about sound impersonal, or even mechanical. I know they are not. Companies are run by real people, who risk real money in creating jobs and economic growth. Hesitating to do so in the face of uncertainty is only human. Workers who lose their jobs as a result of low oil prices may need to contemplate moving to another part of Canada, and layering the Alberta wildfires on top only increases the human burden. Economic adjustment processes that seem so ordinary in our models are painful, costly and take time at the human level.

Still, there's a resilience and flexibility among Canadians that gives me confidence that we will get through these adjustments and our economy will return to natural, self-sustaining growth. My message is that the process has been uneven, and probably will remain so, but we are making real progress. Rest assured the Bank of Canada will keep doing its part to support Canadian workers and businesses along the way.