BANK OF CANADA
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A Progress Report on the Economy

Introduction

I am very happy to be here in Quebec City. People come from all over to visit this city, not only for its beauty, its fine dining and its hospitality, but also for its historical significance to North America. There is a lesser-known anecdote from this region that I quite like because it teaches us a lesson on monetary policy that is still relevant today.

In 1685, as New France faced a shortage of coins, Jacques de Meulles—the intendant of the colony—decided to use playing cards as paper money by writing a value on them. And when I say "playing cards," I really do mean cards like the ones we use to play hearts or bridge. I would say that gives a whole new meaning to the phrase "play money."

These playing cards were the first form of paper money distributed in North America.[1] Although this series of cards was repurchased only three months later, it marked the beginning of a tradition that would last more than half a century.[2] So why did people agree to get paid in playing cards? Because they trusted the authorities would manage them rigorously.

While monetary policy has changed dramatically over the past 300 years, one thing remains the same: trust is key. Today, this trust is buttressed by

[1] W. J. Eccles, "MEULLES, JACQUES DE," in *Dictionary of Canadian Bibliography*, vol. 2, University of Toronto / Université Laval, 2003.

[2] J. Powell, *A History of the Canadian Dollar* (Ottawa: Bank of Canada, 2005).

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explaining—in a way that is transparent—what the Bank of Canada is doing and why. I would like to thank the Association des économistes québécois and CFA Québec for allowing me to do that here today.

My speech is part of an initiative the Bank launched at the beginning of this year. The Bank makes policy interest rate decisions eight times per year. On four of these occasions, we accompany our rate decisions with the *Monetary Policy Report* (MPR) and a press conference. The other four times, the rate decision is now followed by an economic update speech, where a member of our Governing Council explains how we considered the key elements related to the economic outlook in our decision-making process.

Yesterday, the Bank maintained its policy interest rate. The ongoing backdrop for these policy rate discussions is a Canadian economy that, after some challenging years in the wake of the oil price shock, is operating near its potential and inflation that is very close to our 2 per cent target. Here in the province of Quebec, growth was above 3 per cent last year—its best performance in more than 15 years.

The broad-based growth since the beginning of 2017, and its implications for inflation, has led us to raise the policy interest rate three times since July. With the economy facing uncertainty on a few fronts, each decision, including yesterday's, is less straightforward than the picture I just painted might suggest.

The context for the decision

Before diving deeper into the economic environment we are operating in, let me remind you what we are trying to achieve and how we do it. The Bank targets an inflation rate of 2 per cent, within a band of 1 to 3 per cent. It is worth noting that inflation has averaged close to 2 per cent in the past 25 years, and that this success can be attributed in part to our policy, adding to its credibility and increasing public trust in our framework.

To reach our goal sustainably, aggregate demand in the economy must be in balance with aggregate supply. Our main tool for achieving this is the policy interest rate, which allows us to stimulate or temper demand. The policy interest rate is currently below our estimate for the "neutral" rate—that is, the equilibrium interest rate when inflation is at target and the economy is growing at potential, once the effects of any shocks have faded. That means our policy stance remains accommodative. Another way to see this is by noting that once adjusted for inflation, our real policy rate is -0.75 per cent.

Our accommodative stance reflects the presence of some factors that continue to weigh on the economy and, in turn, on our forecast for inflation. For example, two such factors are the uncertainty surrounding trade policy, which is restraining business investment, and the impact of the new mortgage financing guidelines on housing activity.

With this context in mind, I will share our assessment of global and Canadian economic developments and elaborate on the issues that we are watching closely.

Global economic developments and exports

First, let me talk about the global economy. It plays an important role in our forecasts because we rely on exports for one-third of our gross domestic product (GDP).

Our main trading partners—including the United States, the euro area, China and other emerging markets—continue to show solid growth. Such synchronous growth across these regions has not been seen in many years.

Data we have received since mid-April, notably with respect to the US economy, continue to suggest the global economy is expanding roughly as expected. And while global financial markets continue to function well, financial stresses have recently developed in some emerging-market economies as well as in Europe. Though global growth will eventually moderate over time as excess capacity is absorbed, the world economy is nonetheless expected to remain strong and to contribute to our export growth.

Despite a rather slow start to the year, the growth of our goods exports jumped to 3 per cent in March. Their contribution to Canadian GDP in the first quarter should be greater than what we had forecast in the April MPR. This is encouraging.

That said, we know that our exporters are facing increased foreign competition. As we noted in April, the market share of Canadian non-energy goods in the United States has shrunk by almost half since the early 2000s. We see this competition in many sectors—from automobiles to electronic goods to forestry—which is why we are monitoring competitiveness very closely, and expect to publish further analysis on this issue in the months ahead.

We also know that international trade has undergone some significant changes in the past 10 years. Before that, international trade was growing at roughly twice the rate of the global economy. It is now growing at the same rate as the global economy. This, together with more competitive world markets, has been restraining our exports.

Another important factor is the fact that many of our exporters are already operating at full capacity. At an industrial level, three-quarters of the sectors are at their highest capacity utilization rates since 2003. So investments would be needed to meet rising demand. Given ongoing trade policy uncertainty, some firms are waiting to invest in new capacity, while others are deciding to expand outside of Canada. This could limit exporters’ ability to grow further even as foreign demand rises.

For their part, Canadian oil exports are likely to be stronger than expected in April, following pipeline outages last year. Large upward revisions to oil exports in January suggest that oil exporters recovered much faster from these outages than suggested by earlier data.

Canadian economic developments

Turning now to the domestic economy more broadly, in April we forecast that activity would grow at roughly 2 per cent over the next two years, a little higher than our estimate of potential growth. Over this horizon, we expected the

composition of growth to shift, with a higher contribution from exports and investment, alongside a decline in the contribution from household spending. Despite some short-term fluctuations, we also expected growth to average about 2 per cent in the first half of the year.

Overall, the data we have received since April support our near-term projection. Recall that we saw some weak data at the beginning of the year, but the tenor of the more recent data has improved. In addition to the growth in exports I mentioned previously, manufacturing output was especially robust and investment appears to have been stronger than expected. This good news was partly offset by declines in housing resales and retail sales, which suggest that household spending could be a bit weaker than expected in the first quarter. Taken together, all these factors point to growth for the first half of the year around what we forecast in April.

This continued growth of the Canadian economy is contributing to strong labour markets and higher wage growth. Indeed, recent data from the Labour Force Survey show that wages in April were 3.6 per cent higher than a year earlier. However, the signal we get from this reading is muddied by the high volatility of this series and the fact that last year at the same time wages were surprisingly weak.

Because our different wage indicators are all volatile and sometimes send conflicting signals, the Bank developed a wage measure to help us better capture the trend: the wage-common.[3] According to this measure, wage growth has strengthened considerably from its low in mid-2016, reaching about 2.6 per cent in the first quarter of this year.

This stronger wage growth is consistent with what firms surveyed in our quarterly *Business Outlook Survey* have been telling us. They have indicated that it is becoming more difficult to hire, although firms in energy-producing regions still see little wage pressure. Still, at this point in the business cycle, wages would be expected to increase at an annual rate of around 3 per cent—which is the sum of the inflation rate, about 2 per cent, and trend productivity growth, which is close to 1 per cent. And, given that the recent increase in minimum wage in Ontario is temporarily contributing to their growth, wages are rising somewhat more slowly than we would expect to see in an economy operating at capacity. This may indicate that some slack remains. For example, the share of workers who have been unemployed for more than six months remains significantly higher than it was before the Great Recession.

So a key question is to what extent wage growth could increase as further tightening of the labour market takes place, given that some sectors and regions already face a shortage of workers.

[3] The wage-common is created by extracting the common signal from four sources of wage data (the National Accounts; the Productivity Accounts; the Survey of Employment, Payrolls and Hours; and the Labour Force Survey) and filtering out indicator-specific movements. See D. Brouillette, J. Lachaine and B. Vincent, "Wages: Measurement and Key Drivers," Bank of Canada Staff Analytical Note No. 2018-2 (January 2018); and J. Lachaine, "Applying the Wage-Common to the Provinces," Bank of Canada Staff Analytical Note No. 2018-16 (May 2018).

Historically, wage growth accelerates only after a large and sustained period of excess demand, often with a de-anchoring of inflation expectations. We are not expecting such a situation to develop. Indeed, empirical work by Bank staff shows that, in the past, when the economy was operating only slightly above its potential, wage growth did not increase substantially.[4]

What is more, in many sectors, persistently high unemployment in the wake of the financial crisis and subsequent oil price shock has had a profound effect on the labour market. Workers may have also become more concerned about the impact on their jobs from greater automation and outsourcing. As a result, they may be more reluctant now to ask for bigger raises, even when the economy strengthens.

We can look at regional data to examine how labour markets are adjusting in situations of excess demand. The strong economic growth in British Columbia is a valuable example. While rising labour shortages there should eventually put upward pressure on wages, our regional wage-common measure still shows only moderate wage growth in that province. This evidence is consistent with labour supply adjusting to strong demand. Indeed, higher inbound migration and participation rates among youth and prime-age workers have increased the labour supply in British Columbia in the past couple of years.

Similarly, Quebec has also seen strong job creation, a historically low unemployment rate and sustained wage increases in recent quarters. But the growth in Quebec's labour force is slower than that in British Columbia, contributing to relatively stronger wage growth.

Interestingly, we also see the impact of labour supply adjustment in regional housing markets.

How the labour supply adjusts in the face of rising demand conditions is an issue we are watching closely because it affects the evolution of our economic capacity.

For example, given revisions to past investment and our anticipation that trend labour input will rise over the next three years, we increased our estimate of potential output growth in April to 1.8 per cent. Still, with the uncertainty inherent in measuring potential output, we carefully monitor our measures of underlying inflation to ensure they are consistent with our assessment of economic slack.

As such, core measures of inflation remain essentially at 2 per cent, consistent with the economy operating at close to capacity. However, higher crude oil prices, on average, relative to our April forecast are expected to lead to a higher headline inflation rate in the near term. Monetary policy typically looks through transitory fluctuations such as this, as we did last year when inflation was held down by other temporary factors.

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[4] See D. Brouillette, M. Dockrill, H. Lao and L. Savoie-Chabot, "Bending the Curves: Wages and Inflation," Bank of Canada Staff Analytical Note No. 2018-15 (May 2018).

Yesterday's decision

This brings me to our decision yesterday to leave our policy rate unchanged at 1.25 per cent.

As we have emphasized several times in the past, our policy decisions remain guided by incoming data, since they inform our outlook for growth and inflation. As such, in reaching yesterday's decision, we carefully weighed the information we have received since our April MPR. Let me take a few moments to summarize the developments that factored the most into our deliberations.

First, I want to reiterate that the economy is evolving largely as expected, with inflation roughly at our 2 per cent target and economic activity near potential. Given this context, we began by acknowledging the better-than-expected tenor of many recent economic indicators. As I outlined earlier, manufacturing and investment activity has been solid, and exports are proving to be stronger than we expected in April, helped by increased energy exports. Another positive sign is the 11 per cent increase in nominal service exports in the first quarter, which reinforces our view that services will continue to lead export growth, as they have in recent years.

Similarly, higher prices, on average, for Canadian oil since April should be positive, on net, for the Canadian economy. These higher prices help boost profits of Canadian oil producers and improve our terms of trade—the price we receive for our exports relative to the price we pay for our imports. That said, given the uncertainties the oil sector faces, the prospect of substantial increases in investment are not likely to be as high as in past cycles.

We also noted in our discussions that housing resale activity remained soft into the second quarter, as the housing market continues to adjust to new mortgage guidelines and higher borrowing rates. With other measures of activity in the housing sector more generally holding up, we are still expecting resale activity to pick up over the second quarter. More data from a range of sources in the coming weeks will help further inform our understanding of this adjustment process.

As I discussed earlier, the labour market continues to improve and wages are rising at rates closer to what would be expected in an economy operating at potential. Together with sustained high levels of consumer confidence, this should continue to support housing construction and consumption growth more generally.

Finally, Governing Council still sees elevated trade policy uncertainty as a factor restraining business investment. We expect business investment to increase, but not by as much as it could without this uncertainty. That said, business sentiment and investment intentions remain positive, suggesting that firms are getting on with business and adjusting to this more volatile environment. As such, the greater-than-expected increase in imports of machinery and equipment in the first three months of the year bodes well for business investment growth. This is encouraging because it is consistent with our broader narrative of a rising contribution coming from investment and exports, and it is important to the evolution of economic capacity.

A final point before I conclude. Uncertainty is everywhere and can come from many sources. Regardless of the source, it's important to note that households and businesses continue to make economic decisions as they plan for the future. And so does the Bank of Canada in setting monetary policy. Monetary policy decisions are always made with an imperfect picture of the future, and they must be forward looking, always with our mandate—the inflation target—in mind.

Conclusion

Allow me to conclude. Yesterday, we decided that the current policy stance remains appropriate. Overall, developments since April further reinforce Governing Council's view that higher interest rates will be warranted to keep inflation near target. Governing Council will take a gradual approach to policy adjustments, guided by incoming data. In particular, the Bank will continue to assess the economy's sensitivity to interest rate movements and the evolution of economic capacity.