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An Update on Canada's Economic Resilience

Introduction

It is great to visit Regina during the waning days of summer. I would like to thank Chris Dekker of the Saskatchewan Trade & Export Partnership for the invitation to give an update on Canada's economic performance, and discuss the Bank of Canada's interest-rate announcement yesterday.

The big picture over the summer has been that the global economy is doing well, despite some troubling developments on the trade front. Many countries around the world are continuing to grow and put people back to work. Here in Canada the economy has shown its resilience, operating near capacity for the past year—the first time that has happened since the global financial crisis.

Next week marks 10 years since Lehman Brothers failed; and, after many fits and starts, this period of sustained growth seems like it has been a long time coming. Since the crisis, people in Saskatchewan have also been forced to deal with the consequences of the plunge in oil prices that started in 2014, and lower prices for many other commodities. The Saskatchewan economy returned to growth last year, and it is good to see the expansion here is continuing.

The Canadian economy is now on a solid footing, although we are feeling some headwinds from the trade environment. The recent US tariffs on steel and aluminum mean losses on both sides of the border. Trade disputes between the United States and China are affecting Canadian commodity producers too. And uncertainty about the North American Free Trade Agreement (NAFTA) means a number of businesses are wary of making investments in capacity that would help them take advantage of improved global demand.

I know that these issues are top of mind for many here today. For any business, facing the challenges that come with uncertainty is crucial.

I would like to thank Claudia Godbout, Harriet Jackson and Eric Santor
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Farming in Saskatchewan is now an impressively high-tech business. Yet, to succeed, business leaders in this sector still need to deal with the vagaries of Mother Nature and global commodity prices. Decisions must still be taken and followed through on.

It is surprisingly similar for the Bank of Canada's Governing Council. We have some finely honed economic models to guide us, yet we must take decisions about the policy interest rate amid many unknowns to meet our inflation objective. We also must follow through by communicating with Canadians and with financial markets about our outlook for the economy and inflation.

With that in mind, my remarks today will cover three points: First, how the Canadian economy has evolved since our quarterly Monetary Policy Report (MPR) in July; next, how we have factored developments on the trade side into our outlook; and, finally, I will give you a sense of Governing Council's deliberations that led to our decision yesterday to hold our policy rate steady.

Recent economic developments

When it comes to economic developments, Canada has been thrown several curve balls over the past decade: the financial crisis; lower commodity prices; and now, trade tensions. It was only a little over a year ago that we could see that the adjustment to lower oil prices was sufficiently behind us to begin withdrawing the monetary stimulus we had put in place in 2015. We have raised the policy rate four times since July 2017, to 1 1/2 per cent. During this period, overall Canadian economic performance has been solid and broad-based. Growth has been running close to potential, the rate at which the economy can grow on a sustained basis without sparking too much inflation. And core inflation measures are now around 2 per cent.

Today, the policy rate is still relatively low—by that I mean that it is lower than what we would consider to be a "neutral" rate of interest.[1] The data and other information we have received since July reaffirm Governing Council's view that higher interest rates will be required to achieve our inflation target.

In fact, the global economy is performing largely as we expected, and that is a good thing because it will support growth here at home. Our neighbour to the south has seen particularly strong demand, driven by household and business spending. Some jurisdictions, though, are showing signs of weaker momentum, which may be partly linked to trade measures and uncertainty about trade policy.

Meanwhile, the most recent data for Canada indicate that growth should average near potential over the next couple of years.

Some of you might recall that in our July forecast we were counting on a quick rebound from the marked slowdown in gross domestic product (GDP) growth that we saw during the first quarter of this year. This was an important call because it

[1] The Bank estimates that the neutral rate of interest (nominal) is between 2.5 and 3.5 per cent. For more details, see X. S. Chen and J. Dorich, "The Neutral Rate in Canada: 2018 Estimates," Bank of Canada Staff Analytical Note No. 2018-22 (July 2018).

lent support to our view that July was the right time to raise interest rates by 25 basis points.

The GDP data released last week by Statistics Canada show that we were right on the money; the economy grew at an annual pace of 2.9 per cent between April and June, twice the pace we saw earlier this year. Growth was fuelled by consumption and exports and, to a lesser extent, business investment and government spending.[2] The data support our view that the shift in demand toward exports and investment is continuing. Healthy growth in consumption and home renovations also indicates that households are generally adjusting well to higher interest rates.[3]

A wide range of sectors are contributing to these developments. The resource sector continues to expand after a few tough years. The services sector is also growing in many high value-added areas. For example, in the second quarter computer system design and related services grew more than 10 per cent from a year earlier.

We expect the quarterly profile of GDP growth to be volatile for the rest of 2018, but to still average around 2 per cent. Temporary factors that pushed up exports in the second quarter are expected to unwind, and there have been some outages in the oil sector. Those factors will likely weigh on growth in the third quarter, but do not point to weaker underlying momentum.

All of this is encouraging. And we are making progress in understanding some of the issues that have been on our minds for a while.

The first relates to the housing market and household debt, and how they are responding to a wide range of policy changes. These include the tighter guidelines for mortgage financing that came into effect in January, some provincial measures to target specific housing markets and, of course, higher interest rates over the past year.[4]

We saw resale activity in the housing market slow markedly at the beginning of 2018, particularly in the greater Toronto and Vancouver areas. This swing was amplified by the fact that many households had rushed to secure their financing and complete transactions ahead of the new rules coming into effect. Recent data show that in Toronto resales are rebounding and prices are stabilizing too,

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[2] Business investment growth slowed from the first quarter, as investments in machinery and equipment and in intellectual property products returned to more normal rates after recording double-digit growth earlier in the year.

[3] See Box 3 of the July MPR for an assessment of how increases in interest rates will affect people who will need to renew their mortgages over the next couple of years.

[4] On January 1, 2018, the Office of the Superintendent of Financial Institutions (OSFI) introduced the revised “Guideline B-20.” The guideline imposes a more stringent stress test on borrowers seeking new uninsured mortgages by stipulating that lenders should require such households to demonstrate that they could still service their debt at a higher interest rate. In terms of provincial measures, the “Homes for B.C.” plan included an expanded foreign buyer tax as well as additional tax and transparency measures.

although in Vancouver activity and price growth remain subdued. Other urban markets that had weakened, such as Regina and Saskatoon, have steadied or shown some recovery.

So, on a national basis, sales and prices appear to be stabilizing.

This suggests that borrowers and lenders are adjusting to the range of policy changes as anticipated, and that financial vulnerabilities are beginning to ease. Growth in household credit has slowed, and the household debt-to-income ratio is edging lower. We see an improvement in the quality of new uninsured mortgages, resulting in a smaller proportion of these households becoming highly indebted.[5] What I mean by highly indebted is households with loan-to-income ratios above 450 per cent. These are early positive signs, and we will have an even better view of developments as the data come in.

A second issue that we are always working to better understand relates to developments on the inflation front. The companies that participated in our *Business Outlook Survey* (BOS) during the second quarter told us that capacity pressures and labour shortages were intensifying. Yet, wages were rising less quickly than we would expect in an economy that is near capacity. The latest data indicate that this is still the case: Our preferred measure of wage gains was up by just under 2 ½ per cent in the second quarter.

That said, inflation data for July surprised us on the upside by coming in at 3 per cent. We had expected that inflation would average around 2 ½ per cent in the third and fourth quarters, rising toward the upper end of our target range because of temporary factors such as gasoline prices, rather than pressure from excess demand.[6] Since much of the July surprise was due to a jump in the airfare component of the consumer price index (CPI), we continue to hold this view.

Here is where our measures of core inflation are particularly valuable as operational guides, because they strip out a lot of the noise. Those measures have remained around 2 per cent, supporting our assessment that the inflation increase will be temporary.

Factoring the trade policy environment into the outlook

Let me turn now to the final issue—the trade environment—which has been top of mind for some time given its importance to economic prospects here at home and abroad. And, while Canadian officials have been working hard to resolve the issues, a lot of uncertainty remains.

Canadian businesses are telling us that trade tensions are among several factors keeping them from investing in new capacity, even though both demand and investment intentions are strong in many sectors. Here in Saskatchewan, we have spoken with firms whose investment plans are in flux pending more clarity

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[5] Mortgages in Canada with a loan-to-value ratio of 80 per cent or below do not require government-guaranteed mortgage default insurance.

[6] Other temporary factors pushing inflation above 2 per cent are the effects of minimum-wage increases and exchange rate pass-through.

about NAFTA. Others are exploring whether to invest across the border instead of in Canada. These kinds of responses to uncertainty are not adequately captured by our economic models, so we need to apply judgment. This judgment is informed by our quarterly BOS, as well as by other discussions we have with business people across Canada. Canada is not alone in this—we expect that investment in many other jurisdictions is suffering from similar effects.

To assess the impact of the tariffs that have been announced, we followed two steps. The first step was to look at the potential long-term effects of the recent tariff changes. We used a new model developed by staff that is described in a staff analytical note published this morning.[7] It provides an excellent framework for mapping how trade flows might change and how resources might shift across sectors over a long period of time. The second step was to consider the shorter-term effects—what might happen as businesses and workers adjust over the transition period. This is a process that is too complex for models to fully capture, yet is important to understand for monetary policy. Of course, we also accounted for the effects of countermeasures implemented by the Canadian government.

Taken together, the Bank estimates that the combination of reduced confidence and trade measures already taken will shave about two-thirds of 1 per cent from GDP in Canada by 2020.[8]

We are seeing the effects already. June trade data showed steel exports fell the most since 2008, with little movement in July. Moreover, the value of consumer goods subject to a 10-per cent import tariff fell almost 23 per cent in July, following a run-up in the previous months.

Regarding inflation, we estimated that Canada's countermeasures would temporarily boost inflation by about 0.1 percentage point until the third quarter of 2019. The most recent inflation report from Statistics Canada showed no impact from the tariffs on prices to date. Still, some beer and pop manufacturers have announced plans to raise prices in response to the rising cost of aluminum cans.

The outlook for growth and inflation in Canada is also affected by tariff disputes between big players such as the United States and China. These disputes can cause shifts in global markets that affect the prices of many of the commodities we produce. Reflecting this, the prices of base metals and some agricultural products have softened. Saskatchewan was among the provinces to experience this effect earlier in the summer.

It is important to recognize that the challenges facing Canadian exporters are not only about NAFTA and tariffs. Concerns about weak business investment, firms

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[7] See K. Charbonneau and A. Landry, "Estimating the Impacts of Tariff Changes: Two Illustrative Scenarios," Bank of Canada Staff Analytical Note No. 2018-29 (September 2018).

[8] This estimate includes the impact of tariffs previously imposed by the United States on Canadian softwood lumber and newsprint as well as the new tariffs on steel and aluminum. Table 4 of the July MPR provides details on these tariffs. Although the US International Trade Commission recently overturned the newsprint tariffs, this is not expected to meaningfully change the estimate from the July MPR.

building new capacity outside our borders, and declining market shares existed long before the current trade tensions emerged. Competitiveness issues have been hampering Canadian businesses for some time, even while foreign demand has been growing.

Market share in the United States for Canada's non-energy goods has, in fact, been declining over the past 15 years.[9] The effect has been particularly acute in the manufacturing sector. This trend has meant a much lower share of employment for most manufacturing industries, including automotive and parts and clothing. Regardless of what transpires on the trade policy front, the Bank will still need to better understand the competitiveness issues to assess the extent to which Canada has permanently lost market share and export capacity.[10]

Yesterday's decision

Let me now turn to Governing Council's policy deliberations that led to yesterday's decision. It will not surprise you to hear that the implications of the current trade environment were front and centre. As I just outlined, we have already incorporated into our forecast the expected negative effects of uncertainty on business investment and exports, as well as the effects of US tariffs and Canadian countermeasures imposed so far. These estimates are highly uncertain and may need to be adjusted as we get more information about the NAFTA negotiations and how businesses are adjusting their plans.

Our practice is to not incorporate scenarios that have yet to occur, even though they may be the subject of ongoing discussions. That said, the risks to growth related to trade policies are not just on the downside, particularly in light of the ongoing negotiations. There is some significant upside as well.

Nonetheless, it is important to understand that certain trade developments can result in complex trade-offs for monetary policy.

On the one hand, protectionist measures can be costly in terms of growth and incomes, particularly as businesses and people adjust. A recent study by the Bank for International Settlements (BIS) shows how virtually all regions in Canada, Mexico and the United States could expect lower real wages if these countries reverted from NAFTA to World Trade Organization tariff rates.[11]

On the other hand, protectionist measures create risks to the upside for inflation, especially when the economy is operating near full capacity. In weighing these

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[9] For more details, see N. Labelle St-Pierre, "Decomposing Canada's Market Shares: An Update," Bank of Canada Staff Analytical Note No. 2018-26 (August 2018); and D. Brouillette, J. Dorich, C. D'Souza, A. Gagnon and C. Godbout, "What Is Restraining Non-Energy Export Growth?" Bank of Canada Staff Analytical Note No. 2018-25 (August 2018).

[10] See T. Webley, "Characterizing Canada's Export Sector by Industry: A Supply-Side Perspective," Bank of Canada Staff Analytical Note No. 2018-27 (August 2018).

[11] See R. Auer, B. Bonadio and A. Levchenko. "The Economics of Revoking NAFTA," BIS Working Papers No. 739 (August 2018).

trade-offs, you can be sure that Governing Council will not lose sight of our primary mission. Low and stable inflation will help reduce at least one source of uncertainty for companies and households. Of course, there are a number of structural and other policies that are better suited than monetary policy to help manage what would be complex adjustments.

Governing Council also discussed whether the gradual approach to raising rates that we have been taking over the past year remains appropriate. It is a natural question to ask, given that the economy has been operating at potential for the past year and it is in this part of the cycle when interest rates typically rise to pre-empt a buildup in inflation pressures. As I mentioned earlier, the factors that are pushing inflation to the top of our target band appear to be temporary and not signs of excess demand. These factors mean that inflation could turn out to be higher over the next couple of quarters than we had expected in July, but will most likely fall off afterward barring any new price shocks.

We will need to do a full update of our inflation outlook for the October MPR, but we already have a good idea of when the effects of the temporary factors at play right now are likely to dissipate. For example, the increases in gasoline prices from earlier this year are contributing 0.7 percentage point to above-target inflation today. This effect will largely recede by the first quarter of next year. We have seen this in the past, since fluctuations in energy prices have accounted for about three-quarters of the overall movement in inflation. To do our job without causing undue volatility in growth, we look through these factors, while remaining alert to signs of underlying inflation pressures.

Furthermore, we still acknowledge that there may be more room to grow without causing inflation than we have built into our forecast. We also know that high levels of household debt have made the economy more sensitive to interest-rate increases than in the past. That is because people must commit more of their income to servicing their debt when borrowing cost rise, leaving less for other spending. The fact that the job market has been particularly strong, and that average household incomes are rising, helps this adjustment. Consumer confidence has also been relatively high. All this suggests that the economy is adjusting well and can adapt to higher interest rates.

The bottom line is that Governing Council agreed that the gradual approach we have been following is still appropriate.

Finally, we discussed how much momentum remains in the global expansion. Few would disagree that the United States is showing considerable strength, but some commentators see a relatively flat US yield curve as a sign of trouble ahead. While there are downside risks to any outlook, Governing Council prefers to look at a broader range of indicators. For one thing, the yield curve is not currently inverted, and is therefore not pointing to significant slowing.[12] Besides that, the shape of the curve may not be a reliable signal in the current environment anyway. This is because longer-dated bond yields are being

[12] See E. Engstrom and S. Sharpe. "(Don't Fear) The Yield Curve," FEDS Notes. Washington: Board of Governors of the Federal Reserve System (June 28, 2018).

distorted by a combination of central bank quantitative easing programs and strong private demand for long-dated safe assets. Other indicators to look at include credit spreads, which remain narrow.[13] There may be some downside risk to our July outlook for the global economy coming from trade tensions, and cracks have appeared in certain emerging economies with financial vulnerabilities, but with limited spillovers to other countries.

Conclusion

It is time for me to conclude. In terms of momentum in Canada, we are encouraged that the economy is adjusting well to higher borrowing rates and tighter guidelines for mortgage financing. We are also pleased with the continued shift in the composition of growth toward exports and business investment.

Recent data reinforce Governing Council's assessment that higher interest rates will be warranted to achieve the inflation target. We will continue to take a gradual approach, guided by incoming data. In particular, the Bank continues to gauge the economy's reaction to higher interest rates. The Bank is also monitoring closely the course of NAFTA negotiations and other trade policy developments, and their impact on the inflation outlook.

[13] See M. Leboeuf and D. Hyun, "Is the Excess Bond premium a Leading Indicator of Canadian Economic Activity?" Bank of Canada Staff Analytical Note No. 2018-4 (March 2018).