Canadian economy has room to grow before inflation becomes a problem

By Barrie McKenna
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Canada's economy still has plenty of untapped capacity that will help keep inflation in check and interest-rate hikes gradual, Bank of Canada Governor Stephen Poloz says.

The jobless rate is lower than it's been since Statistics Canada started tracking unemployment in 1976, with wages perking up and many companies running flat-out.

Mr. Poloz acknowledged on Tuesday Canada is in a "sweet spot." But as he surveys the landscape, Mr. Poloz sees an economy that still has lots of room to grow before inflation becomes a serious problem.

Speaking to students and faculty at Queen's University in Kingston, Canada's top central banker laid out a series of reasons why the central bank can afford to go slow on getting interest rates back up to more normal levels, including by accessing vast pools of potential new workers.

"The bank has concluded that there remains a degree of untapped potential in the economy," said Mr. Poloz, wearing his Queen's Arts & Science 1978 maroon-leather jacket. "It means Canada may be able to have more economic growth, a larger economy and therefore more income per person, without generating higher inflation."

The remarks suggest the central bank may move much more tentatively in the coming months as it looks to hike its key interest rate – now at 1.25 per cent – to a more normal level. The bank judges that the neutral rate is between 2.5 per cent and 3.5 per cent – the point where interest rates neither spur new economic activity nor put the brakes on growth.

"Getting there from here is a very gradual process," Mr. Poloz told reporters after the speech.

The central bank has raised its key interest rate three times since last July – most recently in January.

"The policy message of this speech was unambiguous: accommodative monetary policy is not going away any time soon," Toronto-Dominion Bank economist Brian DePratto said in a research note.

The Canadian dollar fell on Mr. Poloz's remarks, losing nearly a full cent to trade at 77.02 US cents.

Inflation has been picking up in recent months, but still remains slightly below the central bank's 2-per-cent target.

Mr. Poloz said boosting the participation rate of women, new immigrants, youth, Indigenous people and the disabled would add roughly half-a-million workers to Canada's labour market.

Canada's economy has reached a "sweet spot," in which many companies are running flat-out and will need to invest in new capacity if they want to continue growing, according to Mr. Poloz.

Mr. Poloz said the central bank is keeping a close eye on this creation of new economic potential as part of its "risk-management approach" to monetary policy.

"If the economy builds more supply than usual, that will put downside risk on inflation," he said. "If less, that will create upside risk to inflation, and it is our job to balance those risks."

For example, adding half-a-million workers to the labour pool would boost Canada's potential output by 1.5 per cent, or $30-billion a year, according to central-bank estimates.

The biggest gain would come by raising the participation rate of prime-age women (those 25 to 54 years old) – now at 83 per cent, compared with 91 per cent for men.

Mr. Poloz cited the example of Quebec, which has dramatically raised the participation rate of prime-age women to 87 per cent from 74 per cent over the past two decades by subsidizing child care and extending paid parental leave.

The country as a whole would add 300,000 people to the work force by matching Quebec's female labour-force participation rate.

The federal government took a step in that direction in last month's budget by announcing extended parental leave benefits through Employment Insurance to encourage dual-parent families to share child-care duties. The government also said it would create 40,000 new subsidized child-care spaces.

Youth represent another source of untapped potential. Mr. Poloz said the participation rate of 15- to 24-year-olds is still below the level experienced before the last recession. Getting back to that threshold would add another 100,000 people to the labour force, he said.

It's more complicated than just making more workers available. Mr. Poloz pointed out that job vacancies are also climbing – reaching 470,000 last fall. Many employers say they can't find workers with the right skills.

Mr. Poloz also highlighted the disinflationary effect of new technology, such as 3-D printers, and the natural churn of workers who quit their jobs to take unfilled positions elsewhere.