David Dodge: Monetary policy choices: the Canadian experience

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Chambre de Commerce France-Canada and Les Canadiens en Europe (France), Paris, 12 March 2002.

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It is a great pleasure to be with you today here in this wonderful and historic city. Canada and France share important links that cannot be weakened by time. There was, of course, a vibrant French presence in North America long before there was a country called Canada. The French contribution to Canada is not restricted to language alone. Canada's legal and political institutions, as well as our culture and way of life, retain a clearly visible French influence, and will continue to do so.

Obviously, our economies and the economic links between our countries have come a long way over the years. The Chambre de Commerce France-Canada was established just after the Second World War. The Chambre has played an important role in reinforcing commercial ties between our two countries that reflect the historical and cultural links already in place. Les Canadiens en Europe is another organization that seeks to strengthen the many ties between us. Today, France and Canada are both members of the G-7–partners at the forefront of the global economy.

The strong links between our two countries are also reflected in the close working relationship between the Bank of Canada and the Bank of France. Since becoming Governor of the Bank of Canada last year, I have been pleased to continue this relationship. I am happy to be working once again with Jean-Claude Trichet, the Governor of the Bank of France. Bank of Canada staff regularly attend the annual seminars hosted by the Bank of France. And I hope we will continue to strengthen the working relationship between our two institutions.

Over the years, both Canada and France have had to make decisions about the framework guiding monetary policy. The authorities in the two countries have made choices that reflect the differences in our economies. Today I'd like to talk about some of these choices, and what they have meant for our countries. As well, I will give you a brief update on Canada's current economic situation and outlook.

Inflation targeting

In the early 1990s, most of the world's central banks found themselves facing a common problem. They needed to make sure that their economies did not return to the high and volatile inflation seen in previous decades. Further, they were looking for a way to keep inflation expectations under control. In general, central banks did a good job with this. Certainly the Bank of France was successful in the early 1990s in building credibility as an inflation-fighting central bank.

At that time, the Bank of Canada and the Government of Canada had come to a shared appreciation of the damage that inflation can do. So they made an important decision in early 1991. They announced a joint agreement to adopt explicit inflation-control targets. The agreement has been very successful in giving Canada low, stable, and predictable inflation. It has been renewed three times—most recently for five years until the end of 2006.

Today, both the Bank of Canada and the European Central Bank are working to strengthen the economies in their jurisdictions. We both want to promote stable growth and rising living standards. And, importantly, we agree that promoting low and stable inflation is the best means to those ends. There are similarities between our inflation-control systems. For example, we both focus on inflation, and we both aim for price stability over the medium term. But there are also some differences that I want to highlight for you today.

The Bank of Canada aims for price stability through its inflation target of 2 per cent. On the other hand, the European Central Bank has an inflation ceiling of 2 per cent, as measured by the Harmonized Index of Consumer Prices. This may look like a subtle difference, but it is important.

For the Bank of Canada, 2 per cent is the midpoint of our 1 to 3 per cent inflation-control target range. It is a target, not a ceiling. Our focus on that midpoint makes it clear that we run monetary policy in a symmetrical way. That is to say, we pay equal attention to any significant movement away from 2 per cent—whether above or below.

When demand is strong, it can push the economy against the limits of its capacity to produce. This will tend to raise future inflation above its target midpoint. In these circumstances, the Bank will raise interest rates to cool off the economy, and return inflation to the target.

But this process also works in the other direction. When demand is weak, as we saw in 2001, this means that future inflationary pressures are likely to ease. So the Bank will lower interest rates to stimulate the economy, absorb economic slack, and return inflation to the target.

By working in a symmetrical way in response to surprises in demand, our inflation-targeting system helps to smooth the peaks and valleys of the business cycle. This promotes sound, and generally less variable, economic growth.

In our experience, we have found that operating this way around our inflation target is an effective way to anchor inflation expectations. Indeed, in recent years, inflation expectations have become firmly anchored on the 2 per cent target.

This is important for the economy. With inflation expectations solidly anchored, investors can better assess the future value of their investments. Savers can be more confident that their purchasing power will not be eroded unexpectedly by inflation. Similarly, debtors can better assess the real burden of their interest payments. Wage bargaining can become less contentious so labour disruptions decrease. The duration of wage and financial contracts can be lengthened considerably. All of this is possible because people are confident that inflation will neither greatly exceed, nor greatly fall below, 2 per cent over the medium term. In short, the real economy works better and is more stable.

Moreover, the credibility of the targets has changed the whole dynamic of the inflation process. Sudden temporary swings in energy prices, or movements in the exchange rate, do not feed into other prices in the economy the way they did in the past. Again, this is because inflation expectations are well anchored.

I should be clear that adopting the inflation targets was not the only thing that happened in the past 10 years to improve Canada's economy. The federal government, and the provinces, proceeded to clean up their balance sheets. Because of that, our public debt-to-GDP ratio is on a sustainable downward path, even during a period of economic slowdown.

This improvement in the public sector balance sheet has led to a sharp increase in national savings. As a result, our net foreign indebtedness fell from a peak of 44 per cent of GDP in 1993 to about 20 per cent today. It is important that we continue to reduce our net foreign debt. In Canada, it is particularly important that we do this before the baby-boom generation retires.

So, based on our experience, I can say that a monetary policy aimed at low, stable, and predictable inflation and a fiscal policy aimed at reducing the public debt-to-GDP ratio work well together. Prudent monetary and fiscal policies reinforce each other's credibility.

The role of a flexible exchange rate

Let me now turn briefly to the role of exchange rates. This is one area where our two countries have made different choices. France is one of a dozen European countries that have chosen a monetary union with a single currency.

This remarkable effort reached a crucial milestone at the start of this year. After existing in electronic form for three years, the euro finally began to circulate as notes and coins. By all accounts, the transition went extremely smoothly. The European Central Bank, and the 12 national central banks, deserve a great deal of credit for handling it so well.

Indeed, the completion of the process has rekindled the debate in Canada: If it is advantageous for France and 11 other European countries to form a monetary union with a common currency, would a similar arrangement for Canada and the United States also be advantageous?

After analyzing the costs and benefits, in my view, a separate, floating currency continues to make the most sense for Canada for the foreseeable future. Let me take a few minutes to explain why.

A floating exchange rate is beneficial for Canada, primarily because our production and trade structures are quite different from those of our major trading partner, the United States.

Let me give you a couple of examples. Canada is a net exporter of primary commodities, while the United States is a net importer of commodities. And unlike the United States, Canada's auto industry is geared heavily toward exports. We produce two cars for every one that is sold in Canada.

Because of the differences in our economic structures, major changes, such as large swings in relative prices, affect Canada and the United States differently. One way or another, the Canadian economy must adjust to these changes. A floating exchange rate is important because it helps the economy adjust to economic disturbances, such as fluctuations in world demand for, and prices of, our products. Equally importantly, it also facilitates adjustments to changes in savings and investment flows.

It is true that the Canadian and U.S. economies are becoming more integrated. It is also true that by forming a monetary union, there would be some savings for Canadians in terms of the transactions costs of converting currencies and hedging against currency movements. So the question might well be asked: Since most of Europe has moved to a monetary union with a single currency, what about North America?

From a Canadian perspective, there are at least three major arguments against monetary union in North America. First, in Europe you have single markets for goods, capital and labour. In North America, we do not have a single labour market.

Second, the structures of the largest economies in the euro zone are more similar than the structures of the Canadian and U.S. economies.

Finally, the euro zone is a collection of 12 countries. Although they differ in size, no single nation dominates the group. In contrast, in North America, the United States is dominant, both in terms of population and economic power.

So yes, North American economies are becoming more integrated. But it does not necessarily follow that the structures of our economies are becoming more alike. As long as those structures remain different, the benefits of a flexible exchange rate will outweigh the associated transactions and risk costs. For Canada, our best choice is to have inflation targets as an anchor for our monetary policy, and a distinct, floating currency. As I have said before, this should remain the case for the foreseeable future.

Now let me turn briefly to the current state of Canada's economy and the outlook for the future.

Recent economic developments and prospects in Canada

The immediate impact and the fallout from last September's tragic events in the United States led to a sharp increase in economic uncertainty around the world. This exacerbated the effects of the global economic slowdown, which had become more evident by last summer.

In those circumstances, the Bank of Canada stepped up the pace of interest rate reduction that had begun earlier in 2001. The aim was to minimize the economic effects of the terrorist acts and to limit the loss of confidence at home. Since last September, we have cut the target for our overnight interest rate by 200 basis points. The total reduction since the beginning of 2001 has been 375 basis points.

This substantial monetary easing will have its maximum impact as we move through this year and into 2003. In addition, tax cuts implemented at the beginning of last year continue to provide significant support to the Canadian economy. Further stimulus will also come from spending on enhanced national security. Thus, both monetary and fiscal policies are supporting our economy as we move forward.

Moreover, there has been an improvement since last autumn in the geopolitical climate and in consumer confidence, both in North America and in Europe. Signs are increasing that the global economy has turned the corner and will firm as the year progresses.

For these reasons, the Bank of Canada expects that the Canadian economy will gain momentum through 2002. While growth in the first half will be moderate, it should accelerate in the second half—to something like 3 to 4 per cent—and strengthen further in 2003.

This means that later this year, our economy should start expanding at rates exceeding the growth of potential output. At that point, the slack that has built up over the past several months will begin to be absorbed. Still, it could be well into 2003 before the actual level of output in the Canadian economy will again reach its potential level.

This implies that core inflation will probably average about 1 1/2 per cent in the second half of 2002. Total CPI inflation is expected to stay below the core rate until late 2002, if energy prices remain near their current levels. Given the profile for output growth, the Bank expects both total and core inflation to move back up to 2 per cent in approximately two years.

Recent economic indicators for Canada show that the worst of the downturn is over. A recovery is underway. There were several positive signs in the fourth quarter national accounts data published last month, including strong household spending. Overall, Canada's economy grew at a 2 per cent annualized rate in the fourth quarter of 2001.

In addition, there was a sizable reduction of inventories in the fourth quarter. This bodes well for the coming months, because the lower level of inventories will underpin future production.

Data for the first two months of this year show that the Canadian economy has added 82,000 new jobs. Car sales are continuing to show strength, as is the housing sector.

The Bank expects that fixed investment in Canada and the United States should start to pick up in the second half of the year. But we are very much aware that this depends on a recovery in business confidence, especially for large multinational enterprises. How quickly and how strongly profits and the confidence of those firms bounce back will have an important bearing on the strength and sustainability of the overall economic recovery.

To sum up, Canada has made some difficult choices in recent years to face the challenges of today's globalized economy. We have found that our framework of a symmetrical inflation target and a floating exchange rate is appropriate for our economy. We have a solid anchor for monetary policy, and inflation expectations are well grounded. Fiscal health has been restored and we will continue to make progress in bringing down our public debt-to-GDP ratio.

Thanks to these improvements, the effects of last year's global economic slowdown on Canada were not as pronounced as they might have been. And with encouraging signs of a turnaround in the world economy and a domestic recovery underway, prospects for the Canadian economy are favourable.