David Dodge: Promoting Canada's economic and financial welfare

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Calgary Chamber of Commerce, Calgary, 18 November 2002.

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Good afternoon, and thank you for inviting me here today. It's been a difficult year for many sectors of the Alberta economy. Certainly, the severe drought hurt many western farmers, and investment in the energy sector was held back by low oil and gas prices. In addition, the slump in the telecom sector has affected Calgary. This said, we believe that the outlook is positive for the province's economy, and I would be very interested to hear your views about this in our discussion later.

In a few minutes, I will spend some time talking about the Canadian economy and its prospects. But first, I want to discuss something that has preoccupied business leaders and public officials for most of this year – the need to restore trust in financial markets, in corporations that raise funds in these markets, and in the financial professionals who monitor them.

Restoring confidence in financial markets

Let me tell you why the Bank of Canada is concerned about these issues. The Bank is not a regulator of financial institutions or markets. But we do have a responsibility to promote financial stability and to oversee systemically important clearing and settlement systems. And we are the fiscal agent of the government, so we are actively involved in the functioning of fixed-income markets. Therefore, we have a keen interest in the efficiency with which financial markets operate.

Confidence is key to the efficient operation of financial markets. In the United States, that confidence has been shaken by Enron, WorldCom, and other corporate and accounting scandals. Despite the fact that problems of that magnitude have not emerged in Canada, confidence in Canadian markets, and markets worldwide, has been affected by events in the United States. That is why we are watching closely the current efforts to restore confidence and trust in corporate reporting and in financial markets more generally. It seems that there have not been exactly the right incentives in place for corporate management, boards, and their auditors and investment bankers to disclose all relevant information and to always act in a manner that is fully conducive to fair and open markets.

The market itself will provide some of the solutions to the problems currently undermining investor confidence. But others may best be dealt with by regulation.

The market does impose its own discipline. It rewards firms that successfully maintain investor confidence, and punishes those that have abused investor trust or are not sufficiently transparent. I have been impressed by how seriously the private sector has responded to the challenges raised by the events of this year. Accounting bodies and regulatory agencies are also seeking ways to improve practices and restore confidence. They are re-examining the role and the responsibilities of external auditors to boards and shareholders – and how these can differ from other duties that auditors are sometimes asked to carry out by management. And they are asking if shareholders and boards have the tools and the power to hold management accountable.

It's important that we continue to work on these issues and, moreover, that we are seen to be working on them. We live in a world where impressions matter and where capital markets are increasingly global. Canadian issuers will be judged not only against our own standards, but also against the worldwide standards for accounting, disclosure, and governance.

At the same time, we must be careful not to impose an overly onerous burden of processes and paper on businesses, particularly on smaller firms, given their importance to the Canadian economy. Let me be clear: the same principles must apply to all public companies. While all businesses must abide by the spirit of the new standards, it may well be appropriate that larger, more widely held firms should face more detailed requirements than smaller firms whose shares are not as widely held.

The challenge of developing an appropriate Canadian formula is made more difficult because we do not have a single lead securities regulator, as do the United States, the United Kingdom, and Australia. I'm not here to argue whether or not Canada should have a single lead regulator. The point is we need to improve our current system, and we need to do it now. If we don't, we risk damaging our reputation in world capital markets.

In sum, the best way to restore investor confidence is to put in place a system of incentives that encourages managers and boards to always act in the best interests of shareholders. Disclosure is key. In every case, shareholders are best protected with full, fair, and accurate disclosure of information. To quote a recent C.D. Howe report, "if reforms cannot help investors distinguish good and bad investment prospects, there is no avenue for improving confidence."

This brings me to an important issue for the Bank. We have a shared responsibility to promote a sound financial system – together with the Department of Finance, the Office of the Superintendent of Financial Institutions, the Canada Deposit Insurance Corporation, as well as provincial and other regulatory bodies. For years, the Bank has been conducting analysis and research related to the Canadian financial system, much of which has been published in the *Bank of Canada Review*, and in technical reports and working papers. We are now prepared to take a further step in the interest of making the information about our financial system more widely available. I am pleased to announce that the Bank of Canada will introduce a new semi-annual publication, *The Financial System Review (FSR)*. We are planning for the first issue to be available late next month. In it, we will publish some of the Bank's ongoing work in monitoring financial system developments and analyzing the direction of financial sector policy. The *FSR* aims to promote knowledge of, and discussion about, changes and developments in the Canadian financial system. I would point out that we are not the only central bank to publish such a document. For example, the Bank of England, the Swedish Riksbank, and the International Monetary Fund also produce similar reports.

Promoting economic welfare through inflation control

While we work to promote financial stability in conjunction with other agencies, we alone are responsible for monetary policy. The foundation for that policy is the inflation-targeting system. How this system works may be familiar ground for some of you, but it is worth discussing again, especially during these uncertain economic times.

The Bank of Canada Act calls on us "to promote the economic and financial welfare of Canada." We want strong and sustainable economic and employment growth. The best way we can help to achieve that is to promote confidence among Canadians in the future purchasing power of their currency. In other words, we want Canadians to be confident that inflation will remain low, stable, and predictable.

For over a decade, following a joint agreement with the federal government, the Bank has operated with a system of inflation-control targets. Under the current terms of the agreement, the Bank aims to keep the trend of consumer price inflation at the 2 per cent midpoint of a 1 to 3 per cent range.

Since we instituted the agreement, inflation expectations have become firmly anchored on our 2 per cent target. Well-anchored expectations promote economic growth and stability. Why? Investors can better assess the future value of their investments. Savers can be more confident that their future purchasing power will not be unexpectedly eroded by inflation. Debtors can better assess the real burden of their interest payments. Wage and financial contracts can be set for longer terms. All of this is possible because people are confident that inflation will stay around 2 per cent over the medium term.

Inflation and the "Output Gap"

Our inflation-targeting system also helps to smooth the peaks and valleys of the business cycle and to avoid the boom-and-bust pattern seen in earlier decades. We do this by acting in a symmetrical manner; that is, we pay equal attention to any significant movement in inflation away from the 2 per cent target, whether above or below.

The crucial task in controlling inflation is to judge how the economy is performing relative to its economic potential. Economic potential is a very important concept, so I want to take a minute to describe it. Potential output, or production capacity, is the amount of goods and services that can be produced without putting pressure – in either direction – on inflation. When the economy is producing less than its potential, economists say there is an output gap. That gap tends to put downward pressure on inflation, so the Bank will ease monetary policy to stimulate growth. We do this by lowering our target for the overnight interest rate. When the economy is operating above its potential, excess demand builds. This puts upward pressure on inflation, and the Bank will tighten monetary policy to try to cool the economy, bring it back down to its level of production potential, and return inflation to the target.

Keep in mind that changes in our policy rate work their way through the economy slowly. It takes up to two years for a change in interest rates to have its **full** impact on demand, output, and ultimately, on prices and inflation. So we have to be forward-looking in our interest rate decisions. At our fixed announcement dates, we are not trying to affect today's inflation. What we are aiming at is future inflation and acting pre-emptively to achieve a balance in supply and demand going forward.

This may sound easy in theory, but the reality is complicated. For one thing, it is impossible to measure the economy's potential with precision. All economists can do is to make their best estimate – a highly educated estimate, I might add, but an estimate nonetheless – of the level of economic activity that represents full capacity. And since one cannot measure potential with precision, it is impossible to measure the exact size of the output gap or the amount of excess demand.

So the Bank looks at a wide variety of indicators to assess how much pressure there is on capacity. We monitor Statistics Canada reports on how closely factories are operating relative to their capacity. We survey businesses across the country to see where firms are feeling production constraints. We look at data from the labour market, as well as figures on input costs and wages. We look at real estate market indicators. And, of course, we pay careful attention to financial market developments.

We also measure inflation and inflation expectations. One key indicator is core inflation, which strips out the eight most volatile components of the consumer price index, along with the effects of changes in indirect taxes on the remaining components. We have found that this measure gives a good indication of the trend of future inflation. Indeed, it has done a better job of predicting the path of total inflation than the CPI itself. All of this gives us a comprehensive view of how the economy is operating relative to its capacity, now and in the future. And I should point out that on the Bank's Web site, you can now find the latest data on the indicators that we look at when we assess capacity pressures.

Canada's current growth prospects

Let me now turn to our economic outlook, and tell you how our views have evolved over the year. In last April's *Monetary Policy Report*, we projected that economic growth would be in a range of 3 to 4 per cent, at annual rates, from the second half of this year to the end of next year. Excess capacity in the economy was expected to be eliminated in the second half of 2003. And we noted that since we had taken our policy interest rates down to historically low levels in 2001, we would have to raise interest rates in a **timely** and **measured** way. So we began to tighten monetary policy, raising our target for the overnight rate three times between April and July, by a total of three-quarters of a percentage point.

By late summer, however, uncertainties stemming from beyond our borders were beginning to mount. We noted that slower growth in demand in the United States was likely to hurt our exports in the short run. We also noted that global financial headwinds could affect spending by Canadian businesses and households. Finally, we said that concerns about corporate governance and the unsettled geopolitical situation could cause some firms and households to delay their spending.

By October, the cumulative impact of slower global growth and the financial headwinds led us to reduce our near-term growth projection for Canada. In our latest *Monetary Policy Report*, we say that we expect growth to average slightly less than 3 per cent, at annual rates, through to the middle of 2003. But assuming that the financial headwinds and geopolitical concerns dissipate in the second half of next year, we should see a strengthening of domestic and foreign demand and the resumption of above-potential growth in Canada.

It is interesting to note that our current view on the **level** of economic activity in Canada by the middle of next year is not far from where it was back in April, although the quarterly growth profile has changed. We still project that the small amount of excess supply remaining in the economy should be taken up as output growth moves above potential growth in the second half of 2003.

Finally, let me say a few words on inflation. In our October *Monetary Policy Report*, we noted that core inflation over the next few months would likely be higher than had been previously anticipated. We cited some specific, one-off movements in relative prices, including insurance premiums and the effects of changes in the structure of Ontario's electricity market. We also said that core inflation would likely move still higher in the fourth quarter of this year, because of the "echo effect" of the price discounting that took place in 2001 following the 11 September terrorist attacks. But we said that core inflation should return to 2 per cent in the second half of next year. We are still of that view. However,

because of the change in electricity pricing in Ontario, the monthly pattern of price movements will likely be different than earlier expected.

In October, we had indicated that higher crude oil prices could continue to push total CPI significantly above the target range at the end of this year. But crude oil prices have moderated in recent weeks. Should this moderation continue, total CPI will likely peak at a lower level than we thought in October.

We also continue to expect that the total CPI will converge with the core rate, around 2 per cent, in the second half of next year. However, we will continue to watch this closely, to make sure that the one-off influences I mentioned earlier do not feed into prices more generally.

To conclude, let me repeat what we said in our last *Monetary Policy Report*. As we go forward, we will need to remove some of the monetary stimulus now in place before the economy reaches its level of full potential. The pace of this action will continue to depend on the balance of domestic and external developments and on their implications for pressures on capacity and inflation in Canada.