David Dodge: Meeting global challenges - the importance of sound economic policies

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Canada-UK Chamber of Commerce, London, UK, 12 March 2003.

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I am delighted to be in London to speak with you today.

We are facing a time of great economic and political uncertainty. While economic activity is close to potential in Canada, most other countries are facing very weak demand and lacklustre economic prospects. And, of course, there is the overriding prospect of a war in Iraq.

Voltaire said that "doubt is not a pleasant condition, but certainty is an absurd one." We policy-makers are rarely burdened with certainty at the best of times, and definitely not these days! In an environment as unsettled as this one, it is easy to become preoccupied with the here and now. But, during such times, it is even more important that we remain focused on the medium-term goals of macroeconomic policy. And that's what we're trying to do in Canada.

Many of my colleagues at international meetings this year have commented on Canada's economic strength. It is true that we've had some good luck. But Canada's strong performance during the past two or three difficult years for the world economy primarily reflects extraordinary efforts made during the 1990s to get our macroeconomic framework - that is, our monetary and fiscal policies - right.

Canada, of course, was not alone in making these efforts. During the 1980s, a consensus developed among OECD nations on the combination of policies most likely to deliver sound economic performance. The consensus grew out of the unhappy experiences of earlier policy experiments. And it was built around four key principles: trade liberalization, structural reform, fiscal prudence, and low and stable inflation.

These four principles work like the four legs of a chair. The chair is steadier when all four legs are equally sturdy. Similarly, an economy is more stable when progress is made on all four policy fronts. And when one of the legs starts to weaken, the best way to restore stability is to build that leg back up, not to cut down the other three.

Canadians spent a great deal of effort over the past decade or so putting the four elements of this policy framework into place. It involved considerable short-term economic pain. But the phrase "short-term pain for long-term gain" is more than just a cliché. Canada is now receiving the economic payoff from this effort. Since 1997, our economy has consistently exceeded the average growth rates of the world's most industrialized countries. And it is expected to do so again this year.

The first principle: trade liberalization

Let me briefly review those four principles and the progress that Canada has made on each. I'll start with the principle of trade liberalization. We all know that freer international trade helps countries to more fully exploit the gains that come from increased specialization and greater productivity and competitiveness. Canada's economy made some difficult adjustments to freer trade during the late 1980s and early 1990s. First, we signed the Canada-US Free Trade Agreement, which came into effect in 1989. Then, in 1994, Mexico joined the group through the North American Free Trade Agreement.

Both of these agreements sparked a great deal of political controversy. And many Canadian companies were understandably anxious to avoid increased competition. As well, the Free Trade Agreement came into effect at a time when monetary policy was tight, to fight the high inflation rates of the day.

Despite initial misgivings, Canadian companies rose to the challenge of increased competition. Some of the sectors that we used to protect the most - such as furniture, clothing, and wine - have since established a strong presence in international markets. Overall, Canadian exports have flourished under these agreements.

And that strengthens our resolve to see freer trade extended beyond regional trading blocs. Canada is hoping to see meaningful progress at the World Trade Organization's Doha round of multilateral talks. Clearly, agriculture is going to be a major hurdle. The developed countries, including all of us in the G-7, have a considerable way to go in terms of liberalizing agricultural trade. And there are other sectors where major effort is required. This effort must be made so that the global economy can benefit. It won't be easy but, in the long run, it will be worth it.

The second principle: structural reform

Complementing trade liberalization is the second principle, which focuses on the need to improve the structure of national economies. The goal here is twofold: first, to increase the flexibility of our economies to adjust to changing world economic conditions; and second, to ensure the longer-run viability of our social - and income - security arrangements.

Structural adjustments are always difficult because reforms will affect various groups in differing and often painful ways. Further, the economic benefits of increased flexibility may take a fairly long time to emerge. But these difficulties should not sway us from the task of reducing rigidities and increasing efficiency.

Canada has made some progress on a number of fronts. For example, governments have taken steps to reduce distortions in the personal income tax system, and have implemented a goods and services tax to replace the outdated tax on manufacturers. Unemployment insurance benefits were also reduced and restructured to strengthen the incentive to work.

Another important structural reform was to our public pension system. In 1996, Canadian federal and provincial governments agreed to changes that would put the Canada and Quebec Pension Plans on a sustainable footing. This meant some restructuring of benefits and a sharp increase in contributions - moves that were as unpopular as they were necessary.

The surpluses in the Canada and Quebec Pension Plans now represent almost 1 per cent of GDP. Furthermore, these surpluses are set aside in special funds that cannot be touched by governments for general use. The assets of the public plan are now managed by the Canada Pension Plan Investment Board, a body that is entirely independent of government. Its sole mandate is to invest the contributions in markets, in order to generate the best possible returns, consistent with prudence, over the long term.

The third principle: fiscal prudence

This leads me to the next principle, which relates to fiscal policy and the need for a more disciplined approach to managing the public purse. Fiscal policy must be guided by the principle of putting the ratio of public debt to GDP on a sustainable, downward track.

In Canada's experience, this was a difficult hurdle to overcome. To be sure, the fiscal consolidation of the 1990s was painful. I was federal Deputy Minister of Finance at that time, and I can tell you that many difficult and unpopular decisions had to be taken. Equally important, the provinces had to make tough choices as they reduced their public spending and restored their fiscal health. But as difficult as those years were, waiting would only have made matters worse.

Well, here's the good news: the vicious circle of rising deficits and debt has become a virtuous circle of balanced budgets and falling debt. Reducing the deficit in the 1990s helped Canada's international credibility. This led to a reduction in the risk premium demanded by international investors. The fiscal improvement meant that the Bank of Canada was able to lower interest rates more easily when economic circumstances warranted. Not only did lower interest rates reduce debt-servicing costs, they also stimulated economic growth, which brought in more revenues to the government. The extra revenues and lower debt-servicing costs, in turn, led to an even better fiscal position. At the end of 2002, Canada's total government surplus represented just over 1 per cent of GDP - not including the surplus in the pension plans.

Last month, Finance Minister John Manley announced a fifth consecutive surplus in the federal budget and projected that the budget will continue to be in a balanced position or better for the next three years. The budget maintained the fiscal planning framework of previous years. That framework includes a $3 billion contingency reserve, which is used to reduce debt if it is not needed. It also includes $1 billion in the upcoming budget year for additional economic prudence, and $2 billion in the following year, as further assurance that Canada won't fall back into deficit.

Canada is expected to have one of the lowest debt burdens in the G-7 this year. Not only have we reduced the debt-to-GDP ratio, but we have paid down almost $50 billion of federal debt. This has led to the restoration of Canada's Triple-A credit rating and has freed up about $3 billion of resources every year for the federal government. The main point is that while the initial work of fiscal consolidation is certainly difficult, it is necessary in order to enjoy the dividends later on.

The fourth principle: low and stable inflation

The fourth principle relates to monetary policy - the responsibility of the Bank of Canada. This principle recognizes that, over the medium term, monetary policy should work to keep inflation low, stable, and predictable.

Let me explain how we do this. Since 1991, following a joint agreement with the federal government, the Bank of Canada has operated with a system of inflation-control targets. I don't plan to spend a lot of time explaining our system to this audience, because the United Kingdom adopted a system very similar to ours a couple of years after we did.

We aim to keep consumer price inflation at the 2 per cent midpoint of a 1 to 3 per cent range. If the trend of inflation moves away from the target in either direction, the Bank will take action so that inflation returns to the target within 18 to 24 months.

Canada's inflation-targeting framework works in a symmetrical way, minimizing the chances of both a sustained upward drift in inflation and the threat of deflation. Indeed, through most of the past decade, we have managed to keep inflation around the 2 per cent target midpoint. And so, Canadians' expectations for inflation have become firmly anchored around 2 per cent. This climate of low, stable, and predictable inflation has helped to smooth out the ups and downs in the economy and to create the best possible environment for longer-term economic growth in Canada.

Inflation and the economic outlook

Let me now give you the Bank of Canada's views on the state of the Canadian economy and the outlook. First, a bit of history. Following the 11 September 2001 terrorist attacks in the United States, the Bank of Canada, like other major central banks, moved quickly and aggressively to cut its policy interest rate to shore up confidence. That dramatic monetary policy action helped a great deal. By the spring of 2002, it became evident that our economy hadn't been knocked off track by the events of 11 September. Indeed, evidence was starting to build that the economy was growing faster than its production potential, taking up the remaining small amount of economic slack. So, we raised our key policy rate three times between April and July, by a total of three-quarters of a percentage point.

But by late last summer, we were seeing the effects of financial headwinds, geopolitical uncertainties, and continued weakness in the global economy. These factors remained in play through the autumn. As a result, we refrained from raising interest rates, even though inflation was accelerating.

Our initial analysis was that this increase in inflation would be temporary. However, both core and total CPI inflation remain well above target. This reflects the impact of higher-than-expected prices for crude oil and natural gas, continuing increases in auto insurance premiums, and price pressures in certain sectors, such as housing, food, and some services. The higher inflation also suggests an underlying firmness in the price-setting environment. In other words, relative price increases wouldn't be pushing up trend inflation if there was not sufficient demand.

Indeed, final domestic demand - especially household spending - has remained robust. However, economic growth in Canada moderated in the final three months of 2002, largely because of weaker exports - most notably, a decline in automotive shipments to the United States.

Even with this slowing growth in the fourth quarter, upward revisions for previous quarters leave the level of economic activity slightly higher than we had been monitoring. In fact, Canada's economy remains near full capacity.

Let me list some of the indicators that support this view: high industrial capacity utilization; near record-high labour force participation rates; a record-high employment-to-population ratio; corporate profits at their highest level since early 2001; and, as I said a few moments ago, above-target trend inflation.

While we continue to foresee growth somewhat below potential in the first half of this year, we expect increased demand in the second half of 2003 and into 2004, as global uncertainties diminish. But with an appropriate reduction in the amount of monetary stimulus, we see the level of output remaining close to capacity during this year and into 2004.

So, in making our interest rate decision on 4 March, we weighed the following considerations: domestic inflation pressures, the expectation that Canadian economic activity will remain near potential in 2003 despite geopolitical uncertainties, the stimulative stance of monetary policy, and improved conditions in capital markets. Taking all of these factors into account, the Bank raised its key policy rate by one-quarter of a percentage point to 3 per cent.

Even with this increase, the stance of monetary policy remains stimulative. Thus, over time, further reductions in monetary stimulus will be required to return inflation to the target over the medium term. But, as we have said, the timing and pace of increases in policy interest rates will continue to depend on a number of considerations. These include the strength of demand pressures; the evolution of inflation expectations; the impact on confidence of geopolitical and global economic uncertainties; and the way in which developments in the Middle East affect demand and inflation, both globally and in Canada. The Bank will continue to closely monitor all of these factors.

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Let me conclude. At the beginning of my talk today, I noted that, for over a decade now, Canada has followed a policy based on the four key principles: trade liberalization, structural reform, fiscal prudence, and inflation control. It's never easy to follow those principles, but, over the medium term, they do lead to better economic performance.

Canada's recent economic record is evidence of that. We have maintained an enviable growth performance through what has been a very difficult period for the world economy. We remain optimistic - and so do others - that we will continue to do so. Both the OECD and the IMF predict that Canada's economy will outperform those of other G-7 countries this year.

But these are difficult times. Significant geopolitical and global economic uncertainties continue to overhang the economic outlook for all countries. It is during times like these that policy-makers may be tempted to put the four principles aside and focus instead on short-term economic problems.

In Canada, we have learned that it is by sticking to these principles that we create economic structures that can withstand turmoil. The four policy principles have proven to be the most effective tools for meeting the challenges of a very uncertain world.