David Dodge: Policies to sustain growth domestically and internationally

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Foreign Bankers' Association in the Netherlands, Amsterdam, 13 May 2003.

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Good afternoon, ladies and gentlemen. I have been looking forward to coming to Amsterdam since Governor Wellink extended the invitation last year. I must say that when you consider what has been happening in the world economy, it is certainly an interesting time to be a Canadian at international meetings such as the BIS meeting I attended yesterday. My colleagues from other central banks have often commented on Canada's relatively strong economic performance over the past two or three years. In response, I have told them that there is certainly an element of good fortune in that performance. But, fundamentally, it reflects the extraordinary efforts made during the 1990s to put a coherent economic policy framework in place, and I want to begin by talking about that framework.

The four principles of economic policy

Let me quickly add that this is not simply a Canadian story. The framework that I'm talking about emerged from international discussions and has relevance for all national economies. In the 1980s, a consensus was reached among OECD countries on a set of economic policies that would provide the strongest base for sustained economic growth. This consensus is based on four principles: trade liberalization, structural reform, fiscal prudence, and inflation control. I will spend a few minutes on each one of them, drawing on Canada's experience in recent years.

Let me begin with *trade liberalization*. Your own mission statement acknowledges the importance of the free flow of goods and services, as well as of capital and people, within the European community. Freer international trade allows countries to better exploit the gains made from increased specialization and enhanced productivity.

Canada has promoted reduced barriers to multilateral trade since the Havana Conference of 1947, which launched the General Agreement on Tarriffs and Trade. In 1989, Canada signed a free trade agreement (FTA) with the United States. In 1994, Mexico joined the group through the North American Free Trade Agreement (NAFTA). Both of these agreements initially sparked a great deal of political controversy in Canada. However, they have opened up markets and created tremendous opportunities for Canadian entrepreneurs. Our exports have flourished as a result.

But freeing up trade means more than setting up regional free-trade blocs, such as NAFTA and the European Union. Canada is hoping to see meaningful progress at the World Trade Organization's Doha round of multilateral talks. Clearly, agriculture and a number of other sectors are going to require a major effort. 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 in the OECD policy consensus has to do with *structural reform*. There are two goals here: one, to increase the flexibility of our economies in order to adjust to changing world economic conditions; and two, to ensure the longer-run viability of our social- and income-security arrangements. These adjustments are always difficult, because reforms will affect various groups in different, and often painful, ways. Further, the economic benefits of the 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 in a number of areas. The federal government has made changes to its system of unemployment insurance, trying to base the program more on insurance principles and to improve the employability of labour. Canada has also taken steps to reduce distortions in the personal income tax system and has slashed industrial subsidies by roughly two-thirds.

More recently, we made some major changes to our public pension system, to better prepare for the inevitable pressures that will develop as our population ages. This meant some restructuring of benefits and a sharp increase in contributions—moves that were not popular, but were certainly necessary. In addition, the federal and provincial governments agreed to set up the Canada Pension Plan Investment Board, an entirely independent body. Its sole mandate is to invest the contributions in markets, in order to generate the best possible returns over the long term, with due consideration for

prudence. Demographic pressures are also being felt, perhaps even more strongly, in some European countries, where various governments have dealt with, or are struggling with, this issue.

The third principle in the OECD policy consensus has to do with *fiscal prudence* and the need for a disciplined approach to managing the public purse. In the years leading up to the mid-1990s, provincial and federal governments in Canada ran large budget deficits. These deficits built up as governments continued to borrow, primarily to finance current consumption. It was an unsustainable situation, made more serious by our aging population. Clearly, social spending had to be put on a viable long-term course. And so fiscal policy needed to be based on a plan that would put the ratio of public debt to GDP on a steady downward track. This was a difficult hurdle to overcome, and the fiscal consolidation of the 1990s was painful.

Now, here's the good news. Since that time, the vicious circle of rising deficits and debt has become a virtuous circle of balanced budgets and falling debt. Reducing, and ultimately eliminating, the deficit in the 1990s helped with Canada's international credibility. And this led to a reduction in the risk premium demanded by investors. The fiscal improvement meant that the Bank of Canada was in a position to lower interest rates more easily when economic circumstances warranted. The lower interest rates reduced debt-servicing costs, stimulated economic growth, and boosted government revenues, which led to an even better fiscal position. The main point here is that, while the initial work of fiscal consolidation is certainly difficult, it is necessary in order to enjoy the fiscal dividends later on.

The final policy principle is the one that relates most directly to the Bank of Canada's primary responsibility—monetary policy. The OECD consensus holds that *price stability* is the appropriate goal for monetary policy over the medium term. In Canada, we try to achieve this goal through an inflation-targeting system. The Bank of Canada reached an agreement with the federal government in 1991 to try to keep inflation, as measured by the consumer price index, at the 2 per cent midpoint of a 1 to 3 per cent target range over the medium term.

Importantly, we take a symmetric approach to our inflation target. This means that we worry as much about the trend of inflation falling below the target as we do about inflation rising above the target. We have found that this symmetric approach has been very effective in promoting low, stable, and predictable inflation in Canada. Following a period of higher and more variable inflation in the 1970s and 1980s, the inflation-control targets helped to anchor monetary policy. Inflation quickly fell into the target range, and inflation expectations became focused on the target. This has helped to smooth out the ups and downs of the business cycle and, more generally, has led to stronger economic growth in the long term.

Those are the four principles on which the OECD policy consensus is based: trade liberalization, structural reform, sound fiscal policy, and monetary policy focused on inflation control. Canadians spent a great deal of effort putting the four elements of this framework into place over the past decade or so. It certainly was not easy. It involved a fair bit of short-term economic pain. But the phrase "short-term pain for long-term gain" is more than just a cliché. Canada is now reaping the economic benefits of that effort. In the face of all the negative shocks that hit the global economy in the past two or three years—war, terrorism, corporate governance and accounting concerns, and the collapse of the technology sector—our economy has proven resilient.

With all of the uncertainty in the global economy, it is more important than ever that national authorities around the world stick to a sound economic policy framework. It is only by staying the course that we can establish a steady base for sustained economic growth over the longer term.

I don't want to leave the impression that the way Canada has implemented the OECD policy consensus is the only way to go. Nor do I want to suggest that we have achieved perfection. There is still work to be done in all four areas of the framework, particularly in relation to microeconomic policies. Policy-makers should always be looking for ways to improve economic performance. In that vein, I now want to return to the topic of monetary policy and talk briefly about the potential role of asset prices in monetary policy.

Asset prices and monetary policy

Let me emphasize that I believe that our monetary policy framework, based on an explicit inflation-control target and a floating exchange rate, is the best choice for Canada. Our floating currency helps facilitate the economic adjustments that will always be necessary when shocks occur. This is particularly important for a relatively small and open economy such as ours. All told, Canada has a

coherent monetary policy regime that has proven its worth—one that gives us a solid base for sound long-term economic growth.

But the recent dramatic fall in the share prices of so many technology firms—the so-called bursting of the tech bubble—highlighted the debate about the role of asset prices in the conduct of monetary policy. It somehow seems appropriate that I should talk about this question here in the Netherlands, the location of one of the most famous asset-price bubbles in history—the tulip bubble of the seventeenth century.

This episode, where mass speculation led to the dramatic rise and subsequent collapse in the price of tulip bulbs, illustrates that asset-price bubbles can have serious repercussions for a country's economy when they burst. There has been a tendency recently, particularly in the United States, to ask whether central banks "should try to pop bubbles when they see them, before they get too large". Let me be clear: I do not believe that central banks should try to target asset prices in the same way that we target the inflation rate. And I do not believe that we should be in the business of popping bubbles. To do so would be unrealistic. It would presume that central bankers know better than anyone else what represents fair value for assets. We don't.

Instead, the real issue is, What is the role of asset prices in the setting of monetary policy? Central banks—and here I'm speaking about the Bank of Canada in particular—do take into account the information contained in asset prices in a number of ways. When we set interest rates, we look at cost-of-capital effects and wealth effects, as well as the impact of changes in asset prices on confidence. And there are some asset prices, expressed as the yield spread between high- and low-risk bonds, that give an indication of credit conditions in the economy, so we look at those too. Other asset prices, such as the cost of new houses, form part of the Bank of Canada's core measure of consumer prices, and are therefore taken into account directly.

So clearly, movements in asset prices do play a role and are taken into consideration when we set monetary policy. All of these ways of looking at asset prices provide some information about the future inflation environment within our 18- to 24-month horizon for inflation targeting. But the broader question is, Are there ways in which asset prices can give central banks information about price pressures beyond this medium-term horizon? If so, what should be done about it?

Let me give you a more concrete example. Consider the following scenario for an inflation-targeting central bank. Let's assume that inflation is near its target, but demand in the economy is weak, and the output gap is widening. This situation would normally call for an easing of monetary policy. But what if, at the same time, there was evidence that the prices of assets such as equities or real estate were rising well above historical norms, or that there was a real surge in credit issuance relative to historic levels, or evidence of speculative overinvestment? Should a central bank then adopt a somewhat tighter policy than it otherwise would? And if it did, would this be effective in limiting the rise in asset prices? Should the central bank run the risk of inflation falling below the target, to help guard against a much more serious disinflationary correction of financial imbalances later on? There are no easy answers to these questions, but we have to continue to think hard about them.

The role of the exchange rate

That hard thinking must equally be applied to what is, in effect, another class of asset prices. I am referring to the price of a country's currency—the exchange rate. This is particularly true at times when we see large movements in exchange rates. So it is an issue that faces us all, given the recent sharp depreciation of the U.S. dollar against the Canadian dollar, the euro, the pound, the Australian dollar, and others.

What does this movement mean for the Bank of Canada? As with other asset prices, the Bank does not have a target level for the currency. Its price is determined by the markets, and the floating exchange rate is an important part of our monetary policy system, as I mentioned earlier.

Thus, in setting monetary policy in the context of this system, we do take into account these movements, and what they tell us about demand and inflation. Insofar as movements in the exchange rate do affect the prices of imported goods, we must take them into account because they bear directly on what we do target; that is, the inflation rate. However, we have found in recent years that the pass-through from exchange rates to prices has been less pronounced than in the past. We also try to ascertain the primary causes of the movements in exchange rates, and whether these movements are giving any information about factors that are affecting real economic performance. To the extent that

movements in the Canadian dollar reflect fundamental factors at work in the Canadian economy, such as strong economic performance or higher prices and stronger demand for non-energy commodities, then we clearly need to take these into account.

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Let me close by reiterating that aiming for low, stable, and predictable inflation is a crucial component of the OECD policy framework, along with sound fiscal policy, structural reform, and trade liberalization. In my view, the debate about the role of asset prices in monetary policy is not an argument for moving away from inflation targeting. But I hope that my discussion of the potential role of asset prices in monetary policy underscores the idea that we should never stop looking for ways to improve our economic policy framework, so that we can continue to promote sustainable economic growth and prosperity.