David Dodge: Challenges facing Canada's manufacturing sector

Opening statement by Mr David Dodge, Governor of the Bank of Canada, to the House of Commons Standing Committee on Industry, Science and Technology, Ottawa, 30 May 2006.

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Good morning, Mr. Chairman and members of the Committee. It is an honour to be invited to appear before you and to help you in your examination of the challenges facing Canada's manufacturing sector.

As far as I am aware, this is the first time that a Governor or Senior Deputy Governor of the Bank of Canada has appeared before this committee. So I thought it would be appropriate to begin with a very brief description of the framework in which the Bank conducts monetary policy. Then I will talk about the global forces that are posing challenges for our manufacturing sector, and what they imply for the economy as a whole. Finally, I will share with you some of the evidence we have gathered about how Canadian manufacturers are adjusting to these challenges.

The Bank of Canada Act calls on us to "mitigate … fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada." Over time, it has become clear that the best way for us to fulfill this mandate is to keep inflation low, stable, and predictable. Specifically, we aim to keep the annual rate of consumer price inflation at the 2 per cent midpoint of a 1 to 3 per cent target range.

To keep inflation on target, we try to keep the economy operating at its full capacity. By this, I mean that we aim for a balance between total demand and total supply in the economy. Simply speaking, if strong demand for Canadian goods and services were pushing the economy as a whole against the limits of its capacity, and if inflation were poised to rise above the target, the Bank would raise its key policy interest rate. This, in turn, would push up other interest rates and help to cool off demand, thus keeping supply and demand in balance and inflation on target. On the other hand, if the economy as a whole were operating below its production capacity, and inflation were poised to fall below the target, the Bank would lower its key policy rate to help stimulate demand. By maintaining low and stable inflation, monetary policy helps to keep the economy operating at full capacity and promotes greater stability in economic output. This point is crucial in helping the economy adjust to global economic forces.

A key element of our monetary policy framework is the floating exchange rate. Let me be clear: we do not have a target or preferred exchange rate for the Canadian dollar. But it is an important relative price in our economy. In terms of the Bank's monetary policy, exchange rate movements give us information about economic developments that may be having a direct impact on demand in the Canadian economy. And the movements themselves have their own effect on demand, by changing relative prices for Canadian goods and services and by shifting demand between domestic and foreign products. The challenge for the Bank is to evaluate these movements, together with other data, and set a course for monetary policy that works to keep demand and supply in balance and inflation on target.

When the Canadian dollar rises or falls, we try to determine how much of that movement is due to changes in world demand for our goods and services, and how much is due to other unrelated factors. It is important that we understand the causes of exchange rate movements, because the implications for the economy—and the appropriate monetary policy response—depend on the cause of the change. We set out a fairly detailed explanation of this in our January 2005 *Monetary Policy Report Update*, which is included in your package.

That's a very quick look at our framework. Now, let me apply that framework to our current situation. I am sure that the members of the committee are well aware of the global forces that are affecting not just Canadian manufacturers, but the entire economy. In the past few years, we have had extraordinarily strong global economic growth. There has also been an unusually high amount of liquidity in the global economy, which central banks are now in the process of removing. Meanwhile, we have seen a persistent and growing current account deficit in the United States, mirrored by large and growing current account surpluses elsewhere, especially in Asia and among many oil-exporting

countries. These imbalances reflect the financial flows associated with mismatches in savings and investment on a global scale.

We have also seen the emergence of China and India as economic powerhouses. The strong growth in these countries and other emerging-market economies has led to sharply higher prices for many of the products that Canada produces. At the same time, intense competition from manufacturers around the world has led to lower prices for many consumer durable and semi-durable goods. All of this has resulted in an improvement in our terms of trade and higher incomes for Canadians—particularly for producers of commodities, metal products, energy products, building materials, and machinery. We have also seen a rapid rise in the external value of the Canadian dollar. This increase largely, though not entirely, reflects stronger global demand for Canadian goods and services.

Against this backdrop, Canadian manufacturers have been getting more efficient. Indeed, we have seen a tremendous rebound in manufacturing productivity—output has increased even while the number of jobs has been reduced. This has been very difficult for many workers in the manufacturing sector who have lost jobs as a result of these changes. We all recognize this. But we must also recognize that this reflects, in part, the fact that many firms are taking advantage of the strong Canadian dollar to invest in machinery and equipment in order to improve their productivity. These productivity gains bode well for the future—improved efficiency helps to improve our international competitiveness and our ability to adapt to shocks and to shifting trends in the global economy.

Indeed, we see businesses across the country working hard to adjust to an increasingly competitive environment. We have been tracking this adjustment through our regular communication with business groups, manufacturers, and exporters, as well as through the Bank's *Business Outlook Surveys*. You will find a copy of our spring *Business Outlook Survey* in your package.

Our surveys have highlighted three areas that are posing problems for manufacturers—labour shortages, the appreciation of the Canadian dollar, and competition from Asia. Let me say a few words about each of these areas. Our surveys have shown that the key problem for some manufacturers, like firms in other sectors, has been a shortage of skilled labour. But despite the difficulty in attracting skilled labour, our most recent survey showed that hiring intentions remain strong across most sectors and all regions. Many of the workers who will be hired to alleviate labour shortages in expanding sectors are those who are being released from sectors that are growing less rapidly.

Since 2003, when the Canadian dollar began to appreciate, we have regularly asked businesses how they have been adjusting to the appreciation of the Canadian dollar. Roughly half of the firms surveyed say they have been adversely affected by the rise in the Canadian dollar. Most of these are firms that are highly exposed to international trade—including manufacturing.

Finally, many firms that we surveyed also say that they have felt the effects of increased competition from Asia, in addition to significant increases in their input costs, particularly higher energy costs.

In response to these three challenges, many firms have undertaken a profound restructuring of their businesses. Indeed, some 80 per cent of manufacturers surveyed reported changing their operations. Many firms are repositioning themselves to specialize in higher value-added production. Some have abandoned labour-intensive mass production in favour of small lots and customized products. Many are improving the quality of their products and services. Others have transferred labour-intensive production offshore, but have kept and developed their high-skilled operations in Canada.

Let me make one last very important point. From our discussions and our analysis of the data, it is clear that manufacturing is not a monolithic sector. There is no single strategy that will work for every manufacturer, because every business is unique. Some manufacturers face sector-specific challenges. Others, such as those producing machinery and equipment, are facing booming demand. But while each business is unique, most of them are looking for ways to adapt to, and thrive in, these challenging times.

Paul and I will now be happy to answer your questions.