Paul Jenkins: Weathering economic shocks – the importance of flexibility

Remarks by Mr Paul Jenkins, Senior Deputy Governor of the Bank of Canada, to the Vancouver Board of Trade, Vancouver, BC, 13 September 2006.

*   *   *

Today, I would like to talk about the importance of flexibility to economic adjustment and, hence, about the need to adopt economic policies that promote flexibility in markets for goods, services, capital, and labour. I am particularly pleased to be discussing this issue here in British Columbia where adjustment to changing global and domestic economic developments has been front and centre in the management of your economy.

First, I should explain what I mean by flexibility. As most of you are surely aware, the Bank of Canada has been openly discussing the importance of promoting policies that support economic efficiency, including financial system efficiency. Efficiency refers to the allocation of scarce economic resources to the most productive uses, in a cost-effective way. Flexibility refers to the ability of an economy to adjust to changing circumstances. When economic conditions change, this typically causes movements in relative prices that send important signals to markets. A flexible economy is one that adjusts to these signals and returns to its production potential as quickly, and with as little cost, as possible. Economic flexibility is what I wish to focus on today.

Why flexibility is so important

Over the past several years, economic expansion in Canada and around the world has been robust. And, as we look ahead, prospects remain generally upbeat.

In some respects, what we have witnessed in terms of economic performance is unprecedented, especially since it has been attained in the face of major global and country-specific shocks that, in the past, would have caused great difficulty and threatened to derail the expansion.

This was certainly the case in Canada before the mid-1990s when the economy had a hard time dealing with economic and financial shocks. The boom-bust cycles of the 1970s, 1980s, and early 1990s stand out as clear evidence that we did not have our domestic house in order. The final straw was the extent to which the Canadian economy got caught up in the backwash of the 1994-95 Mexican peso crisis because of our high and unsustainable levels of public debt at that time.

Indeed, the year 1995 proved to be a watershed. By then, the Bank had succeeded in reducing inflation and anchoring short-term inflation expectations to the 2 per cent target. The federal budget deficit began to shrink significantly in 1995, and by the 1997/98 fiscal year, it had moved into a surplus position. Other structural policies, including tax reform and free trade, were also beginning to pay dividends.

Canada's economic record over the past decade stands in stark contrast to this earlier period. Output and employment have continued to grow steadily since the mid-1990s, even as our economy has been buffeted by a series of significant shocks.

Let me recall some of those shocks.

They started with the 1997-98 Asian financial crisis, which then spread to Russia and Latin America. This series of events in emerging-market economies led to a sharp decline in world demand and commodity prices and, hence, to a marked depreciation of the Canadian dollar. Next came the worldwide collapse of the high-tech bubble. It, too, depressed foreign demand for Canadian goods and services, as did the 9/11 terrorist attacks in the United States. On a relatively smaller scale, since the beginning of this century, the Canadian economy has had to contend with other domestic calamities that also had an international dimension to them. I'm referring, of course, to SARS and BSE. More recently, we have had to face intensified competition from major new global players, notably China and India. And, since 2003, we have experienced a sharp appreciation of our currency, which primarily reflects strong world demand and high prices for the energy and other commodities we produce.

What have been some of the key characteristics of these shocks?

The Asian crisis of 1997-98 and the circumstances we have been experiencing since 2003 have involved large movements in relative prices. By this I mean sharp movements in the prices of energy and non-energy commodities (relative to the prices of other goods we produce) and in the exchange rate for the Canadian dollar. These movements have triggered important shifts in economic activity and reallocations of production resources across sectors and regions of our economy. Following the Asian crisis, we saw a shift out of commodities and into manufacturing. Now we see a shift in the opposite direction. And the current intense competition from Asia is clearly evident in reduced prices for manufactured consumer goods.

Adjusting to these shocks has not been easy – indeed, for many firms and their workers it has been downright painful. Still, as I said earlier, total output and employment have continued to grow at a good clip over the past decade - averaging 3 and 2 per cent a year, respectively. Furthermore, during the current episode of marked movements in relative prices, there has been broad-based economic growth across all Canadian regions.

Canada is not the only economy that has coped better with recent shocks. To varying degrees, other countries have as well - which partly explains why world economic growth has held up better this time around.

Clearly, many national economies have been able to respond more flexibly than in the past to unexpected developments. And this has helped to mitigate the impact of shocks, advance the adjustment, and support continued strong economic performance.

This increased flexibility has been the product of economic policies and structural reforms that many countries, including Canada, have undertaken over the years to strengthen their economies and make them more resilient to shocks.

But this does not mean that we have nothing to worry about as we look ahead. We live in an era of rapid change, and we operate in a global environment that is constantly shifting. Uncertainty, risks, and shocks are a constant feature of the economic landscape. For Canada, this is particularly relevant given how open our economy is to international trade and capital flows.

At the Bank of Canada, we believe that world economic prospects remain favourable as we look out over the medium term. But while this reflects our central expectation of how the world will unfold, there are important upside and downside risks around this scenario. On the downside, persistent global imbalances immediately come to mind, as does the lack of success in the Doha round of trade talks. These risks could result in significantly slower global economic growth. At the same time, we cannot rule out the possibility of stronger growth, especially in Asia.

Of course, we know that events can turn out very differently from our expectations today. So we must plan accordingly. In terms of potential risks and sudden developments, the best approach is to constantly ask ourselves what steps we can take to make our economy and domestic markets more flexible and thus better able to adapt. And we need to recognize that the pursuit of such an approach is a *shared* responsibility among firms, workers, and policy-makers.

Firms and their workers need to be able to respond quickly to technological advances and to various shocks that require significant changes in the way they conduct business, the type of goods and services they produce, and the markets they choose to develop. A well-functioning market-based economy and clear relative price signals are critical in this context. At the same time, policy-makers need to be wary of barriers to adjustment, such as labour regulations that inhibit the movement of workers from one type of job, or from one sector or region, to another. Some of these issues are particularly relevant in a Canadian context, and I will return to them later.

The key point I want to make here is that economic policies and structural reforms that enhance flexibility make it easier to withstand shocks and to make adjustments. And this helps to maintain output at the economy's production potential. Put differently, strong, well-functioning domestic markets for goods, services, capital, and labour are essential to the economic well-being of Canadians.

In addition, with national economies so closely connected these days, actions by individual countries to increase flexibility translate into an even greater cumulative benefit for the world economy. Indeed, the greater the number of economies that are flexible enough to adapt to changing circumstances, the stronger and more sustainable world economic growth will be.

So what are the policies that promote flexibility and thus position us to take advantage of the opportunities offered by globalization and to cope with unforeseen shocks that are sure to come our way?

Policies that promote economic flexibility

In Canada – and in many other countries – better macroeconomic management has been instrumental to the good economic performance of recent years.

Specifically, a monetary policy focused on low, stable, and predictable inflation has helped Canadian businesses read price signals more clearly, respond to relative price changes more promptly, and generally allocate production resources more efficiently. And this, together with the Bank of Canada's *symmetric* response to deviations from the 2 per cent inflation target has contributed to solid and more stable economic growth over the past decade.

A floating exchange rate - which is the other key component of our monetary policy framework – has also provided an important stabilization mechanism for the Canadian economy. Movements of the exchange rate provide clear price signals that help speed up adjustment to shocks with lower overall economic costs than if the exchange rate did not move. With a fixed exchange rate, it takes longer for price signals to be recognized, and the adjustment primarily takes place through changes in domestic prices and wages, at the cost of significant variability in output and employment.

It is also important to recognize that it is simply not possible for a central bank to successfully control both the domestic and external values of its currency at the same time. We have only one instrument – our policy interest rate – and so we can have only one target. Thus, with inflation as our target, we naturally operate with a floating currency.

A sound fiscal policy, focused on reducing public sector debt levels relative to the size of the economy, has also contributed significantly to economic stabilization. It gives governments flexibility to respond to evolving circumstances and unexpected developments. They can do this by letting automatic fiscal stabilizers work to help sustain the overall level of demand when the economy is weak or to relieve demand pressures when the economy is booming.

We also know from bitter experience, especially through the late 1980s, that economic outcomes are better and adjustments less costly when macroeconomic policies are working in tandem. In this regard, given the current strength of domestic demand in Canada and the high level of resource utilization, governments need to guard against adding to any excess demand pressures.

Despite considerable progress in Canada and elsewhere in maintaining macroeconomic stability, the growing integration of the world economy has made it clear that this is not enough. To enhance flexibility, raise the economy's growth potential, and increase resilience to shocks, we also need structural reforms.

For Canada, structural reform has a broad context, with many priorities across a number of jurisdictions. I'll mention a couple that I consider to be particularly relevant.

The financial system, with its vital role in supporting a healthy modern economy, has been and will continue to be a top priority. Here, the ultimate goal should be an innovative, efficient, and sound financial system that can provide specialized financing services competitively. Such a system enhances overall economic flexibility by helping to redirect capital and resources to the most productive uses, in a cost-effective way, following a shock.

Removing internal barriers to the free movement of goods, services, and labour is another priority. This is an area that is rightly attracting renewed attention, as differences in regional economic performance and shortages of skilled labour are becoming more pronounced, and as demographic challenges begin to intensify.

A number of initiatives to remove internal barriers have been undertaken over the years - but with mixed and generally modest results. Here, I'm thinking of the "Red Seal" program, which was introduced 45 years ago to help standardize and recognize workers' trade qualifications. I'm also thinking of the Agreement on Internal Trade (AIT), which was signed by First Ministers in 1994 and was aimed at reducing barriers to the movement of goods, services, investment, and labour.

More recently, we have seen some progress in areas such as procurement practices, enforcement and dispute resolution, and licensing and residency requirements for employment. One recent example is the accord reached this past April between British Columbia and Alberta to strengthen enforcement and dispute resolution, and to harmonize labour credentials and business regulations and standards by early 2009. Another example is the agreement, earlier this year, between Ontario and Quebec to allow some further, albeit limited, movement of construction workers between the two provinces. Earlier this month, two temporary "foreign-worker units" started operating in Vancouver and

Calgary to facilitate the entry of skilled foreign workers into Canada. And just last week, the Committee of Ministers Responsible for Internal Trade agreed on an action plan that embraces efforts across a range of internal trade issues.

All this is encouraging because considerably more needs to be done to enhance the flexibility and functioning of our internal markets from coast to coast. Business regulations and standards, including those for the financial sector, need to be harmonized across Canada. Dispute resolution and enforcement under the AIT need to be strengthened. And, to make our labour markets more flexible, trades and professional designations should be recognized and fully transferable across the country. Based on a recent survey, more than one-third of all workers and about half of all foreign-trained workers still have problems getting their credentials recognized across Canadian jurisdictions.[1]

How flexible is the Canadian economy?

The good news is that, despite the challenges that we still face, overall, our economy fares well in international comparisons of flexibility and adaptability. In a 2005 study, the International Monetary Fund (IMF) concluded that "Canada is characterized by a relatively high degree of flexibility, of a magnitude comparable if not larger than many other industrialized countries, with the likely exception of the United States."[2]

For purposes of this study, the IMF looked at different indicators of economic flexibility – with uniform results. For example, the reallocation of production resources across sectors, in response to changing economic conditions over the 1980-2000 period, was quite high in Canada compared with other major industrialized countries (except the United States) - indicating a high degree of economic flexibility. The IMF also compared rates of firm turnover, and of job creation and destruction, across countries. Both of these measures were relatively high for Canada - again suggesting a high degree of flexibility.

Other measures of the way in which our economy responds to macroeconomic disturbances also point in the same direction. As of the first quarter of 2006, interprovincial migration has shown a marked increase over the past two years to 333,000 individuals, representing over one per cent of the total Canadian population. Not surprisingly, the two provinces with a net positive inflow over this period are Alberta and British Columbia. And a more recent study by the IMF that focused on Canadian labour markets concluded that, overall, they are relatively flexible.[3]

So Canada does seem to rate high according to some measures of flexibility. But the challenge is to continue to promote flexibility in all of our domestic markets - for goods, services, capital, and labour. Continuous improvement is essential. Given the openness of the Canadian economy, we cannot be complacent.

Recent economic and financial developments

Before concluding, let me summarize the Bank's current thinking on the economy, as we laid it out last week in the press release announcing our decision to leave the target for the overnight rate unchanged at 4 1/4 per cent.

Basically, we noted that the global economy has continued to expand solidly, with some moderation in U.S. economic growth but with some further strengthening in the rest of the world. Against this backdrop, commodity prices have remained firm.

In Canada, the level of economic activity in the second quarter of 2006 was somewhat below the Bank's expectations, primarily because of weaker exports. Total and core CPI inflation came in slightly higher than expected in July, mainly because of price strength in the housing and services sectors. Nevertheless, all things considered - and here I would include the most recent labour force numbers -

---

1 Forum of Labour Market Ministers. 2005. "Report of Survey Results: Inter-provincial labour mobility in Canada 2004/05."

2 See IMF (2005) "How Flexible Is the Canadian Economy? An International Comparison," in Canada: Selected Issues (Article IV Consultation): 92-100.

3 See T. Bayoumi, B. Sutton, and A. Swiston, "Shocking Aspects of Canadian Labor Markets" (IMF Working Paper No. 83, March 2006).

the underlying trends in the economy appear to be in line with the broad thrust of our projection for output and inflation in the July *Monetary Policy Report Update.*

We continue to expect that the economy will operate at about capacity through 2008, with total CPI inflation returning to the 2 per cent inflation target in the second half of 2007. In line with this outlook, the current level of the target for the overnight rate is judged at this time to be consistent with achieving the inflation target over the medium term.

The key risks to the Canadian outlook for output and inflation over the next few quarters remain those set out in our July *Report:* on the upside, they relate primarily to the momentum in household spending and housing prices; on the downside, U.S. household demand could slow more rapidly than expected, thus reducing demand for Canadian exports. While both these risks appear to be a little greater than they were in July, we continue to judge that, overall, risks are roughly balanced. We will provide a full analysis of economic developments, trends, and risks in our next *Monetary Policy Report,* which will be published on 19 October 2006.

Concluding thoughts

Let me now conclude. As a nation, we are clearly learning from experience and adapting to change. Over the past decade, we have done much to implement sound macroeconomic policies and structural reforms that have helped our economy become more flexible and thus more adaptable to change. Canada's strong economic performance in the face of major disturbances over this period attests to the importance of flexibility.

However, our success to date does not mean that we can rest on our oars. Uncertainty, risks, and shocks will be as much a part of tomorrow's economic picture as they have been of yesterday's and today's. We all have a role to play in moving the Canadian economy to the forefront, in terms of flexibility and adaptability. The Bank of Canada is committed to doing its part.