David Dodge: The Canadian economy - current and future challenges

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Greater Moncton Chamber of Commerce and the Conseil économique du Nouveau-Brunswick, Moncton, New Brunswick, 24 October 2001.

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It's a pleasure to be talking to you today, although I wish these were happier times.

All of us at the Bank of Canada share a deep sorrow at the loss of so many lives in the 11 September terrorist attacks in the United States. Among those who died were innocent citizens of many nationalities, including Canadians. To their families, friends, and colleagues we extend our heartfelt sympathy. As we strive to come to terms with this tragedy and its implications for all of us, we are tremendously encouraged by the co-operation, solidarity, and determination that are abundantly evident both at home and in the international community. Through this time of anxiety and uncertainty, we at the Bank of Canada will continue to fulfill our responsibility to support the economic well-being of Canadians and to promote the stability of the domestic and international financial systems.

As we all struggle to fathom the dimensions of this tragedy and to get a measure of its immediate economic effects, it is important that we look through the short term to the longer-term trends and the potential of our economy. If we are to solidify our economic performance in the years ahead, we cannot lose sight of the challenges we must meet as a nation. Those longer-term challenges are my main topic for today.

Of course, in the current circumstances, there are also important near-term challenges for monetary policy. So I will conclude with a brief discussion of the current economic situation and the steps that the Bank is taking to support domestic demand in Canada.

Longer-term challenges to good economic performance—progress so far

Let me start with the longer-term challenges.

The past decade was a watershed for the Canadian economy. Low inflation was firmly established, fiscal health was restored, and Canadian businesses undertook major restructuring. In short, we made remarkable progress in improving our economic performance.

Let me quickly review that progress, starting with the achievement of a credible low-inflation record.

. . . establishing a record of low and stable inflation

Since the early 1990s, the focus of Canadian monetary policy on low, stable, and predictable inflation has helped to anchor inflation expectations and to reduce the ups and downs in economic activity. Canadians have been able to make spending, saving, and investment decisions with greater certainty, knowing that their central bank will hold the line on future inflation and that the economy will be more stable.

. . . restoring fiscal health

But low inflation, although essential to good economic performance, is not sufficient by itself. It has to go hand in hand with prudent fiscal management.

Since the early 1990s, Canada has also taken action to put its fiscal house in order. And this is paying dividends. Wiping out deficits at all levels of government has helped to bring about low interest rates and relatively more stable financial markets.

. . . undertaking business restructuring and embracing open markets

Low interest rates and greater confidence about the future have, in turn, encouraged Canadian firms to undertake important restructuring initiatives to meet the challenges of sweeping worldwide technological change and intensely competitive global markets.

Over the past decade, these restructuring efforts have taken place against a backdrop of sustained efforts to open up our economy even further. Indeed, building on the trade agreements that we forged in the late 1980s and early 1990s, such as the North American Free Trade Agreement (NAFTA), we have significantly increased our involvement with the world economy.

Altogether, it is clear that, over the past decade, we in Canada have done a lot to strengthen our economic foundations. Because of this, we are now better positioned than we have been in a long time to weather economic turbulence and to take on new challenges.

But, in a rapidly changing, increasingly competitive world, "they who stand still, fall behind." If we are to seize the opportunities out there in the global economy, we have to continue to move forward and make further progress.

Longer-term challenges to good economic performance—the way ahead

Before I focus on the new things we need to do to facilitate progress in the future, let me stress how important it is that we maintain the strong base on which everything else rests—sound macroeconomic policies.

. . . sound macroeconomic policies

Fostering a climate of low, stable, and predictable inflation is the best contribution monetary policy can make to good economic performance over the medium term. The Bank of Canada is carrying forward its commitment to preserve confidence in the future value of money—that you can bank on!

On the fiscal side, it is critical that our public finances remain healthy and that all levels of government continue to reduce their net indebtedness over time. A declining public debt relative to the size of our economy will make us less vulnerable to external shocks. But I hasten to add that I do not mean to suggest that we should not let the "automatic stabilizers" work when faced with an economic shock. (These stabilizers are the built-in features of revenues and expenditures that work to offset economic fluctuations. For example, in an economic downturn, tax revenues automatically go down and some expenditures, such as employment insurance payments, automatically go up.) Let us remember, however, that it is because of the progress we have made over the past decade in restoring healthy public finances that we can now afford to let these automatic stabilizers work.

Now, sound macroeconomic policies, while necessary, are not sufficient if we are to improve the structure and performance of our economy in coming years. I would like to think through with you what other policies and steps we might need.

As we look ahead, the one thing we can be sure about is that world markets for goods, services, and finance will become more and more globalized and competitive. Canada, as a very open economy, must operate in full recognition of that fact. In particular, in light of the heightened security concerns in the United States, it is important that we all work to facilitate the continued flow of goods and services between our two countries. Beyond this issue, there are many challenges for all Canadians. But there are also new opportunities for our firms to increase their global reach and to reap the benefits of large-scale production—provided they pursue new initiatives to enhance productivity and find more efficient ways to deliver products and services to domestic and foreign customers.

This is where innovation enters the picture.

. . . exploiting the potential of new technologies

The world is in the midst of far-reaching changes—changes that are transforming national economies and societies around the world through the widening application of new information and communication technologies. And more change is on the horizon—change that will come from dramatic advances in biotechnology and nanotechnology.

Technologies like these take time to spread and spawn new applications across a broad range of economic sectors—pretty much like the electric motor did in the past. But to realize the full potential of these new applications, major changes in the organization of a firm, of an entire sector or, indeed, of a whole economy, are often necessary. It is the combination of these applications and adaptations that leads to rising productivity and rising incomes.

Like many other economists who have studied these issues, I am optimistic that, over the next couple of decades, productivity will grow significantly faster than it did from 1975 to 1995, although perhaps not as fast as in the high-growth years of the 1950s and 1960s.

But while experience shows that innovations take time to diffuse widely, it is important to remember that the prime opportunities go to those firms and those economies that are quick to take advantage of the new realities. Through the first half of the 1990s, Canada lagged behind the United States in making the investments that are necessary to take advantage of new technologies. But since 1996, there has been a surge in such investments in Canada. And in the last couple of years, we were beginning to see the first signs of a productivity payoff. Once the prevailing global uncertainty and the cyclical forces that are now constraining output and investment growth in Canada dissipate, we will likely see more efficiency gains from those past investments and more capital spending on innovations. And once the necessary adjustments are made to deal with the need for heightened security, those innovations will mean rising standards of living for Canadians.

. . . redesigning organizational structures and upgrading skills

But, as I just said, to benefit fully from technology, changes and improvements in the structure of our economy and in the way we run our businesses are necessary.

At the company level—and that applies also to government departments and to the Bank of Canada—this means organizational changes and changes in management and work practices. It also means upgrading skills. Simply installing state-of-the-art equipment will not be enough. And it will, most certainly, not deliver efficiency and productivity gains if organizational structures and management practices are outmoded and if workers do not know how to use the new technology to advantage.

Some of these issues will no doubt sound familiar to many of you here in the Atlantic provinces, where considerable effort and progress have been made in recent years to diversify the regional economy and to move into areas that make greater use of new technologies. And this is especially clear here in Moncton where, over the past decade, you have enjoyed the strongest employment growth in the province—12,000 new jobs created since 1990—thanks to your ability to attract call centres and other information-technology companies.

. . . enhancing productivity

Now, the reason for adopting new technologies, revamping management and work processes, and upgrading labour skills is that we, as a nation, can become more efficient and more productive. Productivity growth is the key to rising real incomes and improved standards of living over the longer run.

But, you may ask, how does monetary policy fit in all this? And what can the Bank of Canada do to promote higher productivity and rising real incomes?

An increase in real incomes is a key component of the good overall economic performance that the Bank aims at through a policy focused on low inflation. The Bank supports initiatives to improve productivity by delivering a climate of low and stable inflation that encourages well-informed, long-term business decisions, including decisions to invest in new high-tech machinery, equipment, and software.

. . . ensuring that Canada's financial system and markets work efficiently

The Bank also concerns itself with another factor in supporting good economic performance—a sound, innovative, and efficient financial sector. A stable, highly developed financial sector helps to channel savings into investments and allocates capital efficiently.

This is particularly important in these times of rapid technological change, when we want companies that plan to adopt new technologies to have access to proper financing. But of course, we also want to ensure that this is done in a way that preserves the stability of the financial sector. Appropriate safeguards and sound policies aimed at fostering financial stability improve overall economic performance.

The Bank of Canada is helping to promote financial stability in a number of ways. Here at home, we oversee major payments systems and provide ordinary and emergency liquidity to the financial system. We also work with other federal entities and provincial securities commissions to ensure that financial markets function well. And through international organizations, such as the Bank for International Settlements and the International Monetary Fund, we work with other central banks and financial regulators around the world to promote global financial stability.

There are other medium-term issues that we could usefully spend time discussing. But given that time is limited, I would now like to turn to the current economic situation and the near-term challenges for monetary policy.

Current economic situation and near-term policy challenges

Even before last month's events in the United States, evidence had begun to accumulate that the economic slowdown in that country would be deeper and last longer than had been widely expected. By mid-summer, economic activity outside North America had also begun to show more clearly the effects of weaker U.S. growth and of the ongoing global retrenchment in the information and telecommunications sectors. At the same time, there were signs that domestic demand in Canada, which had held up well through the first part of the year, was softening and that the inventory adjustment, particularly in the electrical and electronic sectors, still had some way to go.

This evidence, which had been accumulating through the summer, led the Bank to scale back its previous expectations for economic growth during the second half of 2001 and the first half of 2002. Consequently, on 28 August, we lowered interest rates to support domestic demand growth and to keep inflation near the target of 2 per cent over the medium term.

The events of 11 September, and their repercussions around the world, added a further major element of uncertainty to the near-term prospects for the global economy and for Canada. Because of this heightened uncertainty, the Bank took the exceptional step of lowering interest rates by one-half of a percentage point on 17 September, outside our regular schedule of fixed announcement dates. We also moved immediately after the attacks, as did other major central banks, to provide additional liquidity to the financial system to ensure its smooth functioning. At times like these, a key factor in preserving confidence in the prospects for our economy is a financial system that continues to work effectively.

The ongoing economic effects of last month's shock are very difficult to assess. We know that there was a clear and immediate impact on certain sectors (such as air transportation and tourism) and on those industries that rely on cross-border, just-in-time delivery. But how large the total impact will be and how long it will last are very difficult to gauge. What is even more difficult to evaluate at this stage are the implications for consumer and business attitudes. The recent events are unlike anything we have ever experienced in North America. So it will take some time before we can fully understand their consequences.

When we take into account the direct effects of the terrorist actions in the United States, their immediate negative impact on business and consumer confidence, and the adjustments necessary to deal with increased security risks, it is now clear that economic growth in Canada in the second half of 2001 will be close to zero or slightly negative. This means average growth for the year as a whole of about 1 ½ per cent.

How quickly growth will resume will depend crucially on geopolitical developments and on how soon consumer and business confidence return to normal. By their very nature, geopolitical developments are not easily predictable, although they will likely be more turbulent than usual for some time. Also difficult to predict is the evolution of consumer and business confidence. One could think of a scenario where confidence would be restored quickly. In such a case, fairly robust growth could resume by the second quarter of 2002. On the other hand, consumer and business confidence in North America could stay weak for quite some time. In these circumstances, growth could remain anemic through most of 2002. While the timing of a rebound in economic activity is unclear, we are confident that, once the uncertainty stemming from terrorist actions dissipates, healthy growth in output, investment, and employment will resume, given Canada's sound economic fundamentals.

Under either of these scenarios, there will be less pressure on capacity through the balance of this year and during 2002 than we had thought earlier. Indeed, by the end of 2002, the economy will still be operating below potential. With less pressure on capacity, core inflation is expected to move below 2 per cent in early 2002, and to stay below through the remainder of the year. As for total CPI inflation, it will likely drop to about 2 per cent by the end of 2001 and move below that during 2002, if energy prices remain at or below their levels of early September.

Based on these considerations, yesterday, on our pre-set announcement date, we cut our key policy interest rate—the target for the overnight rate—by ¾ of a percentage point. It is now at 2 ¾ per cent—a full 3 percentage points lower than at the beginning of the year. This action aims to further support economic growth in Canada and to keep inflation close to our 2 per cent target over the medium term.

I do not have to tell you that, because of the many unknowns in the global economic environment, and because of the uncertainty surrounding domestic demand in Canada, we will continue to monitor developments very closely.

Concluding thoughts

To conclude, as we in Canada find ourselves in the middle of economic difficulties, and especially as businesses, governments, and individuals struggle to come to grips with last month's tragedy, our main preoccupation is, naturally, with near-term issues. That is understandable. But, at the same time, it is critically important that we maintain a sense of perspective—that we step back and look past current developments, focusing also on the longer-term trends in our economy and its potential.

Over the past decade, Canada has made remarkable progress in strengthening its economic foundations. This should stand us in good stead, no matter what economic turbulence and near-term uncertainties we face. And it gives us a firm basis to stand on as we embark on new initiatives to improve our longer-term economic performance and meet the challenges of the twenty-first century.