David Dodge: Staying the course

Speech by Mr David Dodge, Governor of the Bank of Canada, during a panel discussion at the Banco de México, Mexico City, 12 November 2002.

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The dramatic events of the last two years and growing concern about the near-term prospects for the global economy have created a climate in which policy-makers focus only on current economic developments and lose sight of longer-term goals.

There's a natural tendency to focus on the here and now, and to use any tools that are readily at hand to deal with today's problems, without proper regard for their long-term consequences.

It's easy to forget the hard-learned lessons of the past and overlook the longer-term fundamentals that are necessary to support a strong recovery and sustained positive economic performance over time.

What are those fundamentals?

Mr. Greenspan, in his opening remarks to this conference, talked about the importance of the fundamentals, going all the way back to Adam Smith. What's interesting is that things have not changed that much. But we don't have to reach that far in history for guiding principles. We can look at the four key principles that emerged as part of the OECD consensus during the 1980s.

The first principle relates to monetary policy. It basically recognized price stability as the appropriate goal for monetary policy over the medium term. Policy-makers were advised to respond symmetrically, and in a forward-looking manner, to excess demand and supply so as to keep the economy on an even keel, thus achieving price stability and maximizing output over the medium term.

The second principle applied to fiscal policy and the need for a more disciplined approach to managing the public purse. Rising debt levels and an aging population made it clear that concrete action was necessary to eliminate deficits and put the debt-to-GDP ratio firmly on a declining path. Automatic stabilizers should still be allowed to work during economic downturns. But in good times, surpluses would be generated that would help preserve the budget balance and keep the debt-to-GDP ratio on a downward trend.

The third principle focused on the need for wide-ranging structural reform to reduce rigidities and inefficiencies. This meant removing burdensome regulations and legislative restrictions and eliminating wasteful government expenditures and distortionary tax and subsidy systems.

The fourth, and final, principle called for trade liberalization. It was based on the premise that only through freer international trade can countries fully exploit the gains from increased specialization, enhanced productivity, and greater competitiveness.

These four principles can be likened to the four legs of a chair. The chair is steadier when all four legs are the same length. Similarly, an economy is more stable when progress is made on all four policy fronts.

But what should we be doing during periods of unexpected, pronounced economic turbulence?

The latest worldwide economic slowdown has increased pressures on policy-makers to take action on a number of fronts. Some of them are being encouraged to erect trade barriers in order to protect favoured national sectors from foreign competition. But experience shows that such beggar-thy-neighbour policies not only impose costs on the rest of the domestic economy, they also undermine global economic welfare.

Other policy-makers are being advised to forget about structural reforms in the short term, for fear of exacerbating economic weakness. Unfortunately, this approach virtually guarantees suboptimal performance in the future and maximizes the long-term costs of dealing with the structural problems – in many cases, sowing the seeds of future crises.

In many countries, weak economic growth, coupled with rising government expenditures, has recently led to a deteriorating fiscal position, reversing the hard-won gains made over the past decade. To the extent this result is driven by the automatic stabilizers in place, it is unavoidable and desirable in the short run. But policy-makers should be very careful about calls for more extensive, discretionary fiscal measures taken for stabilization purposes. Such measures typically take effect long after the need for additional stimulus has passed, and they are often difficult to reverse. In the end, they often simply weaken a country's structural budget position.

Without a doubt, the most suitable tool for dealing with any short-term cyclical problems in the economy is monetary policy. It is flexible, easily reversible, and general in scope. If monetary policy is allowed to perform this function, then there will not be inordinate pressure on other, less appropriate, instruments and policies. But let me be clear: this is not to say that we should use monetary policy to allow us to avoid taking the necessary steps on the other three fronts. For example, it is inappropriate to erect trade barriers and then say we need more monetary stimulus. It is inappropriate to allow rigidities to build in the economy and then call on central banks to provide stimulus. The right thing to do is to continue working on steadying the other three legs of the chair and to use monetary policy appropriately. Central bankers must guard against turning monetary policy itself into a source of instability. So here too, the bottom line is to never lose sight of our longer-term objective of low and stable inflation.

The prevailing worldwide economic weakness, together with geopolitical uncertainty and financial market volatility, has led to significant monetary easing in most countries. This easing has been broadly appropriate and, in some cases, indeed even more may be needed. But it is extremely important that the monetary authorities keep their eyes firmly on the economic horizon. By concentrating on developments 18 to 24 months ahead, not only will they ensure that the critical medium-term objectives are met, but the short-term needs of the economy are also addressed.

Monetary policy-makers should also be wary of taking on too many additional responsibilities, such as trying to stabilize selective market assets.

This is not to say that we should not pay attention to what is happening in financial markets. We certainly should. These markets can convey important information about future developments. And they exert direct and indirect influences on the real economy.

But monetary authorities must resist the siren calls for active management of financial markets and the pleas for regular intervention to help stabilize asset prices. It would be unfortunate if we were to repeat costly past mistakes for the sake of near-term expediency.

Canada, like most other countries, has committed itself to the four principles of sound economic performance: low and stable inflation, fiscal prudence, structural reform, and trade liberalization. As a country, we have made great progress on all four fronts in recent years. Of course, pressures have emerged which threaten to undermine those commitments. These pressures have been resisted vigorously. While particular interest groups are unhappy with this resistance, the Canadian public as a whole supports sound policies. Canadians remain convinced that the authorities will follow these policies; and that is why both household consumption and investment by SMEs continue to be strong. Even in the face of geopolitical and international economic uncertainties, sound medium-term policies are helping to maintain strong domestic demand.

To conclude, the current uncertainties will dissipate, and stronger growth will resume, provided we continue to pursue sound macro, trade, and structural policies. What is important is to anticipate the institutions, structures, and policies that we want to have in place once this latest turbulence subsides, and not to focus too narrowly on the present. Although the near-term challenges that we face may seem daunting, it would be unfortunate if, in attempting to deal with them, we impaired the prospects for future growth and improved economic performance.

Canada is committed to staying the course. The same is true, I hope, of all other countries gathered here today. We all have an important responsibility to make sure that the lessons we have learned, and our continuing strong commitments to prudent policies, are understood more broadly.