David Dodge: Past adjustments and future trends in the Canadian economy

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the London Chamber of Commerce, London, Ontario, 8 December 2003.

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Good afternoon, ladies and gentlemen. I'm happy to have this opportunity to visit the Forest City and to finally honour your long-standing invitation to address you.

When giving a speech near the end of a year, it is common practice to look back over the past 12 months, consider what we have learned from the events and experiences of the year, and think a bit about what might lie ahead. I became Governor of the Bank of Canada in 2001 and, since that time, I have found myself saying at the end of each year, "Well, we won't see another year like that again." In 2001, we saw the bursting of the tech bubble and the 9/11 terrorist attacks in the United States. Last year, we had the fallout from Enron and other examples of corporate malfeasance, as well as the growing threat of war in the Middle East. And our currency dropped to an all-time low against the U.S. dollar.

Not to be outdone, 2003 has also had more than its share of momentous events that had an impact on the Canadian economy. The list seems almost Biblical: war, pestilence, in the form of SARS and mad-cow disease, fires, floods, a hurricane, and a power outage. This year also brought another type of shock to keep Canadians preoccupied, and that is the sharp rise of our currency in foreign exchange markets. The Canadian dollar has jumped from under 64 cents U.S. at the start of the year to over 76 cents at the end of last week - an unprecedented movement.

The Bank of Canada has closely followed the economic effects of all these events, including the rapid movement of the Canadian dollar. But to better understand what has happened in the economy over the past year or so, I will place my comments in the context of longer-term economic trends.

The Adjustments of the 1990s

Let me start by recalling the state of our economy as the 1990s began. Although inflation had come down from the very high levels seen in the early 1980s, it was still quite high by today's standards. Several approaches had been tried to bring about an environment of low, stable, and predictable inflation. These included wage and price controls and the targeting of the money supply. But none of these methods provided a suitable medium-term anchor for inflation expectations. This made it difficult for individuals and businesses to form long-range plans with any degree of certainty. On the fiscal side, the picture was pretty grim at the start of the 1990s and getting worse. Public sector deficits would eventually peak at around 8 per cent of Canada's GDP, and public debt levels were continuing to mount. Clearly, the situation was not sustainable. Adjustments were urgently needed.

The first of these adjustments came in 1991, when the Bank and the Government of Canada agreed to adopt a series of explicit inflation-control targets. The agreement called for an inflation target-defined in terms of the annual rate of increase of the consumer price index - that descended gradually to 2 per cent, the midpoint of a 1 to 3 per cent range. That initial agreement has been extended three times, with the latest agreement covering the period to the end of 2006. In each case, the midpoint of the inflation-control target range has been kept at 2 per cent.

This framework has worked well - better than might have been expected. By January 1992, inflation was already close to 2 per cent, and from the end of 1994 to today, inflation has averaged almost exactly 2 per cent. Moreover, not only has inflation fallen, it has become more stable. Indeed, the trend of inflation - as measured by what we call core inflation - has stayed within the target range almost continuously for the past 10 years.

Just as importantly, we found that, after a few years of inflation targeting, the inflation expectations of Canadians fell into line with the 2 per cent target. And expectations have remained close to the target in recent years.

The point of all this is that we have been successful in using monetary policy to create an economic environment of low, stable, and predictable inflation. With a credible monetary policy, the whole nature of the inflation process has changed. Inflation itself has become more stable and, in turn, this has led to a more stable and better-functioning economy.

The second big adjustment began in earnest around the middle of the 1990s. As I said before, at that time, Canada was facing an unsustainable fiscal situation. Compounding this immediate fiscal problem were the looming challenges posed by our aging population. Spending had to be put on a viable long-term course, and the ratio of public debt to GDP on a steady downward track.

By the middle of the decade, governments - federal and provincial - had begun to take the painful steps to balance their books and reduce their debt burdens. It did not take long for the benefits of those tough decisions to materialize. In most jurisdictions, the vicious circle of rising deficits and debts became a virtuous circle of balanced budgets and falling debt burdens. This fiscal adjustment helped Canada's economic policy credibility and reduced the risk premium that investors demanded on Canadian government bonds. Not only did lower interest rates reduce debt-servicing costs, they stimulated economic growth, which brought in more revenues for governments.

The federal government recently announced a sixth consecutive surplus in its budget. Our public pension plans are once again on a sound footing. The federal debt-to-GDP ratio has fallen to about 44 per cent, from close to 70 per cent at its peak. The ratio of total government liabilities to GDP has declined from a peak of about 100 per cent to about 80 per cent, according to the OECD. And Canada's Triple-A credit rating has been restored.

I don't mean to suggest that inflation targeting and fiscal adjustments were the only factors behind Canada's overall improved economic performance. Of equal importance was the difficult restructuring that had to be done in the wake of free-trade agreements in the 1990s. Businesses and employees made some difficult adjustments. None of this was easy, but it did leave Canada's economy in a better position to grow sustainably and to handle economic shocks. Our economic record over the past few years, even in the face of all the events I have mentioned, is testament to that.

Now, let me talk about the role of the Canadian dollar in this long adjustment process. On a day-to-day basis, there are a number of factors that can drive movements in the value of the Canadian dollar in foreign exchange markets. But my intention is to stick to a discussion of long-term trends. From this perspective, there were really two major factors at work on the currency in the 1990s. Governments were cutting spending to address their fiscal problems, and that led to a reduction in domestic demand. On top of this, commodity prices were down sharply in the second half of the decade. Historically, there has been a fairly strong correlation between the prices of non-energy commodities and the external value of the Canadian dollar.

In the face of these two factors, Canada's floating exchange rate did its job as a "shock absorber" for the economy. How? Given the tight fiscal policy of the time, the lower dollar - in the context of an easing in monetary policy - played an appropriate role in encouraging foreign demand for Canadian products at a time when domestic demand was weak.

Further, while the lower currency cushioned the shock of falling commodity prices on resource producers, it also boosted the profitability of other sectors that were able to expand in the wake of free-trade agreements and strong foreign demand. This helped to facilitate the transfer of resources within the economy from sectors that were shrinking to those that were growing.

The depreciating Canadian dollar of the 1990s also changed the relative price of labour and capital. At the time, there was a fair bit of excess labour in the economy, because of the structural adjustments that were taking place. The lower dollar raised the cost of machinery and equipment relative to labour. And that made it easier for some of the labour that was released by the shrinking sectors of the economy to be absorbed by those that were growing.

Future Trends in the Economy

That's a quick look back at the 1990s. So what can we expect in the future? What are the major issues that we will have to grapple with in the coming decades? What adjustments will be needed?

I don't have a crystal ball, but a couple of issues seem fairly clear to me. As I already mentioned, the first important issue is demographics. The Canadian economy must prepare for the retirement of the baby boomers. Under current projections, Canada's working-age population - those 15 to 64 years of age - will start to decline in about 15 years.

Given this demographic outlook, there are two points to be made. The first is that we need to continue to lower our ratio of public debt to GDP. This will help to ensure that Canada will be able to support its growing elderly population.

The second point is that we will need to make adjustments to help us deal with a labour force that will soon be shrinking in relative terms and, ultimately, in absolute terms as well. What kinds of adjustments? We will need to make sure that the older segment of the working-age population is not discouraged from participating in the labour force. But more importantly, we need to raise productivity if Canadians are to continue to enjoy rising incomes.

It will not be easy to get those productivity gains. We will need to see greater investment in new, improved machinery and equipment. We will need to see more and better application of information and communications technology. We will need to ensure that our workers have the skills and receive the training they require to take advantage of productivity-enhancing technology. And we will need to improve business organization and practices, to fully exploit the potential of new technologies, and to minimize any barriers to their application in the workplace.

Raising productivity will also require a major effort to ensure that our microeconomic policies facilitate innovation and higher productivity in both the private and public sectors in Canada.

In thinking about our macroeconomic policies, we can't assume that all the shocks are behind us. We have seen the buildup of economic imbalances recently, with large current account surpluses in Asia and a large current account deficit in the United States. And fiscal imbalances are growing in Europe and the United States.

So how can the Bank of Canada help to prepare for the challenges ahead? Most importantly, we must stick with the monetary policy framework that we built in the 1990s. That means keeping our commitment to low, stable, and predictable inflation. And it means that our floating exchange rate will continue to be an important part of our monetary policy framework. This framework will continue to help the economy adjust to changing economic circumstances, both at home and abroad.

Of course, exchange rates don't always move as smoothly as desired or expected. Still, let me repeat what I have said many times before: having a floating exchange rate to facilitate economic adjustments is by far the best option for the Canadian economy.

Recent Economic Developments

Let me now turn to the current economic situation, starting with the outlook for inflation. As we noted in our October *Monetary Policy Report*, we expect that Canada's inflation rate will fall over the next few months. The core rate of inflation - a measure that removes the eight most volatile components of the consumer price index - will likely move down close to the bottom of our 1 to 3 per cent inflation-control range early next year, before starting to move back up towards 2 per cent.

On the Bank's latest fixed announcement date last week, we decided to leave our key policy rate unchanged. In doing so, we noted a few developments that have altered our outlook since we published the *Monetary Policy Report*. Let me review some of them.

At the end of November, Statistics Canada released its national accounts data for the third quarter. These data showed that Canada's economy had grown at an annualized rate of just 1.1 per cent in the third quarter, a rate that was well below expectations. What's more, there were downward revisions to growth in previous quarters. This meant that, at the end of the third quarter, there was more excess capacity in the Canadian economy than we had anticipated.

In the *Monetary Policy Report*, we said that we expected the economy to close its output gap and return to its level of full capacity by early 2005. Closing the output gap over that period would be consistent with inflation returning to the 2 per cent target by mid-2005. But because we now know that the output gap is larger than we had expected in October, we also know that the economy will have to grow at a faster rate during the fourth quarter and through 2004 to close that output gap by early 2005.

While growth earlier this year was disappointing, we are now seeing a number of encouraging signs suggesting that stronger growth will resume, beginning in the current quarter. I will mention three of those signs. First, while the overall growth rate in the third quarter was just 1.1 per cent, it should be noted that this figure was depressed because businesses met demand in large part from inventories. Final domestic demand grew quite strongly - by close to 6 per cent - thanks to healthy household spending and rising business investment. This investment bodes well for higher future production. And, with continuing employment growth, we expect household spending to remain robust.

Second, the reduction in inventory investment is probably over. While this adjustment depressed growth in the third quarter, it should not do so in the fourth quarter. In fact, the completion of the inventory correction should contribute to growth in the fourth quarter.

Third, Canada's export sector should receive a boost from rising foreign demand, in particular, from the United States. Remember that the U.S. economy grew at an annualized rate of about 8 per cent in the third quarter, and Canadian exporters should see some benefit from this and from the continuing strong growth expected in the U.S. economy over the months ahead. Rising non-energy commodity prices should also be a boost to the economy.

All told, the Canadian economy should be poised for solid growth ahead, beginning in the fourth quarter. We would expect economic growth in this quarter to be well above 4 per cent on an annualized basis.

However - and let me stress this - the effect of the recent sharp appreciation of the Canadian dollar is a major uncertainty at this time. It is not clear to what extent the increase in foreign demand I have just mentioned will be offset by the effects of a stronger currency. Nor can we be sure that there is enough monetary stimulus in the economy to support the increases in household spending and business investment that would be required to return the economy to full capacity by early 2005.

Some important economic data are expected between now and our next fixed announcement date, on 20 January. These should give us a better sense of how Canada's export sector is doing, and how household spending went over the holiday season. We will be closely watching all the data ahead for evidence that the economy is growing at a rate solidly above the growth of potential.

Conclusion

This past year, like the two years before it, was full of "interesting" economic challenges for Canada and the world. It is tempting to hope that next year will be somewhat less "interesting" and bring fewer challenges. But regardless of what next year brings, what is critical is that we keep our eyes on the longer-term horizon and focus on the challenges ahead. These challenges include adapting to shifting demographics, raising productivity, and getting our microeconomic policy framework right. At the Bank of Canada, we remain committed to the sound monetary policy framework that will help us rise to tomorrow's challenges. And that's good news for all of us, no matter what the coming years may bring.