David Dodge: Adjusting to a changing economic world

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Board of Trade of Metropolitan Montréal, Montréal, 11 February 2004.

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Good afternoon, ladies and gentlemen. It's a pleasure to be with you here in Montréal today.

These are turbulent times, not just for business people, but for all Canadians. We have come through a very difficult year, a year filled with surprises that have challenged us all. At times like these, it is easy to focus on the near-term issues and problems. But by doing that, we risk losing sight of the big picture. The Bank of Canada had plenty to say about the near-term outlook in its *Monetary Policy Report Update* a few weeks ago. So today, I want to talk about the longer-term trends at work in the economy.

In doing so, I want to take a quick look back at some of the major economic events of recent decades, and examine how we approached the issues of adjustment at the time. Then, I will discuss the adjustments that are needed now and in the future. In this way, I hope to draw on the lessons learned from the past. I will frame this discussion in terms of structural economic policies, macroeconomic policies, and the role of the exchange rate in facilitating adjustments.

Previous adjustment policies

I will start by going back to the 1970s. There were at least two forces at play that highlighted the need for economic adjustments. The first was a significant drop in the rate of productivity growth. Canada, like the United States, had become accustomed to productivity rising at a rapid pace during the 1950s and 1960s. With this growth in productivity came steady advances in real incomes. But the trend towards higher productivity slowed abruptly in the early 1970s.

At the time, policy-makers, business, and labour assumed that the slowdown was cyclical. It wasn't. Economists still don't have a complete explanation for it. But what we now understand more clearly is that the productivity increases of the 1950s and 1960s had a lot to do with the application throughout the economy of earlier advances in general-purpose technology. Businesses took advantage of various technological advances in many diverse fields, enabling them to realize significant productivity gains.

When productivity growth slowed in the 1970s, many people assumed that the slowdown was temporary and that rapid growth would resume on its own. This was a mistake. Without solid productivity gains, the economy was unable to deliver the increases in real incomes that everyone had come to expect. This situation was compounded by the second major event of the 1970s: the energy crisis. Unfortunately, we in Canada didn't recognize the full implications of the energy crisis. We were slow to realize that higher oil prices also meant a reduction in the economy's production capacity.

Canadian policy-makers tried to cushion the impact of the higher energy prices and slower productivity through increased transfers, subsidies, and easier monetary and fiscal policies. For example, the Bank of Canada added to liquidity by expanding the money supply too fast in relation to the slower growth in the economy's production capacity. In the wake of these structural and macroeconomic policies, inflation rose, and fiscal deficits grew. This slowed the structural-adjustment process in the late 1970s and early 1980s. All of this was made worse by the shared misperceptions about the productivity slowdown. Businesses, households, and governments all thought that economic growth would recover and that real incomes could continue to rise at their previous rate. But without strong productivity growth the economy could no longer satisfy these demands.

But that difficult period from 1975 to 1985 taught us a lesson. We learned that structural adjustments are important and inevitable, and that macroeconomic policies have a role to play in making those adjustments work quickly and with less disruption. Canada had the opportunity to apply those lessons in the 1990s. Let me explain how.

To begin, recall the state of Canada's economy as the 1990s began. Although inflation had come down from the very high levels seen in the early 1980s, it was still relatively high by today's standards. On the fiscal side, the picture was pretty grim and getting worse. Public sector deficits eventually

peaked at around 8 per cent of Canada's GDP, and public debt levels were continuing to mount. Clearly, the situation was not sustainable. Changes were urgently needed.

The first major change came in 1991, when the Bank and the Government of Canada agreed on a series of explicit inflation-reduction 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. The agreement has been extended three times, with the latest one covering the period to the end of 2006. Each time, the midpoint of the target range has been kept at 2 per cent.

This framework has worked very well. 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. More 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.

Another major adjustment began in the middle of the 1990s. At that time, Canada was facing an unsustainable fiscal situation. Spending had to be put on a viable long-term course, and the ratio of public debt to GDP put on a steady downward track.

By the middle of the decade, governments - federal and provincial - had begun to take the painful but necessary steps to balance their books and reduce their debt burdens. This fiscal adjustment helped improve the credibility of Canada's economic policies and reduced the risk premium that investors demanded on Canadian government bonds. Lower interest rates reduced debt-servicing costs and stimulated economic growth, which brought in more revenues for governments. The federal debt-to-GDP ratio has fallen to about 44 per cent, from a peak of close to 70 per cent. 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.

The other major change in the 1990s was the structural adjustments that took place in the public and private sectors. In both cases, these adjustments were enormously helpful, because they made the Canadian economy more flexible.

In the public sector, governments moved to reduce distortions in the economy, by eliminating many industrial subsidies, lowering income taxes, and putting the Canada and Quebec Pension Plans on a sustainable basis. Further, the government made changes to its system of unemployment insurance, basing the program more on insurance principles and improving the employability of labour. In the private sector, businesses and employees faced restructuring in the wake of free-trade agreements, as Canada opened up further to international competition. None of this was easy, but it did leave Canada's economy more flexible, and in a better position to handle economic shocks and, therefore, to grow sustainably.

Canada's floating exchange rate helped facilitate the adjustments that were taking place on these various fronts. It helped by sending signals to businesses about the kinds of adjustments that were needed. Firms that produced traded goods and services, and that were able to take advantage of free-trade agreements and strong foreign demand, saw their profits increase. And because the depreciating Canadian dollar raised the cost of machinery and equipment relative to labour, businesses in expanding sectors of the economy were encouraged to absorb some of the excess labour that had been released by shrinking sectors. The floating exchange rate also helped on the macroeconomic side. The depreciating Canadian dollar in the late 1990s helped to encourage foreign demand, as demand from the government sector was being restrained.

So you can see how these three factors converged in the 1990s to lay the groundwork for a stronger economy in the future. A sound macroeconomic policy framework, appropriate structural adjustments, and a floating exchange rate, all did their part to help the economy adjust to the changing circumstances of the 1990s.

Economic adjustments in the future

That's a quick look back. Now, I'd like to talk about some of the longer-term forces we can expect to see at work in the economy in the years ahead and the economic adjustments that will likely be necessary.

The first point I would make is that we have an opportunity in the next few years to again register solid productivity gains. This time, the information and communications technology sector is providing the general-purpose technologies that can drive sustained gains in productivity and incomes. Of course, the mere presence of technology is not enough to guarantee higher productivity. We also need investment, as well as training and organizational changes and flexibility. In the latter part of the 1990s, Canadians had begun to invest in these productivity-enhancing technologies. After a pause at the beginning of this decade, such investments seem to have resumed.

These efforts are particularly important, especially in light of the serious demographic challenges we will face over the next few years. That is my second point: our workforce is aging. Current projections are that the share of the population that is of working age - those aged 15 to 64 - will begin to decline in about 15 years. We will need to take these population shifts into account, and to remove impediments for older workers who wish to remain in the labour force.

The third point I would make is that there are powerful forces in the global economy that bear watching. The significant imbalances that we now see in the world's current- and capital-account flows need to be corrected. Emerging markets, particularly in Asia, are becoming increasingly powerful players in the global economy. All these forces will have an impact on the Canadian economy in the years ahead.

Against this backdrop, what kinds of economic adjustments will be needed in the future? Let me suggest a few.

First, Canada's economic structures must continue to adjust to changing circumstances. There will need to be more high-productivity activities in the economy and fewer low-productivity ones. But for significant gains in productivity to resume, governments must ensure that their microeconomic policies encourage flexibility and do not hinder innovation in the public and private sectors. Workers will need to have the training and skills to take advantage of new technologies. And businesses will need to ensure that their organizations and practices allow the potential of new technologies to be fully realized.

Second, Canada must keep its fiscal house in order. Canada's ratio of public debt to GDP will need to decline further. This will free up more resources to help us support our aging population. At the same time, this implies that governments at all levels will be keeping their budgets more or less balanced, if not in surplus.

What about monetary policy in the future? In the Bank's *Monetary Policy Report Update* last month, we said that the role of monetary policy is to facilitate adjustments by helping to sustain aggregate demand.

What does this mean? As always, it means that we will aim to return inflation to its 2 per cent target, by trying to keep the economy operating as close as possible to its full production capacity. That is our constant goal. But it also means that we will be aware of the forces that are driving adjustments in the economy in the years ahead. We know that, with a stronger currency, the economy will have to rely more on domestic demand and less on foreign demand for ongoing, solid growth. We will take this into account as we set monetary policy.

This leads me to my last point, which concerns the exchange rate. A floating exchange rate will continue to be an important part of our monetary policy framework, facilitating the necessary adjustments and sending important price signals. Canadian businesses should continue to be guided by price signals, including those being sent by exchange rates. Just as businesses reacted to the signals of a weaker Canadian dollar in the 1990s, they should now respond to the signals of a stronger currency against the U.S. dollar, as well as to the changing exchange rates against other currencies.

A stronger Canadian currency is consistent with the adjustments that are going to be needed in our economy, even if the speed of the recent appreciation has made these adjustments more difficult. Because it makes machinery and equipment less expensive relative to labour, a stronger currency is in line with our need to increase productivity, as well as with the future demographic pressures on our labour force. A stronger currency is also consistent with the increase in commodity prices relative to those of manufactured goods and services. And it increases the price of non-tradable goods relative to that of tradable goods. This should encourage the shifting of labour and capital into those sectors that are oriented to meeting domestic demand.

We are already seeing signs that Canadian businesses are indeed adjusting to the stronger dollar. Each quarter, the Bank of Canada surveys Canadian firms about the state of their business. Recent

surveys show that Canadian firms are reasonably optimistic about the future. Obviously, the appreciation of the Canadian dollar has affected different companies in different ways. In particular, some manufacturers who have not benefited from rising commodity prices have struggled to adjust. But most firms are acting to raise productivity, as well as cutting costs, adjusting supply chains, and hedging their currency exposure, among other efforts. Those businesses that have been helped by the stronger currency are also adjusting, by lowering prices, strengthening their balance sheets, and in some cases, increasing productivity. Information from the Bank's latest survey can be found on our Web site. Our surveys, as well as those conducted by the Export Development Canada and the Conference Board of Canada, suggest that business investment will increase.

I can appreciate that making some of these adjustments is not easy. For many firms and employees, it can be a painful and difficult process. But in today's world, not adjusting is not an option. Fortunately, thanks to a sound economic policy framework, we have a relatively favourable climate in which to take these necessary steps. Many elements currently support investment: inflation remains low, stable, and predictable, and credit conditions are favourable. Business confidence and balance sheets are strong, and equity markets are performing well.

Conclusion

Let me close by talking about the lessons we can learn from the past. To me, the key points are clear. Economies must have the flexibility to adjust as circumstances change. This means having the right structural policies in place, as well as appropriate macroeconomic policies. Along with the right economic policies, a floating exchange rate will help the economy make adjustments more smoothly.

All of us, whether as economic policy-makers or business people, must be quick to recognize the need to adjust. We ignore economic realities at our own peril. When adjustments are too slow, the economy suffers. When inappropriate policies are followed, the damage can take years to undo. But when the right adjustments are made quickly, the whole economy can benefit.

As business people making your own adjustments to future economic challenges, you can count on the Bank of Canada to pursue the appropriate monetary policy to help you get on with the job.