David Dodge: Policies for changing times

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Mexican Business Coordinating Council, Mexico City, 17 February 2004.

* * *

Good morning. I am glad to have the opportunity to meet with business leaders in Mexico today.

I am also glad to have this opportunity to meet with our colleagues at the Banco de México. Our two central banks have had a long and fruitful relationship, one that includes swap facilities, joint research, and close consultations. I believe that public servants and business leaders in Canada and Mexico have a great deal in common and much to learn from one another.

Indeed, in many ways, Canada and Mexico are partners. We share common issues and challenges. We both share borders with the United States, the most important export market for each of us. Both Canada and Mexico have recently faced setbacks in cross-border trade with the United States. These stem not only from weaker U.S. domestic demand, but also from specific trade problems and from border-crossing delays associated with tighter security.

We have both been affected by the slowdown in the world economy and by global economic imbalances - although the impact of these factors appears to have been somewhat less in Canada than in Mexico over the past three years. And we are both working on the structural adjustments that are necessary to weather shocks and to thrive in a changing environment.

Today, I want to focus my remarks on Canada's adjustment to global economic changes. I will talk about our efforts to adjust to longer-term economic forces and about our challenges in this regard.

And I will talk about some of the lessons that we have all learned during the past couple of decades. Policy-makers in both Canada and Mexico have drawn on these lessons to improve our macroeconomic policy frameworks, and thus to better manage and adjust to change. I will conclude with some thoughts about how Canada and Mexico can continue to adjust to the economic changes that face us in the future.

The most important lesson that we have all learned is that structural adjustments are key in adapting to change, and that macroeconomic policies have a role to play in making those adjustments with a minimum of economic and social disruption.

Past adjustments

Canada has experienced two periods in recent decades when significant economic adjustment was required. The first was during the 1970s, when we were hit by a rapid slowdown in productivity growth and by the effects of the oil crisis. Policy-makers in Canada used macroeconomic and microeconomic policies to try to cushion the economy from the impact of those events. As a result, our adjustment was slower and more painful than it needed to be. We ended up with a weak economy, high inflation, and large government budget deficits.

The lesson that Canadians learned from this period is that macroeconomic and microeconomic policies must be clearly focused on *facilitating* adjustment to economic change. By the beginning of the 1990s, it was clear to us that we needed a framework of policies to help with that adjustment, to bring down inflation, and to put our public finances in order.

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 that would gradually reduce the rate of inflation 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 served us very well. Since the end of 1994, inflation has averaged almost exactly 2 per cent. Moreover, not only has inflation fallen, it has become more stable than it was in the 1970s and early 1980s. Just as importantly, we found that inflation expectations quickly fell into line with the 2 per cent target. And expectations have remained close to 2 per cent in recent years.

One of the most important consequences of adopting a system of inflation-control targets is that we at the Bank of Canada can now explain more clearly to business, to labour, and to the general public what we are doing and why. One should not underestimate the benefits that arise from having the public understand the policies and actions of its monetary authority. This understanding makes the conduct of monetary policy easier, and gives citizens a measure by which to judge the performance of their central bank. While no single mechanism is perfect in this regard, our experience suggests that the outcomes of monetary policy are better with a clear, well-understood framework.

The second major adjustment that we had to make in Canada was to get our fiscal situation under control. In the early 1990s, the combined federal and provincial deficits were running at about 8 per cent of GDP. This was clearly unsustainable. And so between 1993 and 1997, governments in Canada made a determined, and successful, effort to eliminate their deficits.

This fiscal adjustment helped improve the credibility of our economic policies and reduced the risk premium on Canadian bonds demanded by investors.

Canada's economy, like that of Mexico and many others, also underwent structural adjustments in the 1990s, in both the public and private sectors. These adjustments were enormously helpful, because they made the Canadian economy more flexible.

Governments moved to reduce distortions in the economy by eliminating many industrial subsidies, reducing personal income taxes, and reforming the unemployment insurance system. At the same time, enterprises responded to the challenges of trade liberalization by improving the quality of their products and marketing them aggressively to new North American customers. These adjustments were not easy. But they did leave Canada's economy in a better position to handle economic shocks and, therefore, to grow on a sustained basis.

Canada's floating exchange rate helped facilitate these structural adjustments. The depreciating Canadian dollar in the late 1990s encouraged foreign demand, which helped to compensate for reduced demand from the government sector. It also helped by sending signals to businesses about the kinds of adjustments that were needed.

In sum, a sound macroeconomic policy framework, appropriate structural adjustments, and a floating exchange rate all did their part to help Canada's economy adjust to the changing circumstances of the 1990s. While these adjustments were difficult, the payoff came quickly. By the end of the decade, Canadians were beginning to see higher real incomes.

International forces

So that's a quick backward look. Let's now consider the ongoing international forces at work in our economies. Both Canada and Mexico are going to need to increase productivity in the face of fierce competition from China and other lower-cost countries.

Indeed, it is clear that all countries are going to have to find ways to become more competitive. In Canada, we have an opportunity in the next few years to again realize solid, steady productivity gains, thanks to past investments in information and communications technology. Of course, technology alone is not enough to guarantee higher productivity. To actually realize productivity gains, enterprises must make the necessary investments and organizational changes. And they must train their staff to use technology to its best advantage.

Other forces in the world economy bear watching. These include significant imbalances in global current- and capital-account flows. And new players, particularly in Asia, are becoming increasingly powerful in the global economy. As I've mentioned, that increases the competitive pressure facing our manufacturers. But it also means new, fast-growing sources of demand, and new opportunities.

Adjustments in the future

In the face of all of these forces, what kinds of economic adjustments will be needed in the future? Let me speak about the adjustments that we in Canada will have to make.

First, our economy will need more high-productivity activities. 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.

Canada already benefits from an educated and skilled labour force. Nevertheless, workers must continue to have access to the training they need to take advantage of new technologies. And businesses need to ensure that their organizational structure and practices allow them to realize the potential of these new technologies.

Second, Canada, like Mexico, must keep its fiscal house in order. As I have said, we have made great strides in reducing our ratio of public debt to GDP. That ratio will need to decline further to give Canada the flexibility to meet the demands of our aging population.

Third, we must provide the appropriate microeconomic policies with regard to labour markets, intellectual property law, environment, and foreign investment, among others.

Fourth, we must ensure that our social policies strike a balance between facilitating the adjustments that need to be made and supporting those members of our society who are displaced by structural adjustment.

Fifth, I believe that it is crucial that Mexico and Canada continue working together, and with our U.S. partners, to make NAFTA even more successful. And the benefits we have seen from NAFTA should strengthen our resolve to see freer trade globally. We need to continue to work towards reduced trade barriers at the Doha round of multilateral trade negotiations. It won't be easy, but the long-term economic benefits will make our efforts worthwhile.

What is the role of monetary policy in all of this? As always, it is to facilitate adjustments by helping to maintain the balance between supply and demand in our economies.

For the Bank of Canada, this means that we will aim to maintain inflation near 2 per cent 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, at the same time, we will be aware of the longer-term forces that are driving adjustments in our economy. In Canada, 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.

Both Canada and Mexico have, as a critical element of their monetary policy frameworks, a flexible exchange rate. This gives monetary authorities the ability to set monetary policy tailored to our own domestic economic circumstances. A floating Canadian dollar, or floating Mexican peso, facilitates the necessary economic adjustments and sends important price signals to economic participants.

Conclusion

Let me conclude. For many firms and many employees, we know that adjustment can be painful and difficult. But in today's world, not adjusting is not an option.

Fortunately, in both our countries, we are making these adjustments under relatively favourable conditions. Global demand is strengthening, and credit conditions are good. We have a better knowledge of what we need to do. And we have made important progress in strengthening our macroeconomic frameworks.

The challenges that we will face make it even more important that we continue to strengthen our policy frameworks in order to adjust to changing circumstances and to take advantage of potential gains. The faster we are able to adjust, the greater the wealth we can create for our citizens.

That is not to say that adjusting will be easy. Indeed, the experience of recent decades proves that it can be difficult, at least over the short term. But if we take the leap, and seize the opportunities that change will bring, our societies will surely benefit.