David Dodge: Adjusting to global economic change

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Brazil-Canada Chamber of Commerce, São Paulo, 10 March 2004.

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Good morning. I am glad to have the opportunity to meet with business leaders in São Paulo today. I am also pleased to meet with my counterpart, Governor Henrique Meirelles, and with some of his colleagues at the Banco Central do Brasil.

Geographically, Brazil and Canada are far apart. But from an economic viewpoint, we have more in common than some might think. We share common issues and challenges. We both operate monetary policy systems based on inflation targets and floating exchange rates. We are both being affected by the recent slowdown in the world economy and by global economic imbalances. 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 changes in the global economy. I will talk about our efforts to adjust to longer-term economic forces and about the challenges that these forces present. Some of our experiences may be relevant to other economies that are making similar adjustments in the face of similar economic circumstances.

Past adjustments

Our experience over the last couple of decades has taught us that structural adjustments are key to adapting to change, and, just as important, that sound macroeconomic policies have a role to play in making those adjustments with a minimum of economic and social disruption.

These lessons may seem self-evident. But Canadians have been reminded of their importance through some significant and painful economic adjustments during the past 30 years.

For example, Canada was hit by an abrupt slowdown in productivity growth during the 1970s. That slower productivity growth made it impossible to continue to provide the gains in real wages to which Canadians had become accustomed. The situation was exacerbated by the OPEC oil embargo of 1973 and by the subsequent energy crisis that hit economies around the globe. The consensus of the day was that the impact of those events on Canada would be temporary. And so Canadian policy-makers used macroeconomic and microeconomic policies to try to shield our economy from the impact of those events. Instead of making the necessary adjustments, we tried to avoid them. As a result, the eventual adjustment was slower and more painful than it needed to be. And we ended up with slower growth, relatively high inflation, and large government budget deficits.

Canadians learned during this period that economic policies must be focused on adjusting to change - even if that adjustment causes short-term difficulties. By the beginning of the 1990s, it was clear that we needed a framework of policies to help with adjustment, to bring down inflation, and to put our public finances in order.

The first major change came in 1991, when the government and the Bank of Canada agreed on an explicit anchor for monetary policy. That anchor was a series of inflation-reduction targets that would gradually lower 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 and currently covers the period to the end of 2006. Each time, the midpoint of the target range has been kept at 2 per cent.

I want to note here that while the Bank and the government established the monetary policy anchor jointly, the Bank alone takes responsibility for the conduct of monetary policy and for achieving the inflation target. I want to stress the importance of that independence. Experience around the world has shown that there are distinct advantages to having monetary policy carried out by an independent central bank, not the least of which is separating the power to print money from the power to spend it. Central bank independence is also a mechanism for building credibility among investors.

Central banks have a choice to make as to how to anchor their monetary policy. Some countries have chosen a fixed exchange rate as their anchor. In doing so, their central banks give up the power to control domestic inflation. In contrast, other countries - such as Canada - have chosen domestic inflation as their anchor. By doing this, they leave it to foreign exchange markets to set the external value of the currency. The key point is that, since capital is mobile, no central bank can successfully control inflation *and* the exchange rate at the same time.

The choice of an inflation-targeting framework has served Canada 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, inflation expectations have fallen into line with the 2 per cent target and have remained there. As for the floating exchange rate, it helps the economy adjust to disturbances and fluctuations in the world prices of our products, notably commodities. It also helps our economy adjust to changes in global savings and investment flows.

One of the most important advantages 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. We do this through eight regularly scheduled interest rate announcements each year, plus our regular *Monetary Policy Reports* and *Updates*. One should not underestimate the benefits that arise from having the public understand the policies and actions of its monetary authority. This understanding makes it easier for us to conduct monetary policy, and it allows citizens to judge the performance of their central bank.

It has been less than five years since Brazil adopted its own inflation-targeting system in July 1999, after floating its currency in January of that same year. The system is already proving to be extremely helpful in reducing inflation rates in this country, even in the face of some large shocks. Establishing a track record of credible inflation targeting leads to lower inflation expectations. These lower expectations create a virtuous circle - they lead businesses and consumers to make pricing and spending decisions that, in turn, help the central bank meet inflation targets. And consistently meeting inflation targets allows citizens to make investment and savings decisions with confidence that inflation will remain close to the target.

The second major adjustment that Canada had to make in the 1990s was to get its fiscal situation under control. In the early part of that decade, the combined federal and provincial primary deficit (which excludes debt-service costs) peaked at just under 3 per cent of GDP, and the total deficit was close to 8 per cent. The combined public debt reached a peak of 100 per cent of GDP. While some of the shortfall reflected cyclical factors, it was clear that the situation was unsustainable. So between 1993 and 1997, both federal and provincial governments in Canada made a determined, and successful, effort to eliminate their deficits and run consistent primary budget surpluses.

The fiscal adjustments made by both levels of government helped to improve the credibility of our economic policies and reduced the risk premium that investors demanded on Canadian bonds. While this credibility is always useful, it is particularly beneficial during periods of crisis, when the spreads on riskier investments tend to widen.

Consider Canada's experience with the Mexican currency crisis of 1994, before the credibility of our monetary and fiscal policy was fully established. Spreads on Canadian bonds widened significantly during that event, and consumption and investment slowed, leading to a period of weaker economic growth.

Our credibility was better established by 1997, and so we were able to weather the financial crises in Asia and Russia with only a slight widening of spreads. There was minimal uncertainty, and growth actually strengthened in the wake of those events. When you compare these two experiences, you can see that there is a real payoff from the achievement of fiscal and monetary credibility. And it does not take too long for that payoff to be realized.

Canada's public and private sectors also made structural adjustments in the 1990s, leading to a more flexible economy. This added flexibility helped us to weather the recent global economic slowdown.

Our governments, both federal and provincial, also took steps to reduce distortions in the economy. In the latter half of the 1990s, federal industrial subsidies were cut by more than 60 per cent. Provinces eliminated many of their own subsidy programs. The federal government reformed its unemployment insurance system, and Canada's public pension plans were overhauled to make them self-financing in the decades ahead. This involved some restructuring of benefits and an increase in contribution rates. And contributions are now being invested in markets in order to generate the best possible returns - with due consideration for prudence - over the long term.

Throughout this difficult period, governments worked hard to ensure that the burden of adjustment did not fall disproportionately on those segments of the population that were least able to bear it. It was only after the adjustment process was well underway that the federal government began to reduce corporate and personal income taxes.

As governments take steps to improve the structure of their economies, it is equally important that businesses make their own adjustments. During the 1990s, Canadian firms responded to the challenges of freer trade by improving the quality of their products and by marketing them aggressively to new North American customers. These adjustments were not easy. But they did leave Canada in a better position to handle economic shocks and, therefore, to grow on a sustained basis.

To recap, a sound monetary policy supported by a floating exchange rate, sound fiscal policy, and appropriate structural adjustments all did their part to help Canada's economy respond 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.

Adjustments in the future

So that's a quick look at the lessons we have learned from past experience. Let's turn now to the international forces at work in our economies and talk about what these forces will mean for economic policies in the future.

In the global economy today, we see significant financial imbalances. The United States is faced with a large fiscal deficit and a high and growing current account deficit, while some Asian countries are accumulating record current account surpluses. The economies of China and India, as well as yours here in Brazil, are becoming increasingly powerful players on the world stage. This increases the competitive pressure facing Canadian producers. But it also means new, fast-growing sources of demand and new opportunities.

So in the face of these forces, what kinds of adjustments are needed? I will talk about our situation in Canada, but what I have to say is applicable to most economies.

The first thing I would say is that maintaining fiscal balance must remain a priority for Canada in the years ahead. Our federal and provincial governments have made great progress on this front, but we in Canada cannot afford to give back these hard-won gains. Neither can governments in this country. Maintaining fiscal balance is as important for Brazil as it is for Canada.

This priority is heightened in Canada by our longer-term demographic challenges. Our ratio of public debt to GDP will need to decline further to give us the flexibility to meet the demands of our aging population.

My second point is that we must provide the appropriate microeconomic policies in areas such as labour markets, intellectual property law, the environment, and foreign investment. The right microeconomic policies are essential in order to increase productivity and raise living standards in the future. This is true for every country.

However, we know that implementing the right economic policies can mean that some groups will bear an unfair share of the burden of adjustment. This does not mean that we should shy away from the task. But it does lead to my third point, which is that authorities must put in place the right policies to facilitate adjustment, such as providing access to training, or helping workers relocate or shift into expanding areas of the economy. In doing so, we should keep in mind that government help should be directed towards people, and not towards specific businesses or industries.

So what can policy-makers do to provide a supportive economic environment for business? In my view, promoting an efficient and robust financial system, including a strong banking sector, is critical. And that is my fourth point. This is particularly true in countries such as Canada, where small and medium-sized businesses create the majority of jobs. Growing firms must have access to credit within a well-functioning financial system. Further, people need to have confidence in the banking sector, so that savings can be efficiently recycled to help businesses expand.

A robust financial system can also be a country's best defence against international financial crises. A key lesson from the Asian and Russian crises was that countries with strong banking sectors are much less likely to be affected than countries where the banking sectors are weak.

Beyond the banking sector, countries should also work to develop healthy and efficient financial markets. This is not a new idea. Canada's efforts to build domestic money markets go back over 50 years. And we built these markets living next door to the country with the deepest, most liquid financial markets in the world - the United States. Now, and in the future, we will need to remain focused on promoting healthy and efficient markets. This topic is an ongoing priority for research at the Bank of Canada. In fact, later this year we will host, along with the German Bundesbank, a G-20 workshop on building strong domestic financial systems.

My fifth and final point has to do with trade. Canada has a long history of supporting multilateral trade agreements. We have seen, first-hand, how our economy has benefited from opening our borders to trade. That is why we are committed to trying to extend the benefits of free trade to the whole of the Americas through the Free Trade Area of the Americas (FTAA). It is why we also support your efforts in Mercosur. And, most importantly, it is why we are committed to lowering trade barriers at the Doha round of multilateral negotiations. I have seen many examples of the challenges that governments face in reducing trade barriers and subsidies. We in Canada have our own difficulties in this regard but, as an economist, I know that the economic benefits of freer trade make the effort worthwhile.

So those are the five areas that should be priorities for Canada in the years ahead: fiscal prudence, the right microeconomic policies, appropriate social policies, a strong and stable financial system, and more open trade. Monetary policy, for its part, will continue to be focused on keeping inflation low, stable, and predictable, thus giving citizens, businesses, and investors confidence in the future value of their money. To achieve this, we will try to keep supply and demand in balance.

Since the Bank of Canada has chosen low domestic inflation as its monetary policy anchor, we will continue to have a flexible exchange rate. We recognize that a floating currency implies some volatility. But I can tell you that Canada derives enormous benefits from having a floating currency working in conjunction with a solid monetary policy anchor. It gives us the ability to set monetary policy tailored to Canada’s specific economic circumstances. It sends important price signals to economic participants and helps our economy to make the necessary adjustments.

Conclusion

Let me conclude. For many firms and many employees, 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 economic policy frameworks.

The challenges that we will face make it even more important for us to continue to strengthen those 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 that Canada and Brazil can create for their 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.