David Dodge: The changing world economy - what it means for Canada

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Hamilton Chamber of Commerce, Hamilton, Ontario, 16 June 2004.

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Good afternoon. I am very glad to be in Hamilton today. This city has undergone tremendous change over the past couple of decades, and it's certainly exciting to see the revitalization efforts taking place here. And now, Hamilton is working to diversify its economic base. It's obvious that adjusting to change is not a new thing for Hamiltonians.

The same is true of the Canadian economy, which must always adjust to changing domestic and world circumstances. During 2003 and so far this year, some of those adjustments may have felt more like overhauls, particularly for some manufacturing firms here in Ontario.

One of the most important changes that we have all seen since 2002 has been the realignment of major currencies in the face of global trade imbalances. This has been driven primarily by weakness in the U.S. dollar against other currencies, including our own.

A second change has been the weaker demand for Canadian exports in 2002 and 2003. In addition to the exchange rate effects, some of this weakness has been linked to growing competitive pressures arising from the rapid integration of China and, to a lesser extent, India, into the global economy. These countries are becoming increasingly important exporters and importers of a wide range of goods and services.

Third, last year, the Canadian economy faced a number of specific domestic shocks, such as SARS, mad-cow disease, floods, fires, and the power blackout in Ontario. All of these developments since 2002 have left us with an economy that is operating below its production potential.

I'll come back to Canada's specific economic outlook later on. But I'll spend the bulk of my time today discussing the major changes that are taking place in the global economy, and how Canada is adjusting to this new environment. I will also talk about how the macroeconomic framework we have developed in Canada during the past couple of decades gives us more flexibility to adjust to global economic shocks and to embrace the new opportunities that change brings.

The only constant is change

We've all heard the old saying that the only thing we can be sure of is change. And we have certainly seen sweeping changes in the world economy over the past 20 years. Today, we are seeing significant swings in the balance of economic power, as large emerging markets have opened up to trade.

But let's remember that integrating new regions of the world into the international trade order is not a new phenomenon. Since the early nineteenth century, various countries have emerged at different times as major forces on the international economic scene.

After the Second World War, the world trade order, which had broken down in the 1930s, had to be rebuilt. The war-torn countries of Western Europe were slowly reintegrated back into that order. Through the 1950s and 1960s, Japan re-emerged as a major economic power. Then Korea took off in the 1970s, followed by other so-called "Asian tigers" during the 1980s and 1990s. Now, it's China's turn. And India is not far behind.

What makes the ascent of China and India different from that of other countries is their sheer size. Together, these two countries represent close to 40 per cent of the world's population. Their combined economies, measured on the basis of purchasing-power parity (which compares economies by equalizing the purchasing power of their currencies for a similar basket of goods and services) add up to more than 85 per cent of the U.S. economy. In fact, by that measure, China's economy is the second largest in the world, after that of the United States, and India's is fourth, after Japan's. Their influence is intensifying the competitive pressure facing producers in other countries, including Canada. But it also means new, fast-growing sources of demand and new opportunities for us. Let's remember that some of the early emerging-market economies have become important markets for Canadian goods and services. The integration of China and India into the world trade order is taking

place as other emerging-market economies, such as Mexico and Brazil, continue to carve out their niches in world markets.

Now, I'd like to spend a few minutes discussing the adjustments that all open trading nations must make in this changing environment, and recall some of the lessons that past adjustments have taught us.

Benefits of international competition

First, let me say a few more words about the competitive environment. Not surprisingly, some perceive the growing competition from China and India as a threat. Companies everywhere are under constant pressure to lower costs, and many of them are finding that China and India are attractive places to establish production facilities and service centres. The loss of certain jobs in the home countries of those companies is a sensitive social and political issue and can contribute to protectionist pressures, especially during periods of relative economic weakness.

But as we consider the impact of increased competition from Asia, it is important to remember that economic growth in Asia is lifting hundreds of millions of people out of poverty. That's an absolute good. And it is a new source of opportunity, creating more demand for goods and services from the industrialized countries and thus providing a boost to global economic growth.

Healthy financial systems

As our economies have become more open, we have also been reminded of the importance of a solid, efficient financial system. In any country, growing firms need access to credit from a sound, well-functioning financial sector, including a healthy banking sector. Countries with strong financial systems are much less likely to trigger or to amplify international financial crises than countries where those systems are weak. With the increasing integration of world markets, it is in everyone's interest to promote efforts to limit the impact and the spread of financial shocks.

Since the Asian and Russian financial crises of 1997-98, countries have worked to improve the transparency and reliability of their domestic financial systems. Mexico, for example, has made tremendous efforts to improve the health of its banking sector, partly by drawing on the sound business practices of large banks from other countries, including Canada. In some countries, however, progress is less evident. And in China, the building of a strong commercial banking sector presents an enormous challenge.

But it is not just domestic financial systems that need to be strong and flexible. As the global economic environment evolves, it is important that international financial institutions adjust in response. That is why institutions such as the International Monetary Fund and the World Bank must continue to modernize themselves, to remain relevant in a changing world. While the IMF and the World Bank have evolved somewhat since their creation in 1944, they have changed much less than the global economy they oversee. So it is encouraging that a strategic review of their mandates and operations has begun. This review is a first step towards a much-needed updating of these institutions.

Commodity price adjustments

I've spent some time outlining some of the structural forces at work in the world economy. Now I'd like to talk about some of the adjustments that are being made following the recent sharp rise in global demand.

The first adjustment is to higher commodity prices. The rapid growth of some emerging-market economies and the strong recovery in the United States are fuelling demand for raw materials. And that, in turn, is pushing up the prices of these raw materials. Certainly, we have seen the effect of this demand on most commodity prices.

Of course, one price increase that we all feel acutely is that of oil. The recent surge in crude oil prices is another example of pressure stemming, at least in part, from strong world demand. This stronger demand has not yet been met by compensating growth in the supply of crude oil - although a recent agreement by OPEC to boost production will help. Nor have we seen substantial efforts by price-

sensitive consumers to use less oil and gas. Meanwhile, geopolitical events have contributed to concerns about potential supply disruptions, exacerbating the run-up in oil prices.

It is reasonable to expect that oil prices will remain relatively high until some of the geopolitical uncertainty dissipates, world production capacity expands, and further conservation efforts take hold. Higher energy costs mean that it will be more expensive to produce many goods and some services. It is not clear to what extent companies will be able to offset rising costs and limit price increases to consumers.

What is clear is that economies need to adjust to these higher costs - and economic policies must support that adjustment. We have learned this from the mistakes made during the oil crisis of the 1970s, when many countries, including Canada, tried to shield their economies from the effects of rapidly rising energy prices. The result was an eventual adjustment that was slower and more painful than it needed to be.

A return to more normal world interest rates

A second adjustment underway in the global economy is the return to more normal interest rates and somewhat wider spreads on risky investments.

After the global economic slowdown of 2000 and the terrorist attacks of 11 September 2001, central banks around the world lowered their policy interest rates to provide the liquidity to help their economies recover and absorb excess capacity. The world economic recovery we are seeing is due, in large part, to accommodative monetary policy - that is, historically low interest rates. Through 2003 and the early part of 2004, interest rates in some countries hit their lowest levels in 50 years, and global credit conditions were very expansionary.

But we know from experience that, as growth resumes and economies get closer to their production capacity, inflationary pressures start to build. And so central banks in many countries will have to remove some of the stimulus, and interest rates around the world will have to return to more normal levels. This process has already started, with market rates adjusting in anticipation of future increases in policy interest rates. There is no doubt that over the next year, we will see upward adjustments in policy interest rates around the world. The timing and the magnitude of these adjustments will vary from country to country, according to each one’s economic circumstances.

The good news is that all this is happening before economies reach the limits of their production capacity, and before inflation takes off and inflation expectations start to rise. That bodes well for sustained economic growth without the credit crunches or accelerating inflation that occurred in earlier global business cycles.

I have painted a reasonably sanguine view of the world economy and its ability to meet challenges. I don’t mean to suggest, however, that there aren’t any economic risks in the adjustments that I have outlined. As you all know, we are again facing heightened geopolitical uncertainties. And there are significant global economic imbalances that must be corrected over time. But, over the past couple of decades, central bankers and governments, as well as corporations and financial institutions, have learned a great deal about managing global risks. And most countries agree on the critical elements and policies necessary to adjust to global economic change.

How well is Canada’s economy adjusting?

So, just how well is Canada’s economy adjusting? Let me look at some of the important efforts we have made and at the policies that are necessary to help us manage change and seize new opportunities.

First, maintaining solid economic growth in Canada requires confidence based on well-managed monetary and fiscal policies. As you know, the Bank of Canada is responsible for monetary policy. You may also recall that in 1991, together with the federal government, we agreed on an anchor for monetary policy. This anchor was an explicit inflation target that would gradually lower the annual rate of consumer price increases to 2 per cent - the midpoint of a range of 1 to 3 per cent. Since then, we have kept inflation around 2 per cent, on average. And inflation expectations have fallen in line with this target.

Our inflation-targeting system means that the Bank of Canada lowers rates when we see the trend of inflation heading below 2 per cent. And it also means that we raise rates when it looks as if the trend of inflation will be moving above the target. This symmetric response helps to smooth the ups and downs of the business cycle. In our decision-making process, we must allow for the fact that it takes 18 to 24 months for changes in interest rates to have their full effect on the economy and on inflation. Therefore, we must constantly look ahead to make timely decisions that will help to smooth the business cycle, rather than exacerbate its volatility.

Another important benefit is that inflation targets have enabled the Bank to explain more clearly to business, labour, and the public what we are doing and why. Better public understanding of central bank policies and actions makes monetary policy more effective.

Canada's experience shows that monetary policy works best when it goes hand in hand with other sound economic policies. In particular, implementing and maintaining sound fiscal policy at all levels of government is fundamental to good economic performance. This gives a country the credibility and flexibility to manage economic challenges. And it gives citizens confidence that the authorities will manage public finances prudently.

I talked earlier about the impact of increased global competition. Canada has clearly felt that impact, and we continue to adjust to meet competitive pressures. Canada has a long history of supporting multilateral trade agreements. Opening up to global competition and to new markets has made us a more innovative and competitive economy.

As we see the integration of major new players in the world economy, our firms must continuously adapt, innovate, and improve their efficiency. That means continued investments in research and development, as well as education and training. And, in a changing world economy, our firms must continue to find and to exploit new opportunities.

I noted earlier that the booming growth of large economies like China and India means that demand for both energy and non-energy commodities will likely remain strong. And so Canada will need the flexibility to shift resources into the production of those commodities, as demand requires. It is important that our resource sector strives to remain among the world's most efficient, and that our manufacturing sector continues to innovate.

The steps that I have just described will help us meet the long-term challenges that we, as well as other national economies, face. Canada's economy continues to adjust to global economic developments. Monetary policy has been facilitating these adjustments by supporting aggregate demand, with the goal of keeping the economy near its full production capacity and inflation on target.

Canadian economic outlook

Before I close, I want to spend a couple of minutes on the Bank's views about the current economic outlook and inflation in Canada. Growth in the first quarter of this year was 2.4 per cent, below the economy's estimated potential growth rate of about 3 per cent. This implies that the level of output in the economy is still significantly below its production potential. However, both final domestic demand and exports grew strongly in the first quarter. These indicators, along with more recent data, suggest that growth in the first half of 2004 is likely to be somewhat above 3 per cent.

In our April *Monetary Policy Report*, we said that we expected the economy to grow by about 2 3/4 per cent in 2004 and by about 3 3/4 per cent in 2005. We also said that core inflation - a measure of trend inflation obtained by removing eight volatile components from the consumer price index, as well as the impact of changes in indirect taxes on the remaining components - was expected to average 1 1/2 per cent over the remainder of 2004 and to move back up to 2 per cent by the end of 2005. Information received since the release of our April *Report* has been generally consistent with expectations about core inflation.

But the sharp rise in world oil prices, in response to stronger-than-anticipated global demand for oil and heightened geopolitical uncertainties in the Middle East, means that total CPI inflation over the next several months will be higher than the Bank expected in April. It is important to note that while higher oil prices may push up the total CPI over the next few months, they should not feed through into higher trend inflation, as long as inflation expectations remain anchored around the 2 per cent target.

Conclusion

To conclude, the world economy has undergone tremendous change in recent years. And we can be sure that there is more to come.

While we Canadians can remain confident of our ability to adjust to change, we must not be complacent. We should continue to work at strengthening our macroeconomic framework, enhancing our productivity, and opening up further to trade. That is the best way to ready ourselves for the challenges and opportunities that lie ahead.