David Dodge: Canadian monetary policy in an evolving world economy

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Canadian Chamber of Commerce, Calgary, Alberta, 20 September 2004.

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Good afternoon. I'm glad to be back in Calgary. We at the Bank of Canada welcome these opportunities to get out across the country, to speak to business people, and hear your perspectives on the economy. The feedback we receive from businesses from coast to coast is an important part of our monetary policy deliberations. I know that the staff of our regional office here in Calgary work hard to stay on top of local business conditions on the Prairies, as do our other offices for their regions.

I am happy to have the opportunity to meet with the national body of the Chamber of Commerce. I can tell you that my regular contacts with the Ottawa liaison group are very valuable to me. The Bank does look to the Chamber to help us understand how economic developments are unfolding at the industry level. And I particularly want to thank the Chamber for being an ongoing partner in our efforts to smoothly introduce three new high-denomination bank notes this year. This is the second straight year in which we have set up a currency-education kiosk at your annual meeting, to help spread the word about our new bank notes. You can learn about the security features that we have included in our high-denomination notes. And we have materials about our new $20 note that we unveiled last month, and which goes into circulation beginning next Wednesday, 29 September.

I should add that I'll be back here in Calgary on 13 October to unveil the new $50 bank note, which goes into circulation beginning in mid-November.

During the past year, powerful forces have continued to shape the global economy. Alberta, and indeed all of Canada, have felt the impact of these forces. Of course, the evolution of the global economy is not a short-term event. Some of the forces currently at work have been building for years. Similarly, today's developments may have repercussions, and raise the need for adjustments, for years to come. So today, I want to talk about Canada's economic outlook and the prospects for monetary policy within the context of the evolving world economy.

How the monetary policy framework works

I will start with a brief review of our monetary policy framework. Let me remind you of the goal of Canadian monetary policy. Experience has taught us that the best contribution the Bank of Canada can make to good economic performance is to keep inflation low, stable, and predictable. By doing so, we can provide the backdrop that best allows our economy to grow in a strong and sustainable way.

We aim to keep inflation - as measured by the annual rate of increase in the consumer price index - at 2 per cent. It's important to note that we conduct monetary policy in a symmetric way. This means that we will raise interest rates to dampen total demand when we see that inflation is threatening to rise above our 2 per cent target over the next 18 to 24 months. In the same way, we will lower interest rates to stimulate demand when we see that the trend of inflation is poised to fall below the target. This symmetric approach to monetary policy has delivered an average rate of inflation that has been very close to 2 per cent since inflation targeting was adopted in 1991.

It is also important to keep in mind that monetary policy actions take time to have their full effect. The lags are variable, but it typically takes a year and a half to two years for a change in interest rates to have its *full* impact on the economy and inflation. That is why we say that we need to be forward looking with our monetary policy, and that is why we are always trying to assess the state of the economy 18 to 24 months into the future. Specifically, we try to evaluate the various factors that will affect supply and demand, to help us estimate the future size of the output gap.

What do I mean by "output gap?" That term refers to the difference between actual output - what the economy is producing - and potential output - the maximum amount the economy could produce without triggering higher inflation. Another way that we sometimes refer to this concept is to talk about how close the economy is to its production capacity. This idea is important because when economies operate above their capacity - or, as economists like to put it, there is excess demand and a positive output gap - inflationary pressures can build. But when economies operate below capacity - meaning that there is excess supply and a negative output gap - disinflationary pressures can set in. Ideally, we want to see the economy operating close to its capacity, with total demand roughly in balance with total supply. If we achieve this, we can have the best outcome over time - strong, sustainable growth that avoids booms and busts, along with rising employment and low inflation.

One major problem is that we cannot directly measure potential output. Further, the economic data that measure actual output are often revised - sometimes significantly so. The challenge for us, then, lies in estimating the size of the output gap, and there is always a significant degree of uncertainty around that estimate. So we look at a number of other economic variables to help us form an opinion about how large the output gap is. You can find out more about these variables on our Web site. They include, among others, indicators of capacity in goods markets, signs of tightness in labour markets, and signals of pressures in the real estate market. Some of these are quantitative, and some are qualitative, based on surveys of businesses conducted by our regional offices. Another indicator is the rate of inflation itself. If core inflation - which strips out eight highly volatile components of the consumer price index - is *consistently* coming in above or below our expectations, it may lead us to adjust our view about the current size of the output gap.

Earlier, I said that when the economy is operating near its capacity, total demand for Canadian goods and services - or what economists like to refer to as "aggregate demand" - is roughly in balance with total supply. Total demand has two components - domestic demand and foreign demand. Assessing foreign demand is difficult, but because it represents such a large share of total output in Canada, we at the Bank spend a great deal of time and effort trying to gauge that demand.

Of course, it is nothing new to say that our economy is importantly affected by events abroad. Canada has always relied on international trade. For a long time now, the United States has been the focus of attention in assessing the world economy. But many of today's global economic developments have their origins outside North America, most notably in Asia. Before I talk about their current implications, I would like to take a few minutes to discuss the nature of these developments and their likely implications over the next decade or so.

The medium-term implications of global developments

Just as Japan and Korea emerged as major players on the global stage in previous decades, China is now quickly becoming an economic powerhouse. And India is not far behind. When you consider that these two countries account for 40 per cent of the world's population, it is not hard to see why they are having such an impact on the global economy.

As we look ahead, it is clear that China and India will be major global competitors, not just in labour-intensive industries, but increasingly in skill-intensive industries as well. It's a pattern of development that the world has seen before. Established firms in many industries will feel competitive pressure from China and India, until the large pool of surplus labour in those countries can be absorbed. But at the same time, this process will create income and wealth in China and India and, hence, increase their ability to buy more goods and services from abroad.

So, the integration of these countries into the global economy represents both a competitive challenge and a tremendous opportunity for the industrialized world. These emerging markets are just that - markets. China is already one of the largest importers in the world and its importance will increase over the next decade. This source of growing demand can provide a much-needed boost to the global economy in general and to the Canadian economy in particular. We have already seen some Canadian commodity producers step in to fill the demand from Asia. Indeed, Statistics Canada recently reported that the value of Canadian exports to China in the first seven months of this year rose by 58 per cent compared with the same period in 2003.

There will also be opportunities for Canadian firms to integrate low-cost components into their own production processes, through direct investment or joint ventures. This will be an increasingly important way for Canadian firms to maintain cost competitiveness.

Over the medium term, it will be absolutely crucial for all Canadian businesses and governments to continue to take advantage of these opportunities as they arise.

At the same time, Canadian businesses and governments need to recognize that these global developments will require adjustments here in Canada. There will be some activities, particularly those that are labour-intensive and lower-value-added, where Canadian firms will not be well placed to compete with lower-cost producers in Asia. The key will be to adjust by shifting resources into expanding, higher-value-added activities, where Canadian firms can exploit the opportunities presented by the changing world economy. By making these adjustments, we will be able to increase productivity and raise our standards of living over the medium term.

Of course, it is not just developments in Asia that will require us to make adjustments here in Canada. We will also have to adjust as the U.S. economy reduces the size of its fiscal and current account deficits. But the subject of adjustments to global imbalances is beyond the scope of my remarks today. What I can say, though, is that the Bank of Canada will facilitate whatever adjustments are necessary by keeping inflation low, stable, and predictable. This will help Canadian firms and individuals read market signals more clearly and allow them to make plans with confidence in the future value of their money.

Near-term implications of global developments

That's a look at the medium term, and it is important for business people and economic policy-makers to always keep an eye on the horizon. But, as you run your business from day to day, and as we at the Bank conduct monetary policy, it is the shorter-term developments that are the greater focus of attention. So, let me spend a few minutes on the near-term outlook for the world economy, and what that outlook implies for foreign demand for Canadian goods and services.

As I said before, the emergence of China and India is having an important impact on the Canadian economy through an increase in demand for many of the commodities that we produce. This has caused a run-up in the prices of nickel, potash, and steel, among others. And, in turn, this has boosted the income of many Canadian producers, even after taking into account the effects of the large appreciation of the Canadian dollar that we saw in 2003.

Of course, the most high-profile price increase recently has been that of oil. Very rapid growth in Asia has led to unexpected additional demand for oil. For the time being, this unanticipated demand is putting pressure on a market that already had little spare capacity. Over the medium term, oil production will, in all likelihood, increase to meet this additional demand. But it takes time for new production to come on line. Thus, it is not unreasonable to think that oil prices will be higher in the near term than what we might expect them to be over the medium term.

Our best judgment at the moment is that high levels of growth in Asia will continue over the next couple of years, and that demand for commodities will continue to grow, although perhaps not quite as rapidly as in the past couple of years. This is based on the not-unreasonable assumption that the Chinese authorities will be able to manage economic growth at a more sustainable pace.

While developments in Asia are likely to play a very important role in supporting continued strength in the global economy, developments in the United States will still have the largest impact on the volume of Canada's exports over the short term. As we said in our July *Monetary Policy Report Update*, recent data point to some slowing of U.S. growth from the red-hot pace of the second half of 2003 and the first quarter of 2004. Higher oil prices appear to be having some restraining effect on U.S. consumer spending, and both consumers and businesses seem to be somewhat less optimistic than they were earlier this year. Nevertheless, we still expect growth to be similar to what we forecast in July - that is, faster than the growth rate of U.S. production capacity. This strong U.S. growth bodes well for continued high *levels* of Canadian exports, although they are unlikely to continue to grow at the rapid pace of the first half of this year.

Consistent with this profile for solid U.S. and global economic growth and with the expectations of financial markets, we continue to assume some upward movement in global policy interest rates to moderate inflation pressures as output levels approach production capacity.

Canada’s economic prospects

Let me now turn to Canada, beginning with a quick recap of the first half of 2004.

At the start of the year, we said that we did not expect *net* exports - the difference between what we export and what we import - to make a significant contribution to Canada's economic growth in 2004 or 2005, because of the sharp appreciation of the Canadian dollar last year. We also said that economic growth would have to come primarily from domestic demand in order to eliminate the excess supply that existed at the start of the year and to close the output gap. To facilitate growth in domestic demand, we reduced our key policy interest rate from 2 3/4 per cent to 2 per cent in three steps earlier this year.

However, Canada's economic performance in the first half of 2004 turned out somewhat differently from our expectations. The volume of exports grew much more rapidly than we had anticipated. So did imports, but not to the same extent as exports. As a result, *net* exports made a very significant contribution to growth, and aggregate demand in the first half of the year grew more strongly than we had expected at the beginning of 2004. So the output gap at mid-year was smaller than we had projected. Indeed, the Bank judges that the Canadian economy is now operating close to its production capacity.

As we look ahead to the remainder of this year and to 2005, we expect that exports will grow more slowly than in the first half of 2004. But there are lots of uncertainties that cloud the outlook for foreign demand and Canadian growth. These include uncertainty about the western grain crop, the re-opening of the U.S. border to live cattle exports, and auto production, as the "Big Three" automakers face softer markets for their products. Despite these caveats, aggregate demand will likely grow at a rate equal to, or marginally above, the rate of growth of production capacity over the next four quarters.

With the economy currently operating close to capacity, we reduced the amount of monetary stimulus in the economy two weeks ago by raising our key policy interest rate to 2 1/4 per cent.

Inflation, both total and core, has been volatile in recent months, primarily because of swings in energy prices and because of automobile purchase-incentive programs. But despite this volatility, we continue to project that core inflation will be a bit above 1.5 per cent for the second half of 2004, before gradually moving up to the 2 per cent target in 2005.

Looking forward, we will need to continue to reduce monetary stimulus to avoid a buildup of inflationary pressures and to contribute to sustainable, solid economic growth. However, the pace of our actions will depend on our continuing assessment of the evolving prospects for pressures on capacity and inflation.

In this context, there are several key factors that the Bank will be watching closely. As always, there is uncertainty about the exact size of the output gap. There is also considerable uncertainty at this time about the future growth rate of both exports and imports, and about the evolution of world prices for energy and non-energy commodities. And we will be watching the impact of geopolitical developments on global confidence and demand. We will update our outlook for the Canadian economy in our next *Monetary Policy Report*, which will be published on 21 October.

Conclusion

Let me conclude by going back to my earlier point about the need to adjust to changes in the world economy. We can be certain that the powerful global economic forces I spoke of today will continue to be felt as the world economy continues to evolve. This evolution will lead to challenges that we must face, but it will also lead to opportunities that we must seize.

At the Bank of Canada, we will continue to monitor these global forces closely and assess their impact at home and abroad. This will help us contribute to Canada's future economic prospects through low and stable inflation.

For Canada to grow and prosper over the long run, Canadian businesses and governments will need to make the right adjustments to the evolving world economy. As leaders in the business community, your job will not be easy. But over the past several years, we have seen ample evidence that you can face challenges and take advantage of opportunities. I am confident that you will continue to do so in the future.