David Dodge: Global economic developments and the implications for Ontario

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Ontario Economic Summit, Niagara-on-the-Lake, Ontario, 7 October 2004.

*   *   *

Good afternoon. I am glad to be here, and to participate in this very important summit.

It's not easy to come up with something fresh to say this late in the conference agenda. My topic is "Ontario's Place in the World," but, of course, you've already spent a day and a half listening to the opinions of smart people who spend a great deal of their time studying this very subject. You've discussed at length the forces at play in the world economy, and how they are influencing Canada's economy and, of course, the economy of Ontario.

Unfortunately, I have not been able to attend the entire event, so I have missed hearing many of the interesting speakers and presentations that have gone before. So, to contribute to this discussion about Ontario and its place in the world, I thought that I would begin by giving you a brief synopsis of what I heard this past weekend at the meetings of the G7 and the International Monetary Fund in Washington. I'll recap what was said about the challenges facing the global economy, both over the next year and further out over the medium term. Then, I will talk about how those themes and their implications relate to the Ontario economy.

The global economy in the near term

One theme that I heard repeatedly in Washington is that 2004 is turning out to be a better year than many had thought, particularly over the first half of the year. Indeed, the IMF is now projecting global economic growth of 5 per cent in 2004, which would be a marked improvement from the 3.9 per cent rate seen in 2003. Globally, while the United States continues to be an important source of growth, it is encouraging to note the very strong growth in Asia and the improved momentum in Europe.

There have been a few factors underpinning this growth, including a still-favourable financing environment, and a general improvement in the banking sector and in private sector balance sheets and profitability. The outlook for consumption and investment in most countries continues to be good.

This outlook bodes well for the rest of this year and 2005, even though there was a sense at the meetings that growth over this period will not be quite as strong as we saw in the first half of 2004. The IMF's own forecast, for example, pegs global growth for 2005 at 4.3 per cent - still above the trend rate, but off a bit from 2004.

However, this optimistic outlook came with a clear caveat. The balance of risks for the global economy in 2005 has shifted slightly to the downside. Let me briefly mention some of the risks that were talked about. There was a general sense that the sharp rise in oil prices could become a more significant drag on growth next year, particularly if prices were to stay at current levels. Higher oil prices have cut into the rate of economic growth, but the consensus is that, so far, the overall effects appear to be manageable.

Geopolitical events remain a risk to the world economy. As well, we are beginning to see the potential for inflationary pressures in some countries, as economies approach the limits of their production capacity. The challenge for monetary authorities will be to manage the transition from a very low interest-rate environment to one where policy rates are somewhat higher.

Medium-term prospects for the global economy

Looking beyond 2005, there was a general consensus that economic policy-makers around the world need to move ahead with addressing the problems that the global economy will face. So let me now take a few minutes to discuss what was said about the medium-term challenges for the global economy.

In 2006 and beyond, a key concern will be how economies will adjust to the current global economic imbalances. A large U.S. current account deficit has its counterpart in the large current account surpluses in almost every other region of the world, most notably in Asia. At the same time, we have seen a sharp rise in the net foreign liability position of the United States and a massive accumulation of foreign exchange reserves by the Asian countries.

Looking forward, the U.S. current account deficit is likely to continue to deteriorate, and current account surpluses in emerging Asia may remain larger than desired for longer than desired. For now, there is no reason to believe that world capital markets cannot manage these imbalances. But, over the longer haul, the magnitude of these current account imbalances cannot continue, and no country can pile up foreign exchange reserves indefinitely. Global adjustment will be needed to restore balance.

This global adjustment could take place in several ways and through several channels. Hopefully, these will allow the adjustment to take place in an orderly way. The first channel is through changes in the global pattern of savings and consumption. Domestic savings in the United States could rise - both government and household savings rates can be expected to head up. And foreign consumption could increase, as economies and markets continue to expand.

It is worth noting that in North America, household consumption is running well over 60 per cent of GDP. As we look ahead, and take into account the aging population, it is important that savings rates increase in North America. At the same time, household consumption in emerging Asia is only about 40 per cent of that region's GDP. As Asian incomes rise, there is great potential for household consumption in that region to increase. So these are natural forces that will be working towards the adjustment of these imbalances.

The second channel for adjustment will undoubtedly involve changes in real exchange rates; that is, the relative value of currencies taking into account the effects of inflation. Changes in real exchange rates could come about either through movements in relative inflation rates, or movements in nominal exchange rates, or some combination of the two. With respect to nominal exchange rates, the big issue is the need for some effective depreciation of the U.S. dollar against the currencies of emerging Asia. A key element here is China's fixed exchange rate, and how successful the Chinese authorities will be in meeting their stated goal of moving to a floating currency.

In all likelihood, both of these channels of adjustment will play some part in facilitating the correction of global imbalances. As these adjustments take place, two things will be critical to ensuring that real incomes continue to rise worldwide. First, global trade flows must continue unimpeded. That is why we must push for continued progress at the Doha Round of trade negotiations under the World Trade Organization. It is also why we must fight against any outbreak of protectionism.

Second, all economies must take steps to enhance their flexibility so that the adjustment doesn't have to take place through loss of real incomes. Here in Canada, we have to continue to increase the flexibility of our markets for goods and services, for capital, and crucially, for labour. At the same time, all of us leaders of corporations and public sector institutions must work to enhance the productivity of our workplaces. That leads me to the issues that we have to consider here in Ontario. The remainder of my remarks today will deal with these issues.

Adjustments in Ontario

Now, as I mentioned, I was not able to participate in your earlier discussions about the structure of Ontario's economy. But, having outlined the forces that the international experts believe will be at work in the years ahead, let me now spend a few minutes talking about the competitive and structural issues that we face here at home in light of these global forces.

Experience has taught me that one has to be very careful in trying to predict exactly how structures in an economy are going to evolve. But I think that we can safely predict that the first and most obvious adjustment will be a transformation of manufacturing processes around the world, as low-cost, highly efficient capacity is built in Asia. This means tremendous and continuing competitive pressure on industries that have traditionally been mainstays of the Ontario economy - automobiles and parts, other transportation equipment, and some areas of light manufacturing. Over time, those pressures will increasingly be felt by industries such as steel and heavy manufacturing. There are no signs that these pressures will abate in the years ahead.

A second adjustment will be to higher energy costs in the years ahead. This is a major issue for all countries, and poses a problem for Canada and Ontario, which are energy-intensive by world standards. But energy cost increases and supply concerns are not limited to oil and natural gas. The blackout of August 2003 was a spectacular example of the need to have adequate and failsafe electricity supplies. We know that our electricity supplies are often stretched to the limit. And we know that demand in Ontario will continue to grow in the future, and that there is no clear plan to replace the capacity that has been slated for closure.

A third adjustment relates to non-energy commodities. Strong demand from the booming economies of Asia is behind the rise in non-energy commodity prices such as nickel and iron ore. In response, we are seeing significant efforts in countries around the world to find new sources for these commodities and to improve their efficiency in extracting them. This province's commodity producers must take advantage of this healthy environment to boost their own productivity to meet new competitive challenges.

Fourth, we are in the process of adjusting to the fact that services, once thought to be non-tradable, are increasingly open to worldwide competition because of changes in technology. Ontario's service-producing industries are facing increased competitive pressure from new suppliers, such as India's burgeoning information technology and business services industries. All indications are that this pattern will continue, and will be repeated in other service industries.

Perhaps the biggest challenge for Ontario's service sector will be from the continued consolidation within financial services industries around the world. This poses a real competitive challenge to the financial services industry that is so important to the Greater Toronto Area. Indeed, while financial services companies may be concentrated around Toronto, they are important to the whole province - the finance, insurance, and leasing sector represents almost 15 per cent of Ontario's GDP.

All these competitive challenges are compelling Ontario's businesses, politicians and policy-makers to find ways to increase industrial productivity and market efficiency.

Let me just stop for a second, because what I've said so far may sound overly negative about Ontario's economic prospects. We need to keep in mind that changes in the global economy are also creating income and wealth in China and India, thus increasing their demand for goods and services from abroad. These emerging markets are just that - markets. This source of growing demand can provide a boost to the global economy in general, and the Ontario economy in particular.

Now, in the past two days, you have heard from people who are far more expert than I am about how individual sectors can meet this competition and take advantage of these opportunities. So I'm not going to try to add my own specific policy prescriptions to the debate. But I would like to point out some issues that I believe must receive considerable focus in order to position Ontario to meet the global challenges facing us over the medium term.

The first is **the need to improve the efficiency of labour markets and the quality of Ontario's human resources.** This is a critical element of Ontario's ability to meet future competitive challenges. To develop the skilled workers that this province will require to meet its labour demands, Ontario must ensure that its education and training systems are second to none. This applies to early childhood education and development, the provincial school system, and post-secondary education and skills training. And all employers, both public and private, have a responsibility to provide their workers with opportunities to upgrade their skills. Appropriate investment by individuals, by employers, and by governments, will be needed.

But even the best-educated and trained workforce will still face inevitable economic adjustment that will lead to displacement and additional burdens on some groups in society. This does not mean that we should shy away from the task. But it does mean that a second area of focus should be **to have policies in place that help to smooth the adjustment**. These include providing access to training, or helping workers relocate or shift into expanding areas of the economy.

The third area would be **to improve the efficiency of capital markets and the financial system** in Ontario and Canada. We all know that an economy works better when its financial services sector is sound and efficient. A robust and well-functioning financial system is key, so that growing firms have access to credit, and savings can be efficiently recycled to help businesses expand.

Now, I am not here with a prescription for what needs to be done in this area. But we must not lose sight of the fact that the financial sector is an important contributor to economic growth in Ontario. An efficient financial sector will continue to be a competitive advantage for this province, both in maintaining efficiency in our own market, and in providing an opportunity to export expertise around the world. So policy-makers have an interest in providing a framework that will allow our financial institutions and markets to compete in an increasingly globalized world. With global standards evolving rapidly, Canada and Ontario must be at the forefront in terms of efficiency and competitiveness.

A fourth area of focus is **the province's infrastructure** - it needs to be a contributor to industrial efficiency, not an impediment. An important part of this is transportation infrastructure. And this applies not only within the province, but also to the links with our trading partners in other provinces, other parts of North America, and overseas. But it is not just physical infrastructure that is important. We also need the right policy infrastructure in areas such as security, inter-provincial trade, and regulation. For example, as industries increasingly rely on just-in-time delivery, border delays can cause real damage to businesses. That is why it is critical to develop and maintain border crossings that are as safe as these times require, yet open enough to allow the rapid flow of goods and people.

The fifth issue would be **securing reliable sources of cost-effective energy** for the future. Ways must be found to foster the development of new sources of energy and to provide the right incentives for the efficient use of that energy. Clearly, there is a need for an appropriate framework to encourage investment in electricity transmission and generation, including renewable energy and alternative technologies.

So those are five critical elements that I see as part of Ontario's efforts to meet the challenges that lie ahead, and to take advantage of the opportunities presented by growing world markets. It is by no means a comprehensive list. There are many other important issues that I have not discussed. But I have tried to point out five areas that, in my opinion, policy-makers and business leaders cannot ignore.

Conclusion

We know that the challenges facing our economy will not be easy to meet. We know that tough choices will have to be made to secure an economic framework that enhances Ontario's efficiency and its flexibility. We know that the burden of adjustment will fall disproportionately on some individuals and groups and that we have a collective responsibility to help with that adjustment.

But we also know that Canadians and Ontarians have made tough choices in the past that have proved right. These choices have yielded an economy that is resilient, and capable of competing with the best in the world. That tradition must continue. The choices Ontarians make in the years ahead will determine our ability to meet the challenges thrown at us by this changing world economy, and to seize the opportunities that growth in world markets will bring. This province has tremendous human and natural advantages. I am confident that it also has the will to make the choices that will help Ontario thrive in this new world economy.