David Dodge: The Canadian economy - adjusting to global economic forces

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Ottawa Chamber of Commerce, Ottawa, 6 May 2005.

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Good morning. It's a pleasure to be here. I'm always glad to deliver a speech in Ottawa and to get a chance to play before the hometown crowd. But the opportunity is especially welcome this year, because this is an anniversary year for both the City of Ottawa and the Bank of Canada.

The year 2005 marks the 150th anniversary of the establishment of Ottawa as a city. On 1 January 1855, the logging community of Bytown was formally incorporated as a city and adopted Ottawa as its new name.

This year is also the 70th anniversary of the Bank of Canada. The Bank opened its doors on 11 March 1935. Both the City of Ottawa and the Bank of Canada have evolved and grown since their early days. But at the Bank, one thing that has not changed is our commitment to promoting the economic and financial welfare of Canada.

Our work at the Bank of Canada breaks down into four main functions. Let me briefly review them. First, the Bank issues and distributes Canada's paper currency and protects it from counterfeiting. Last year we issued new $100, $50, and $20 bank notes with enhanced security features. We are adding these security features to an upgraded $10 note, which will begin circulating on 18 May.

The Bank of Canada's second function is to act as the federal government's banker, managing government funds and the public debt. Third, the Bank promotes the safety and efficiency of Canada's financial system. It provides banking services to commercial banks and oversees the systems that financial institutions use to transfer funds and settle their accounts. Finally, the Bank of Canada conducts monetary policy in order to preserve the confidence of Canadians in the value of their money by controlling inflation. In this way, we contribute to the long-term stability and strength of the Canadian economy.

I will spend most of my time this morning discussing this last function - monetary policy. The Bank of Canada Act calls on us to "mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada." We do this by trying to keep inflation low, stable, and predictable. Specifically, we aim to keep the annual rate of consumer price inflation at the 2 per cent midpoint of a 1 to 3 per cent target range.

We pursue this objective by trying to keep the economy operating at full capacity; that is, we aim for a balance between total demand and supply in the economy. Simply speaking, if the demand for goods and services is pushing the Canadian economy against the limits of its capacity, and if inflation is poised to rise above the target, the Bank would raise its official policy interest rate. This, in turn, would push up other interest rates and help to cool off the economy. Conversely, if the economy is operating below its production capacity, and inflation is poised to fall below the target, the Bank would lower its target rate, to help bring down interest rates and stimulate growth. So, by maintaining low and stable inflation, monetary policy promotes greater stability in economic output, too.

A flexible exchange rate is a critical part of our monetary policy framework. We do not have a target or preferred exchange rate for the Canadian dollar. But it is an important relative price in our economy. A floating currency helps us to achieve our inflation target and can act as a shock absorber to cushion our economy from external shocks.

How monetary policy helps the economy adjust

Now, let me say a few words about the economic environment in which we're conducting monetary policy. There are powerful forces at work in the global economy, including growing competition from emerging-market economies, such as China and India, and large and growing financial imbalances in the United States and Asia. The growth of emerging-market economies is driving up demand for commodities, and that is pushing up world prices for oil and many non-energy commodities. Meanwhile, productivity improvements in some countries and a competitive world environment are lowering the prices for some consumer goods, communications services, and computer equipment. All of these forces are causing significant movement in the exchange rates of key currencies. They have also contributed to the sharp appreciation of the Canadian dollar against the U.S. dollar over the past couple of years.

Some of the adjustments we're now seeing in the Canadian economy are in direct response to these forces. Our monetary policy is helping these adjustments by aiming to support continued high levels of domestic demand. In our most recent *Monetary Policy Report*, released in April, we projected that domestic demand will grow by almost 4 per cent in 2005. This will offset softer foreign demand and the weaker contribution that exports are making to economic growth this year. This is important in the context of the Ottawa region, and I'll return to that in a moment.

I mentioned earlier that monetary policy works to control inflation. Low and stable inflation allows businesses and consumers to better read price signals in markets, which helps them to make better long-term decisions in the face of major economic developments. These signals prompt sectors that are shrinking because of weak demand to release resources that can be absorbed by expanding sectors, where demand is strong. Of course, adjustment is never simple or without pain. Individuals may have to retrain or relocate, and expanding businesses may require time to put the necessary capital equipment in place. But from a macroeconomic point of view, adjustment can take place with less social and economic cost when inflation expectations are well anchored, the economy is operating close to its potential, and a floating exchange rate is helping to absorb external shocks.

How businesses are adjusting

Let's now explore ways in which Canada's economy is responding to global economic developments. Over the past couple of years, commodity prices have risen dramatically. Our terms of trade - that is, the ratio of the prices that Canadians receive for their exports to the prices that Canadians pay for their imports - have improved by more than 16 per cent since late 2001. In response to these higher prices and stronger demand, we've seen stronger investment spending in oil and gas extraction, mining activity, and wood-product manufacturing.

We are also seeing rising investment spending in sectors with low exposure to international trade, such as electric power generation, finance and insurance, and information and cultural industries. In these cases, firms are reacting to strong growth in Canadian domestic demand. I should add that the increased activity in the construction sector reflects increases in both domestic and foreign demand.

But there are other sectors that are highly exposed to international trade where the prices of products are not rising. Here, I am referring to goods-producing sectors such as auto parts, textiles, and clothing manufacturing, as well as service sectors such as tourism. Firms in these industries are feeling the pressure of the higher Canadian dollar, and they are also facing increased competition from other regions of the world.

The good news is that many Canadian firms are making adjustments. Investment spending is being channelled towards increased specialization, higher productivity, and lower costs. In the goods-producing sector, where much of the productivity-enhancing machinery and equipment is produced abroad and priced in U.S. dollars, the stronger Canadian dollar has substantially lowered the cost of this machinery and equipment and has encouraged firms to buy tools that boost their productivity. In the services sector, stiffer competition is encouraging firms to increase their specialization and offer more value-added, customized services.

Other adjustments are also taking place. A growing number of firms are looking to cut costs by importing more inputs. We've certainly seen this type of adjustment taking place among the manufacturers of telecommunications equipment. Other firms are phasing out the production of goods and services with low profit margins and concentrating on those that yield higher returns.

Monetary policy is working to support this adjustment process by maintaining strong growth in domestic demand. Low interest rates help encourage consumer and business spending to keep the economy operating close to its production potential. This is important nationally, but strong consumer and business demand will be particularly important to Ottawa this year and next, as growth in the public administration sector is likely to slow. While we at the Bank don't conduct detailed analysis at the municipal level, our general analysis suggests that growth in manufacturing can be expected to moderate, as the higher Canadian dollar dampens demand for made-in-Canada products - including technology products from Ottawa. Like the tourism industry nationally, Ottawa's tourism and hospitality sector is also facing increased competitive pressure from the higher Canadian dollar. On the other hand, continued strong business and consumer demand can be expected to provide support for Ottawa's business services, software, and retail sectors.

Financial system efficiency

Before I conclude, let me say a few words about the financial system and the Bank of Canada's role in promoting its efficiency. As I have said before, an efficient financial system is critical to maintaining Canada's international competitiveness and long-term economic health. An efficient financial system is one that helps to allocate scarce economic resources to the most productive uses, in a cost-effective way. The ultimate goal is to have Canada's financial institutions and markets match investors and their savings with appropriate, productive investments.

In other speeches, I have talked about ways to encourage competition, transparency, and efficiency in Canada's financial markets and institutions. I won't review these discussions today, but I do want to repeat that it is critical that Canada makes headway on these issues. If Canadians want sustainable economic growth and prosperity, our financial system must function as efficiently as possible.

One initiative in this area is benefiting from the attention of Jim Watson, Minister of Consumer and Business Services, and the Government of Ontario, and that is the Uniform Securities Transfer Act. The efficiency of our financial markets would be improved if provincial and territorial governments would proceed with legislation to replace the current patchwork of legal rules in this area and to provide a sounder legal basis for the holding and transfer of rights in securities that are held in book-entry form.

This is just one example of encouraging initiatives that are under way. At the Bank of Canada, we will continue to contribute to these efforts by conducting research and promoting discussion on ways to improve the functioning of our financial institutions and markets and to enhance the safety and soundness of Canada's financial system. We share this research with regulators, market participants, and the public. Our *Financial System Review*, published twice a year, is part of that effort.

Conclusion

Let me now conclude. As I noted at the beginning, there are powerful global economic forces at work, and economies everywhere need to adjust. Businesses in Ottawa, and in the rest of Canada, are making adjustments to meet these challenges and to take advantage of emerging opportunities.

At the Bank of Canada, we will continue to monitor these global forces closely and to assess their impact. We will continue to conduct monetary policy with the aim of keeping inflation close to our target and the economy operating at its full potential. We will maintain our efforts to promote a safe and efficient financial system. And, as always, we will work to enhance the confidence of Canadians in the value of their money and the stability of their economy. In this way, we will do our part to facilitate the adjustments that the Canadian economy is making to changes in the global economy.