David Dodge: Adjusting to change

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Winnipeg Chamber of Commerce, Winnipeg, Manitoba, 15 June 2005.

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Good afternoon. I'm glad to be back in Winnipeg. The last time I delivered a speech here was in January 2002. A lot has changed since then - in this city and in the Canadian economy. At that time, our economy was recovering from a worldwide economic slowdown and from the impact of the September 2001 terrorist attacks in the United States. Today, we face more-intense international competition, but we also face new opportunities, as expanding economies become important markets for our products. Like the rest of Canada, Winnipeg and Manitoba are feeling the impact of these international changes.

Change is the central theme of my remarks today. First, I will talk about some of the changes that have taken place at the Bank of Canada over its 70-year history. Then, I'll talk about some of the changes that are currently taking place in the global economy, as well as how we see our economy - across Canada and right here in Manitoba - adjusting to these changes.

Changes at the Bank of Canada

This year marks the 70th anniversary of the Bank of Canada. The Bank opened its doors on 11 March 1935, at a time when the Canadian economy was reeling from the effects of a Prairie drought and a worldwide Depression. In its early days, much of the Bank's work was focused on trying to cushion the economy from the effects of high unemployment and falling prices, and replacing bank notes from different issuers with Bank of Canada notes. Almost every aspect of the Bank's work has changed since that time. But today I'll focus on the changes that have taken place in the conduct of monetary policy.

By the late 1950s, the Bank's monetary policy and the federal government's fiscal policy were trying to find a balance between controlling inflationary pressures in the economy and encouraging high levels of employment. The economic boom of the 1960s and the bitter inflationary experiences of the 1970s eventually led to an increased focus on price stability as the goal for monetary policy. We developed a better appreciation that keeping inflation low, stable, and predictable is the best contribution a central bank can make to the economic welfare of a nation.

During those decades, we learned some key lessons. The first is that a floating exchange rate is a tremendous asset in helping an economy adjust to changes, particularly an economy as open as ours. A floating currency gives a country the flexibility it needs to adjust to economic forces that originate from inside and outside its borders.

The second lesson we learned is that, for monetary policy to be successful in controlling inflation, a floating exchange rate is not enough. An "anchor" for monetary policy is also needed. Canada first floated its dollar in 1950, but returned to a fixed exchange rate for eight years during the 1960s. After the decision to float the dollar again in 1970, the Bank spent the 1970s and 1980s searching for an appropriate monetary policy anchor. By this, I mean a clear target for monetary policy, a way to help policy-makers keep policy on track, and a way to tie down or "anchor" expectations about future inflation. The outcome of that search was the eventual adoption of inflation targets as the anchor for Canadian monetary policy.

In February 1991, the Bank and the federal government announced an agreement on a series of inflation-reduction targets. This agreement has been extended three times, and since 1995, it has called for the Bank to keep inflation at 2 per cent, the midpoint of a 1 to 3 per cent target range. This inflation-targeting system, supported by a floating exchange rate, has done more than keep inflation low - it has delivered strong and sustained growth in output and employment in Canada.

Let me quickly stress that our inflation-targeting framework operates in a symmetric way - we care just as much about inflation falling below target as we do about inflation rising above target. If demand for goods and services pushes the Canadian economy against the limits of its capacity, and inflation is poised to rise above the target, the Bank will raise interest rates to cool off the economy. And when the economy is operating below its production capacity, and inflation is poised to fall below the target, the Bank will lower interest rates to stimulate growth. This symmetric approach helps the Canadian economy adjust to changing circumstances, while maintaining strong, sustained growth in output and employment.

The Bank's commitment to the idea of transparency is another way in which our monetary policy has evolved. There was a time when central bankers kept their actions and thoughts shrouded in secrecy, convinced that their policy would be more effective if implemented with an element of surprise. Times have changed, and best practices in monetary policy have evolved. We have found that monetary policy is more effective when people understand what we are doing and why. That's why we communicate regularly with parliamentarians, with markets, and with the public. We do this through our regular *Monetary Policy Reports* and *Updates* to those reports. We do this through press releases on fixed announcement dates for interest rate decisions, eight times a year. And we do this through public speaking engagements with audiences across the country.

Our methods of communication also continue to change. Today, we use more tools and more technologies to reach Canadians and explain our work. For example, the audio portion of this speech is being broadcast live on the Internet. And we have just completed a redevelopment of the Bank's website. Since its creation in 1995, our website has been central to our efforts to conduct the Bank's business in an open and transparent manner. The site is visited over 180,000 times a week. In 2003, it was named "Central Bank Website of the Year" by Central Banking Publications in the United Kingdom. We wanted to make the site even better, and so on Monday we launched a new version. It features an attractive graphic redesign, improved navigation, and a lot of new content. I encourage you to visit our new site, and we welcome your comments.

Changes in the global economy

So that's a quick look at some of the ways that the Bank has changed in 70 years. I'll spend the remainder of my time today discussing some of the major changes afoot in the global economy and how the Canadian economy is adjusting to these developments.

I've just returned to Canada from meetings with central bankers in China and Japan. I have also attended meetings in Switzerland, the United States, and Morocco over the past month. And in two weeks, I will head to the United Kingdom. In these countries, and in almost every other nation, people are being affected by the same powerful forces - 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 has driven up demand for commodities, and that has pushed up the world prices for oil and many other commodities that we produce in Canada. Meanwhile, the more competitive world environment and productivity improvements in some countries are lowering the prices for a number of consumer goods, communications services, and computer equipment.

All of these forces are causing significant exchange rate movements, including a sharp appreciation of the Canadian dollar against the U.S. dollar over the past couple of years. Higher prices for many commodities produced in Canada means that our terms of trade - that is, the ratio of the prices that Canadians receive for their exports to the prices that they pay for their imports - have improved by about 14 per cent since late 2001. This has contributed importantly to higher real incomes and stronger domestic demand.

How has the Canadian economy been adjusting to these various economic forces? In the Bank's last *Monetary Policy Report*, published in April, we noted that we have seen increased business investment spending in oil and gas extraction, in other mining activity, and in wood-product manufacturing. These sectors are benefiting from higher world prices for their products. We are also seeing rising investment in sectors that are not very exposed to international trade, such as electric power generation, finance and insurance, and information and cultural industries. In these latter cases, firms are reacting to strong growth in domestic demand. We've also had very strong investment in housing.

But in other sectors that are highly exposed to international trade, prices are either falling or are rising very slowly. Here, I am referring to goods-producing sectors, such as auto parts, furniture, 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 the necessary adjustments. Investment spending is being directed towards increased specialization, higher productivity, and lower costs. Since much of the productivity-enhancing machinery and equipment is priced in U.S. dollars, the stronger Canadian dollar has made it easier for firms to invest in equipment that boosts productivity. Stiffer competition is also encouraging firms to seek new markets, 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 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.

Current economic developments in Canada and Manitoba

Through its monetary policy, the Bank is helping these adjustments by supporting domestic demand. In our April *Monetary Policy Report*, we projected that domestic demand would grow by almost 4 per cent in 2005. According to recently released data, it grew by slightly more than expected during the first quarter of the year. So we continue to see evidence that strong domestic demand is offsetting the smaller contribution that net exports are making to economic growth.

On 14 July, we will publish our *Monetary Policy Report Update*, which will contain our latest views on the Canadian economy. The Bank is in the process of gathering and analyzing the full set of information on the global and the Canadian economies that will feed into our next interest rate decision, and into the Update.

On our last policy-announcement date in May, we decided to maintain the target for the overnight interest rate at 2 1/2 per cent. At that time, we indicated that global and Canadian economic developments had been unfolding broadly in line with our expectations and that our outlook for the Canadian economy through to the end of 2006 was unchanged from the one we presented in our April *Monetary Policy Report*. The analysis contained in that Report is still relevant. So is our statement that, in line with this outlook for growth and inflation, a reduction of monetary stimulus - that is, an increase in our key policy rate - will be required over time.

Now, let me say a few words about the economic prospects for Manitoba. The provincial economy grew by an estimated 2.3 per cent last year, up from 1.5 per cent in 2003. Like the rest of Canada, Manitoba will rely heavily on domestic spending as an engine of growth in 2005. Private sector forecasters are expecting output growth of about 2.7 per cent this year, largely as a result of strong consumption and investment. Exports should also continue to grow, albeit at a slower pace than in 2004. This projection assumes that agricultural production will increase in 2005. It is too early to predict the impact of the recent floods that have ruined many fields in the province.

Diversification in Manitoba's economy has been helpful. This province's economy is one of the most diversified in Canada - with a good mix of goods-producing and service industries, resources and manufacturing, traditional and new technology. And there is growing diversity and innovation within industries, such as pharmaceuticals, furniture manufacturing, and the transportation-equipment sector. The broadening of Manitoba's economic base has provided stability to the economy and has kept the province's unemployment rate well below the national average. Manitoba has also been helped by continued fiscal prudence.

Conclusion

Change is rarely made without difficulty, even when we know that the change is for the better. This is certainly true of adjustments in response to the global economic realities of today. In some cases, industries are being forced to rethink the way they do business. Some firms will close, and some jobs will be lost. This type of adjustment is never easy.

But economic change creates new opportunities. And in cities like Winnipeg, and all across Canada, individuals, businesses, industries, and public sector institutions are making the adjustments that will help them improve their competitiveness and seize new opportunities. These efforts also make the Canadian economy stronger and more resilient. That is the best way to prepare ourselves and our economy for whatever changes the future may bring.