David Dodge: Global economic forces and the need for adjustment

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Chambre de commerce du Montréal métropolitain and the Fédération des chambres de commerce du Québec, Montréal, Quebec, 21 June 2006.

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Since the start of the millennium, developments in the global economy have led to important changes throughout the Canadian economy and to serious challenges for many sectors and regions. Because nobody can anticipate precisely how the world will unfold, the best we can do is to ensure that our economy is as flexible as possible. What I want to do today is look briefly at how the Canadian economy has adjusted so far and talk about what public policies - including monetary policy - can do to promote economic flexibility.

Let me start by listing the main global developments since 2000. First, China and India have emerged as economic powerhouses. Second, global economic growth has been extraordinarily strong. Third, we have gone through a period marked by an unusually high amount of monetary stimulus, which central banks are now in the process of reducing. At the same time, we have seen a persistent and growing current account deficit in the United States, mirrored by large and growing current account surpluses elsewhere, especially in Asia and among many oil-exporting countries.

These developments have had significant consequences for the Canadian economy. The strong global growth, especially in China, India, and the United States, has led to sharply higher prices for many of the primary commodities that Canada produces. The emergence of China and India has also led to intense competition for many manufacturers, as well as lower prices for various consumer durable and semi-durable goods. The higher prices for many of our exports, coupled with lower prices for imported goods, have led to an improvement in our terms of trade and rising incomes for Canadians - particularly for producers of commodities, including metals and energy products. In this environment, we have seen a rapid increase in the external value of the Canadian dollar.

It is clear that we must all adjust to these developments and be ready to take advantage of the opportunities presented by the strong global economy.

Of course, adjustment is easier said than done. And it is important to acknowledge that adjustment is often very difficult on a personal level. The adjustments over the past three years have been particularly difficult because of the speed and size of the movements in relative prices. This has been a double-edged sword. On the one hand, some firms are facing booming demand and have been unable to expand quickly enough, hindered by shortages of skilled labour, outdated machinery, and inadequate infrastructure. On the other hand, some firms have struggled to increase the value-added of the goods they produce in Canada in the face of falling prices and global competition. They have had to find ways to shift some activities offshore. This second type of difficulty has been more prevalent in traditional goods-producing industries such as clothing, textiles, and newsprint. In some cases, business owners and employees - who have invested decades of their lives in a particular firm or industry - are coming to terms with plant closures and the loss of jobs. None of this is easy. These difficulties have been plain to see in media reports and in official economic data. However, these same data also show increases in output in sectors such as wholesale trade and financial and business services, as well as manufacturing sectors such as pharmaceuticals and transportation equipment.

Despite all the challenges, we are seeing businesses across the country being inventive in responding to the necessity of adjustment. We have been tracking this adjustment through our regular communications with business groups, manufacturers, and exporters, as well as through the Bank's *Business Outlook Surveys*. These surveys, conducted by staff in the Bank's regional offices, are available on our website, and I encourage you to look at them. Since 2003, when the Canadian dollar began to appreciate, they have told an encouraging story of how businesses have found ways to innovate and adjust to changing circumstances.

The role of public policies

But what role is there for public policies in this adjustment process? Above all, governments should not try to shield business from global forces, nor should they interfere with market signals. Which policies then can support market-based adjustment? At the macroeconomic level, monetary and fiscal policies can facilitate adjustment by promoting stable and sustainable long-term economic growth. I'll have more to say about the role of monetary policy in a moment. On the microeconomic side, let me mention a few areas where governments can act.

The first has to do with infrastructure, and there are really two sides to that - human and physical. In terms of human infrastructure, there is a crucial role for government in promoting education and training. Ultimately, the strength of our economy depends on the skills of its workforce. Obviously, governments should make sure that everyone has the opportunity to receive a sound, basic education. And in the face of shortages of skilled labour, public policies should encourage the training and retraining of employees, so that they can move more easily into sectors that are expanding. But I would not stop there. There is much that we as employers can do to give our employees the opportunity to improve and develop their skills.

In terms of physical infrastructure, public policies can support both public and private investment so that firms can become more productive. By infrastructure, I am referring not only to traditional projects such as roads, bridges, and pipelines, but also to assets such as the so-called "information superhighway." Having modern, reliable infrastructure in place allows businesses to invest with greater certainty, thus furthering the adjustment process. This may mean the use of private funds to develop public infrastructure projects, as I have mentioned in past speeches. And now is the time to encourage this type of investment, given our climate of low nominal interest rates, and the presence of large pension funds that are searching for these kinds of investment opportunities.

The second area where governments can act has to do with policies to promote economic flexibility. Governments must see to it that rules and regulations are not hindering that flexibility. In terms of labour markets, we need to recognize that supporting workers does not mean propping up factories or industries that cannot compete in the global economy. Rather, it means removing barriers so that workers can make adjustments as easily and painlessly as possible. Rules and regulations should not prevent workers from shifting from sector to sector, province to province, or even region to region within a province. Too often, labour mobility is hindered because credentials are not recognized from one province to another. All of these barriers to labour mobility are unhelpful, not just to the economy, but to the workers themselves. The focus for policy must be how to encourage and support the mobility of our workforce.

Third, we need policies that allow Canadian capital markets to work at peak efficiency. This will also provide business with flexibility to help them invest and expand, and so support the adjustment process. As I have said before, we need policies that do not impede efficiency in our financial institutions and markets, and at the same time encourage competition. This is crucial, not only because it allows firms to have appropriate access to capital, but also because financial services is a high value-added industry that makes a large contribution to employment and income, particularly here in Montréal.

Those are three of the most important microeconomic policy considerations for the public sector in terms of supporting economic adjustment. On the macroeconomic side, governments should continue to aim for sustainable fiscal policies, with budgets in rough balance or in small surplus. But I want to spend a few minutes speaking about monetary policy and the role of the Bank of Canada.

The Bank of Canada's monetary policy aims to preserve a climate of low, stable, and predictable inflation. This can help with the adjustment process in several ways. Such a climate minimizes the distortion of price signals that can lead to inappropriate investment choices. Low and stable inflation allows firms to undertake long-term investments with greater certainty. But crucially, low inflation also reduces the risk premium demanded by investors. This means that nominal long-term interest rates are kept low, which supports the investment that helps with the adjustment process.

In addition, the Bank's monetary policy has a stabilizing function, which also facilitates adjustment. Let me explain. We keep inflation in check by trying to have the economy operate at full capacity, with aggregate supply and demand in balance. In doing so, we help the adjustment process because resources that are released by sectors under pressure can be more readily absorbed by sectors that are expanding. We see clear evidence of this process happening right now in Canada.

Let me now say a few words about how our flexible exchange rate fits into our monetary policy framework. There are some who have called on the Bank to smooth out fluctuations in the Canadian dollar, or to slow its ascent. But we have one monetary policy instrument - our influence over interest rates - so we can have only one target. Canada has chosen low inflation as the target, because experience clearly shows that low inflation is the best contribution that monetary policy can make to economic health. We do *not* have a target for the Canadian dollar.

However, this does not mean that the Bank does not care about the impact of movements in the exchange rate on the Canadian economy. The truth is quite the opposite - the exchange rate plays an important role in our monetary policy deliberations. Exchange rate movements tell us something about economic developments that may be having a direct impact on the demand for Canadian goods and services. And the movements themselves have their own effect on aggregate demand, by changing relative prices and by shifting demand between domestic- and foreign-produced products. The challenge for the Bank is to evaluate these movements, together with other data, and to set a course for monetary policy that works to keep demand and supply in balance and inflation low and stable.

In making this evaluation, we try to determine how much of a particular movement in the Canadian dollar is due to changes in world demand for our goods and services, and how much is due to other factors unrelated to the demand for Canadian goods and services. It is important that we understand the causes of exchange rate movements, because the implications for the economy, and the appropriate monetary policy response, depend on the cause of the change. Generally speaking, movements related to changes in demand for our goods and services would require little, if any, monetary policy response. This is because their impact on Canadian aggregate demand would serve to offset the initial direct changes in global demand for our goods and services. And this would help to keep overall supply and demand in balance.

So what can we say about the appreciation of the Canadian dollar? Since 2003, most of the appreciation - but not all - appears to have been related to our improved terms of trade and the increased demand for Canadian goods and services. Some of the appreciation has also reflected the broad-based weakness of the U.S. dollar associated with global current account imbalances. My colleague, Tiff Macklem, spoke on this topic at some length a couple of weeks ago, and you can find his remarks on our website. Determining how much of each of these forces is behind the movement in the currency is an important, but very difficult, judgment that the Bank must make. This judgment is even more difficult during times of market volatility, such as we have seen since the Bank's last fixed announcement date on 24 May. During that time, a number of Canadian economic indicators have also been published. Some of these indicators have been stronger than expected, others have been weaker. But on balance, the projection we set out in our April *Monetary Policy Report* appears to be reasonable. That is to say, we continue to expect economic growth roughly in line with the growth of potential output, and inflation to average close to the 2 per cent target in 2007 and 2008, excluding any temporary effects on inflation that will follow the forthcoming reduction in the Goods and Services Tax.

As we said at our last fixed announcement date, we will continue to monitor all economic and financial developments in the global and domestic economies relative to the projection in the April *Report*. But it is important to remember that when it comes to setting monetary policy, the Bank always tries to develop a complete picture of the economy. We do not react unduly to any individual piece of information. Rather, we put all the pieces together to get to the underlying trends in the economy. And, as always, we will look at the complete economic picture as we lead up to our next decision date on 11 July, and we will present that complete picture in our *Monetary Policy Report Update* two days later.

Conclusion

Let me conclude. Powerful global economic forces have been affecting the Canadian economy and will continue to have an impact for the foreseeable future.

Adjustment must take place. It hasn't been easy, and it hasn't been without pain. And adjustment won't be easy in the months and years ahead. But I'm encouraged to see that most firms are getting on with the job. I encourage you to persevere with these adjustments.

For our part, we remain committed to keeping inflation low, stable, and predictable. That is the best contribution we can make to helping output and employment remain strong.