David Dodge: Monetary policy and developments in the global and Canadian economies

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Canadian Netherlands Business and Professional Association, and the European Union Chamber of Commerce in Toronto, Toronto, 25 January 2007.

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Good afternoon. I'm happy to be here in Toronto to take part in your Outlook 2007 event. I'd like to begin with a few words about the framework that guides the Bank of Canada in conducting monetary policy. After this brief introduction, I will spell out the Bank's interpretation of recent economic developments and our outlook for 2007 and 2008, both in Canada and elsewhere. Then, I'll say just a few words on another important topic – the need to improve our understanding of the interdependencies of the global economy, and thus to strengthen the surveillance function of the International Monetary Fund. Finally, I will open the floor for your questions and comments.

A framework for monetary policy

So let me begin by discussing our framework for monetary policy. The Bank of Canada has been around for over 70 years. Throughout this period, the Bank has had one over-arching mandate: to promote the economic and financial welfare of Canadians. Over the years, we have learned that the best contribution that monetary policy can make in this regard is to give Canadians confidence in the future value of their money. We do this by keeping inflation low, stable, and predictable.

In earlier decades, the Bank of Canada tried various approaches to achieving price stability by controlling variables that indirectly affected prices. For example, in the 1970s, the Bank aimed to control the growth of monetary aggregates. But there were problems with all the methods we tried. Finally, at the beginning of the 1990s, the Bank decided that the best way to achieve price stability was to target inflation directly. We reached a formal agreement with the federal government that spelled out the details of our inflation-targeting system. This agreement has been renewed four times. The latest renewal occurred last year, and extends through to the end of 2011. In that renewal, we agreed to continue our policy of targeting consumer price inflation at the 2 per cent midpoint of a 1 to 3 per cent target range over the medium term.

We also set out a research program to explore whether our very good policy framework can be made even better. In particular, we want to examine the potential costs and benefits of moving to a lower inflation target, and the potential costs and benefits of pursuing a price-level path instead of an annual inflation target. That said, the research would need to uncover compelling evidence in favour of a change before we would want to alter the system that has proven so successful over the past 15 years.

A key part of that success is that the framework sets out a rather simple paradigm that allows people to understand and predict how the Bank will react to economic developments. If the economy is moving above the limits of its capacity, so that the trend of inflation is threatening to move above our target, we tend to raise interest rates, all other things equal. This restrains demand in the economy and brings demand back into balance with supply, thus reducing inflationary pressures. Conversely, if the economy is moving below its capacity limits and the trend of inflation is likely to fall below the target, we tend to lower interest rates. This stimulates demand and brings it back in line with supply, thus increasing inflationary pressures.

This simple paradigm is very helpful because monetary policy works better when it is understood. Because people understand the paradigm, they can anticipate how we will react to events that have an impact on inflation in Canada. Once every quarter, we spell out our views about where we see the starting point for the economy in terms of the balance between total demand and supply, and our base-case projection for how we see the economy evolving. Last week, we published our most recent outlook in our *Monetary Policy Report Update*. Let me now take you through that document, and talk about our base-case projection for the global and Canadian economies.

Recent economic developments and outlook

I'll begin with the global economy. Over the past five years, global growth has been very strong, and this growth has continued in recent months. Overseas, growth in the euro area has been slightly stronger than expected, while growth in China has continued to outperform expectations. In Japan, we have seen encouraging signs that business investment and exports remain strong, although household consumption has been weaker than expected. Global growth likely exceeded 5 per cent in 2006. Our base-case projection is that the world economy will expand by about 4 3/4 per cent this year, and by about 4 1/2 per cent next year – a more sustainable pace.

The strong growth of recent years has had several important implications for Canada. It boosted the prices of many of the commodities that we export – including oil and natural gas. This led to strong increases in our terms of trade and to a corresponding rise in the external value of our currency. But more recently, some of these effects have begun to ease slightly amid signs of moderating global demand and, in some cases, increased supply. Oil prices have come down from their highs, as have some metals prices. This has led to a recent reduction in our terms of trade, a decline in the external value of our currency, and a slowing in nominal GDP growth, implying reduced growth of government revenues.

For Canada, the performance of the U.S. economy is crucial to our prospects, so let me turn to the situation there. After a strong start to 2006, U.S. economic growth moderated. This moderation largely reflected a substantial downturn in the U.S. housing market and a cyclical slowdown in the market for automobiles. There are two important points to be made here. First, there is little evidence that the weakness in these two sectors has spread to the rest of the U.S. economy. Indeed, household consumption has remained firm, backed by employment gains seen in a very healthy service sector. Second, recent evidence suggests that a significant portion of the adjustment in these sectors has already taken place. The adjustment in the automotive sector appears to be well advanced, and the housing sector is working through its adjustment. This bodes well for the U.S. outlook. Our base-case projection is that real GDP growth should recover to the rate of growth in potential output by the second half of 2007, before moving slightly above potential growth through 2008. On an annual basis, growth is projected to be 2.5 per cent in 2007 and 3.2 per cent in 2008.

Let me now turn to the Canadian economy. In the second half of 2006, final domestic demand for Canadian goods and services continued to grow robustly. But Canadian businesses began to reduce production of a number of goods and to reduce their rate of inventory investment. Much of the impetus for this reduction was the slowdown in U.S. demand for automobiles and housing. The inventory correction and lower exports served to restrain real GDP growth in Canada in the second half of 2006. When Statistics Canada publishes the national accounts data for 2006, we expect it to show that growth for the second half averaged about 1.6 per cent.

In line with the paradigm I outlined earlier, we looked at the implications of these developments, and at many other pieces of information, in order to determine the starting point for the level of total demand relative to supply. The Bank's conventional measure of the output gap suggests that the economy was operating just above its production potential in the fourth quarter. There have also been other signs of upward pressures on capacity and inflation. In our winter *Business Outlook Survey*, the percentage of companies reporting that they would have difficulty in meeting an unanticipated increase in demand was still above average. The employment-to-population ratio stayed very high in December compared with historical experience, while the unemployment rate was at a 30-year low. Finally, the Bank's measure of core inflation – which we use as an operational guide – had remained slightly above 2 per cent, and above our earlier expectations, because of pressure from prices for shelter and some other services.

On the other hand, there were also some signs of downward pressure on inflation. There has been an easing in the underlying trend increase in wages in recent months. And the percentage of firms reporting labour shortages in the Bank's winter *Survey* was slightly below average. Overall, our judgment is that the economy was operating right at, or just slightly above, the limits of its capacity at the end of 2006.

That's a quick look backwards. Now, let me turn to the Bank's base-case projection for the rest of this year and for 2008. Overall, we project that real GDP growth will pick up during 2007, averaging about 2 1/2 per cent in the first half of this year, and about 2 3/4 per cent in the second half. The detailed breakdown can be found in the *Update*, but the bottom line is that we project that the Canadian economy will continue to operate close to its production capacity through to the end of 2008.

The Bank projects that core inflation will stabilize at close to 2 per cent as pressures from house prices ease and the economy remains near potential. Total consumer price inflation will continue to be affected by movements in energy prices and, for the first half of the year, by last year's cut in the Goods and Services Tax. Overall, given recent energy prices in futures markets, total inflation is projected to average just above 1 per cent in the first half of the year, before returning to the 2 per cent target in 2008.

That's a look at our base-case economic projection. But if there's one thing we can be certain about, it's that the economy will not evolve exactly as set out in our base case. So a very important part of our outlook is the assessment of the risks surrounding our projection. There are risks on both the upside and the downside. The main risks are the ones that we have been talking about for the past six months or so.

The main upside risk to our inflation projection comes from stronger household demand in Canada. With the increases in house prices in many parts of the country, consumption could be stronger than expected as households borrow against the increased equity in their homes. There has been strong growth in various indicators of household credit over the past year, although the pace of growth has eased in recent months, and we have seen a slight deceleration in the annual rate of increase of new house prices more recently. So while this main upside risk remains, it appears to have diminished somewhat since October.

The main downside risk continues to come from the United States, where clear weakness remains in the housing sector. But there are some encouraging signs. As I mentioned earlier, the slowdown in the U.S. housing and automotive sectors does not appear to have spread more broadly. There is evidence that a significant portion of the adjustment in the automotive sector has already taken place, while the adjustment in the housing sector continues. So, in the Bank's judgment, the main downside risk to our inflation projection for Canada does remain, but it has also diminished. Overall, we judge that the risks to our inflation outlook are roughly balanced.

In addition to these risks, we are faced with a great deal of uncertainty about the trend growth rate of potential output in Canada. We are fairly confident in our assessment of the contribution of labour force growth to future potential output. However, there is a lot of uncertainty about the trend rate of productivity growth. We use the past trend rate – roughly 1.5 per cent – as the basis for our projection of future productivity growth. But recent data on productivity have been disappointing. It is unclear how much of this weak performance is caused by cyclical factors that will be reversed in due course, and how much represents a permanent downward shift in the trend rate of productivity growth. Adding to the uncertainty is the way the data tend to be revised over time. Remember that you calculate productivity by dividing total output by total hours worked. Both numbers are revised over time, sometimes fairly dramatically. This makes the challenge of understanding what's happening to the trend rate of productivity growth more difficult.

Finally, there does remain a possibility of a disorderly resolution of global imbalances. In general, the term "global imbalances" refers to the large and persistent current account deficit seen in the United States that is mirrored by current account surpluses in Asia and many oil-exporting countries. These current-account imbalances have resulted from imbalances in global savings and investment. While the U.S. economy has seen very strong domestic consumption and negative savings in recent years, many other economies – particularly in Asia and the OPEC nations – have seen too much saving and not enough domestic consumption. This global savings glut outside the United States has contributed to low long-term interest rates and to what some observers have called a "wall of liquidity" that has led to strong investment flows into many assets, and higher prices for these assets.

As long as market participants have reason to believe that policy-makers will take appropriate actions, there is no reason to expect that these imbalances won't be unwound in a gradual and orderly way. Indeed, this is what the Bank's base-case assumes. So far, financial markets have handled these imbalances smoothly. This smooth handling of global imbalances has been helped by innovations in financial markets that have led to new ways to price and transfer risk. Currently, there is little evidence to suggest that these risks are being distributed inappropriately across the global economy. But assessing such risks is very difficult. It requires the ability to conduct analysis at a global level and a real understanding of the interdependencies in the global economy. National authorities, here in Canada and elsewhere, do their best to carry out this analysis. But this analysis can be greatly helped by an organization with global reach, and which is dedicated to looking at the global economy as a whole. This organization already exists – it is the International Monetary Fund.

Strengthening the International Monetary Fund

In recent years, there have been some who have called into question the relevance of the IMF. But at the Bank of Canada, we believe that the IMF still has an important role to play. The danger posed by global imbalances shows that we need an international institution charged with supporting the smooth functioning of the global economy.

Now, it is true that the IMF does need to change if it is to better carry out this task. At the Bank of Canada, we have spent a great deal of effort over the past year or so thinking about this topic. We believe that a strengthened IMF can best support the global economy by improving the way it conducts surveillance. The Fund has a very important role to play in analyzing spillovers and interdependencies. And it is the only institution that can perform this role: it is global in scope, and it regularly convenes the national authorities from the world's most important economies.

So how can we best accomplish the goal of strengthening Fund surveillance? I would say two things. First, the IMF needs to update the rules for conducting surveillance. We need a clear statement that surveillance will focus on exchange rate, monetary, fiscal, and financial policies, and on whether or not a country's policy choices are coherent. This is not just because these policies can affect other members of the global economy, but also because these global effects can, in turn, have repercussions for a country's own economic prospects.

Second, the Fund should adopt the idea of setting out an annual work program for surveillance. Each year, the members, along with the Managing Director and staff, would update and specify – in concrete and transparent terms – the objectives and priorities of surveillance for that year.

I mention these issues today because we have a window of opportunity to move forward on IMF reform. There is today, at least in some quarters, a willingness to strengthen this institution, to make it more relevant. As the world's economies become increasingly globalized, I would argue that now, more than ever, a strengthened IMF is in every country's interest. The risk of a disorderly resolution of global imbalances may be relatively small, but it remains an important risk for all economies. Strengthening the IMF is one way of reducing this risk.