David Dodge: Meeting global economic challenges – the need for flexibility

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Calgary Chamber of Commerce, Calgary, Alberta, 8 March 2007.

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Good afternoon. I'm very happy to be here in Calgary today to talk to you about what I see as one of the most important issues that we face in dealing with global economic challenges; namely, how we can increase the flexibility of our economy.

I'll spend a bit of time talking about some of the structural concerns that I think are very important to our future prosperity. In light of the global challenges that have become very clear to us all, I'll particularly focus on the necessity of a well-trained and flexible workforce.

But first, I'd like to provide you with some context for my remarks by saying a few words about the framework that we follow at the Bank of Canada in conducting monetary policy.

A framework for monetary policy

Our primary objective at the Bank is 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.

How we can best achieve this goal has been a matter of much study and debate and, indeed, some trial and error. But by the early 1990s, the Bank decided to achieve price stability by directly targeting inflation. A formal agreement between the Bank and the federal government set out the goals for reducing inflation to 2 per cent by 1995. And that inflation-targeting system worked so well that it has been renewed four times, most recently, near the end of last year. This means that we will continue with our goal of holding inflation to 2 per cent – the midpoint of a 1- to 3-per cent target band – over the coming five years.

But we don't want to rest on our laurels. We have been pondering whether it might be possible to improve upon what has been a very good policy for the Canadian economy. To that end, the Bank has announced a major research program for the next three years to probe whether there might be ways to improve our inflation-targeting regime. In particular, we want to examine the potential costs and benefits of moving to a lower inflation target, as well as the potential costs and benefits of pursuing a price-level path instead of an annual inflation target. But that said, the research would need to show very strong evidence in support of any change before we would be willing to alter the system that has proven so successful over the past 15 years.

A very important factor in the success of our inflation-targeting paradigm is the effort that we have put into making this system understandable, transparent, and predictable. In doing so, we've managed to help people comprehend how the Bank will react to economic developments, and thus, we've reduced the risk of misunderstandings.

The basic principles are pretty simple. When the economy is expanding beyond the limits of its capacity in a way that would threaten to push inflation above our target, we tend to raise interest rates, all other things being equal. This action helps to restrain demand in the economy, thus reducing inflationary pressures. Or, if the economy is expanding more slowly and would likely operate below capacity, which would threaten to push inflation below our target, we would tend to lower rates. This would likely give demand a bit of a boost, thus nudging inflation back towards our target.

Now, an essential element of this paradigm is that it aims to make very clear that we are targeting the *national* inflation rate. That can sometimes be hard to appreciate in a country as large and diverse as Canada, where there are frequently sizable differences in inflation pressures in different parts of the country. Right now, inflation rates in Alberta are dramatically higher than those in central Canada. In January, for example, national inflation, measured by the total consumer price index across the country, showed an average increase of 1.2 per cent per year. But the national average masked a much higher annual inflation rate of 3.9 per cent here in Alberta. In contrast, the annual rate was considerably lower in Ontario, at 0.3 per cent, and in Quebec, at 0.6 per cent.

Of course, the different rates of inflation in different regions reflect changes in the relative prices of goods and services across Canada. The energy and mining sectors, which are particularly important in the West, have been gaining strength in recent years relative to the manufacturing sector, much of which is based in central Canada. As part of this shift in activity between industrial sectors, we have seen waves of new workers flood into Alberta to fill jobs in the booming energy industry. That is driving up demand and prices for housing and other goods and services here.

These regional and sectoral distinctions are important. But our mandate at the Bank of Canada is to work for the economic benefit of *all* Canadians. It's therefore crucial that we keep our focus on the *national* inflation rate. We can't concentrate on just one region, because at any given time, it's very likely that different regions will be experiencing quite different economic conditions. And since we at the Bank of Canada have only one policy lever – our ability to control the overnight interest rate – we can focus on only one policy goal: the national inflation rate.

But, we do take note of the difficulties that various sectors of the economy are experiencing, and we are well aware of the diverse issues facing different regions. To better understand concerns across the country, we have staff in regional offices – including our office in Calgary – who actively seek input from businesses. One message that we have been hearing is that business widely recognizes the importance of flexibility and the need to be able to rapidly adjust to changing circumstances. That realization has certainly helped Alberta to better adjust to economic upheaval and change more quickly today than it did during the 1970s and '80s. Since those days, we've all learned that it does no good to try to shelter the economy from adjustments driven by global changes such as large swings in energy prices.

The need for flexibility

So, let me talk a bit more about flexibility. I'm going to address this from two perspectives. First, I'll give the macroeconomic view, and then I'll look at the microeconomic issues.

Canadian governments, both federal and provincial, are in a strong fiscal position. At the federal level, overall government debt has been reduced. Alberta has successfully eliminated its debt, and other provincial governments have worked hard to balance their books. This success has given governments more flexibility to deal with cyclical shocks. More importantly, lower debt-to-GDP ratios have meant that over time, the share of government revenues that must go to servicing debt has been reduced. That frees up revenues to help governments deal with looming demographic issues without the necessity of raising taxes. At the same time, federal and provincial governments have made strides in preparing for these demographic changes, with reforms designed to ensure the long-term viability of the Canada Pension Plan. So, from a fiscal point of view, Canada is in a position that is envied by almost every other country in the world. And, as I said earlier, we at the Bank of Canada have kept the rate of inflation low, stable, and predictable. This has allowed business and consumers to have confidence in the value of their money. So, I can say with assurance that Canada, because of its strong fiscal position and low inflation rate, has the flexibility needed to deal with whatever comes its way in the future.

But while good macroeconomic policies are a necessary condition for meeting the challenges we face, they are not sufficient. Improved microeconomic policies are also required to increase flexibility and contribute to growing productivity over time. There are a number of important aspects to these policies, but I can talk about only a few today. And the first that I want to focus on relates to labour.

Critical to building a flexible labour force is, as always, the education and training of young people. We must not only invest in basic education for our children. We must also prepare for an economy where most workers will expect to train and re-train throughout their careers; an economy where it will be considered normal to add skills or change career paths through life.

We have to recognize that changing demographics mean there will be fewer and fewer young people in the labour pool to draw upon. We must therefore learn to concentrate on making the most of our experienced and trained workers. How can we make the very best use of the skills of those workers who are now in their 50s and 60s? Many individuals may wish to remain active in the labour force well past the conventional retirement age, and to increase our flexibility, it's important that we remove any barriers to their continued participation.

This means that we, as employers, have to be more flexible in setting up work schedules. It means that we, as employers, must look at the redesign of pension plans. It also means that we, as employers, must put more effort into upgrading skills and increasing our openness to hiring mature workers. And it means that we, as employers, have to put more emphasis on mentoring programs, so that younger workers can benefit from the skills and experience of older workers, ensuring that intellectual capital is not lost.

I've talked about government obligations and about our obligations as employers. But individuals also have an obligation to seize every opportunity to learn new skills. Failure on any of our parts would be very short-sighted and will mean lower standards of living for us all. And these are ongoing obligations. Even in times like these, when the labour market is very tight, none of us can afford to lose sight of the importance of skills development.

We must keep in mind that it's not just developing and using skills that's important. Provinces must ensure that they don't set up road blocks that impede the mobility of workers. In this respect, I really do commend the provinces of Alberta and British Columbia for their recent pact allowing a free flow of labour and investment across the Rockies.

Labour markets are not the only things that must be able to adjust – flexibility is important in all of our policies. We need legal and regulatory frameworks in place that encourage competition and allow market incentives to flow through. We really must eliminate barriers to interprovincial trade. As you know, these can take the form of a wide range of regulatory obstacles in areas as diverse as transportation, packaging, or financial services.

Capitalizing on Alberta’s strengths

Policies that encourage flexibility are crucial for Alberta if the economy here is to capitalize on its current strengths and build a solid base for the future. The important and growing knowledge base in Alberta is creating opportunities to develop industries that complement the oil and gas sector. It also provides a platform, built on skilled professionals and financial resources, for expanding the vital education and health sectors.

A challenge, as well as an opportunity, for Alberta relates to the production and use of hydrocarbons in a time of increasing global concern about climate change. Around the world, there is a growing demand for products and technologies that limit or reduce the emission of greenhouse gases. And what better place than Alberta for the development of these types of technologies? As I've mentioned, the dramatic growth in the province's oil and gas sector has made Alberta a magnet for workers, many of whom have the specialized knowledge and spirit of innovation needed to develop such new products.

The province's knowledge base and rising prosperity also give Calgary a great opportunity to build a solid financial services sector. This industry could be very important for Calgary's future. Financial services is a sector that attracts highly skilled workers who add a great deal of value. And Calgary has some natural advantages. It is situated in the heart of the oil patch and is already home to the Venture Exchange and to a fledging commodity exchange. But Calgary is unlikely to be able to fully exploit these advantages until Canada, as a whole, develops a more efficient framework for its securities market.

From the analysis that we have done at the Bank of Canada, it's clearly in the interests of all Canadians, but particularly in the interests of Calgarians, to establish a uniform Canadian regulatory framework. This must be based on uniform principles, which are applied appropriately, taking into account the size and complexity of the issuer. And our securities laws must be consistently enforced. Just as Alberta played a lead role in reshaping the Canada Pension Plan to make it a model for the world, I trust that the Government of Alberta and the Calgary business community will play a lead role in establishing a uniform framework for securities regulation in Canada – a framework that will help to develop this city's potential beyond the oil and gas sector.

Economic issues

Before concluding, I'd like to say just a few words about our most recent thinking on what we at the Bank of Canada see happening globally and in our national economy.

Last month, I attended the Group of Seven meetings in Germany. The discussions on the global economy were very much in line with what we had set out in the Bank's January *Monetary Policy Report Update*. Global prospects remain very favourable. While weakness in the U.S. housing sector is likely to continue for a short while, the weakness doesn't appear to have spread to the rest of the U.S. economy, and growth is expected to pick up over the course of 2007. The Bank judges that the Canadian economy was operating at, or just above, its production capacity at the end of last year. We continue to project that it should operate near its capacity throughout 2007 and 2008. Total CPI inflation at the national level should average just above 1 per cent in the first half of this year, returning to the 2 per cent inflation target in early 2008. Core inflation should remain near 2 per cent through to the end of next year.

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 upside risk to our inflation projection continues to come from stronger household demand in Canada. Consumption could be stronger than expected, as households borrow against increased equity in their homes. Various indicators of household credit have also shown strong growth over the past year.

The main downside risk continues to come from the United States where, as I mentioned, clear weakness remains in the housing sector. But there are some encouraging signs. 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.

Overall, we judge that the risks to our inflation outlook in Canada are roughly balanced. However, there remains a possibility of a disorderly resolution of global imbalances.

On 6 March, we left our key policy interest rate unchanged at 4 1/4 per cent. In line with our outlook, the current level of the target for the overnight rate is judged, at this time, to be consistent with achieving the inflation target over the medium term.

Conclusion

I've discussed some of what I see as the major challenges that we all face. I've also emphasized the crucial need for flexibility on all of our parts: government, labour, and business. This flexibility is vitally important. It will enable all of us to successfully capitalize on the opportunities presented by an expanding global economy.

I'd now be happy to answer your questions.