Remarks by David Dodge
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The Benefits of Sound Economic Policies

It is truly a pleasure for me to visit this magnificent and historic city. I certainly appreciate the opportunity to speak to your association today.

Canada and Italy share many similar characteristics. We both belong to the G-7, and we are among the smaller members of that group. Our two economies vary greatly from region to region, both in terms of structure and strength. Overcoming these regional disparities is one of the great challenges we both face. After the serious inflation problems of the 1970s and early 1980s, Canada and Italy are now enjoying the benefits of a low-inflation environment. And we both trade a great deal with a large partner—in our case, with the United States, in your case, with the rest of the euro zone. We in Canada and you in Italy have recently taken steps to overhaul our tax systems, and we both face the challenges of an aging population.

Given our similarities, there is clearly much we can take from each other. What I would like to do today is talk about some of the lessons that we in Canada have learned about economic policy in recent years.

The "Four Legs" of Economic Policy

During the 1980s, a consensus began to take shape among OECD countries on a set of economic policies that would provide the strongest base for sustained economic growth. There are four principles involved in this consensus. I like to think of them as the four legs of a chair. Just as a chair is steadiest when all of its legs are the same length, policy-makers can get the best results by paying equal attention to all four principles. And when one of the legs starts to weaken, the best way to restore stability is to build that leg back up, not to cut down the other three.

Over the past decade or so, Canadians spent a great deal of effort putting the four elements of this framework into place. It certainly was not easy. It involved a fair bit of short-term economic pain. But the phrase "short-term pain for long-term gain" is more than just a cliché. Canada is now reaping the economic benefits of this effort.

Of course, part of the reason for our recent good performance is the basic structure of our economy. For example, the current global economic uncertainties are having their greatest effect on large, multinational firms. But Canada's economy consists more of small and medium-sized enterprises. As well, while the hard-hit technology sector has become an increasingly important part of the Canadian economy in recent years, it still represents a smaller share of our economy, compared with, for example, the United States.

But good fortune is only part of the story. Without Canada's commitment to the OECD's "four legs" of sound economic policy, our recent performance would no doubt have been poorer.

So, what are the "four legs" of the OECD consensus? The principles that I am referring to deal with monetary policy, fiscal policy, trade liberalization, and structural reform. I will spend a few minutes on each of these, drawing on Canada's experience in recent years.

Let me start with the one that relates most directly to the Bank of Canada's primary responsibility—monetary policy. The OECD consensus holds that price stability is the appropriate goal for monetary policy over the medium term. In Canada, we try to achieve this goal through an inflation-targeting framework. The Bank of Canada reached an agreement with the federal government and introduced this policy in 1991. Under that agreement, we aim to keep inflation, as measured by the consumer price index (CPI), at the 2 per cent midpoint of a 1 to 3 per cent target range over the medium term.

We have found that this inflation-targeting system has been very effective in promoting low, stable, and predictable inflation in Canada. Following a period of higher and more variable inflation in the 1970s and 1980s, the inflation-control targets have helped to anchor monetary policy. After the agreement came into effect, inflation quickly fell into the target range. Subsequently, inflation expectations have become focused on the target, helping to promote sustained economic growth.

Here in Italy, the inflation-targeting monetary authority is the European Central Bank (ECB). Italy's recent inflation record is certainly favourable. But there is a slight difference in the approaches of the ECB and the Bank of Canada that I will mention. At the Bank of Canada, we explicitly run monetary policy in a symmetric way around our 2 per cent target. The ECB's only explicit commitment is to keep inflation <u>below</u> 2 per cent.

There are always challenges to operating a single monetary policy in a country with diverse regions. As I said earlier, Canada, like Italy, has several regions with different economic structures. The ECB faces the even more daunting challenge of conducting monetary policy for an entire continent! But the important point I want to make here is that both the ECB and the Bank of Canada are determined to keep price stability as the medium-term policy goal.

That is the first of the four legs.

The second leg of the consensus has to do with fiscal policy. In the years leading up to the mid-1990s, provincial and federal governments in Canada were in the habit of running budget deficits. These deficits built up as governments continued to borrow, primarily to finance current consumption. It was an unsustainable situation, made more serious by our aging population. Clearly, social spending had to be put on a viable long-term course. And so fiscal policy needed to be based on a plan for putting the ratio of public debt to GDP on a steady downward track.

In Canada's experience, this was a difficult hurdle to overcome. The fiscal consolidation of the 1990s was painful. I was the federal Deputy Minister of Finance at the time, and I can tell you that many difficult and unpopular decisions had to be taken. Equally important, the provinces had to make hard choices as they reduced their public spending and restored their fiscal health. But as difficult as those years were, waiting would only have made matters worse.

Now, here's the good news: the vicious circle of rising deficits and debt has become a virtuous circle of balanced budgets and falling debt. Reducing the deficit in the 1990s helped Canada's international credibility. And this led to a reduction in the risk premium demanded by international investors. The fiscal improvement meant that the Bank of Canada was able to lower interest rates more easily when economic circumstances warranted. Not only did the lower interest rates reduce debt-servicing costs, they also stimulated economic growth, which brought in more revenues for the government. The extra revenue and lower debt-servicing costs, in turn, led to an even better fiscal position. Canada's total government surplus at the end of 2002 represented just over 1 per cent of GDP, which does not include the surpluses in public pension plans.

Last month, Finance Minister John Manley announced a fifth consecutive surplus in the federal budget and projected that the budget will continue to be in a balanced position or better for the next three years. The budget maintained the fiscal planning framework of previous years. That framework includes a $3 billion contingency reserve, which is used to reduce debt if it is not needed for other purposes. It also includes $1 billion in the 2003–04 budget year for additional economic prudence, and $2 billion in the following year, as further assurance that Canada won't fall back into a deficit position. Not only have we reduced the debt-to-GDP ratio, but the federal government has paid down almost $50 billion of debt. This has led to the restoration of Canada's Triple-A credit rating and has freed up about $3 billion of resources every year for the federal government. The main point is that while the initial work of fiscal consolidation is certainly difficult, it is necessary in order to enjoy the fiscal dividends later on.

The third leg of the consensus deals with trade liberalization. Countries need freer international trade to exploit the gains that come from increased specialization, enhanced productivity, and greater competitiveness.

Canada's recent experience in this area first involved signing the Canada-U.S. Free Trade Agreement, which came into effect in 1989. In 1994, Mexico joined the group through the North American Free Trade Agreement (NAFTA). Both of these agreements sparked a great deal of domestic political controversy. But they also opened markets and created tremendous opportunities. Canada's exports have flourished as a result.

But freeing up trade means more than setting up regional free-trade blocs, such as NAFTA and the European Union. Canada is hoping to see meaningful progress at the World Trade Organization's Doha round of multilateral talks. Clearly, agriculture is going to be a major hurdle. The developed countries, including all of us in the G-7, have a considerable way to go in terms of liberalizing agricultural trade. And a number of other sectors will also require a major effort. This effort must be made so that the global economy can benefit. It won't be easy, but in the long run, it will be worth it.

The fourth policy leg has to do with structural reform. These adjustments are always difficult because reforms will affect various groups in differing and often painful ways. Further, the economic benefits of the increased flexibility may take a fairly long time to emerge. But these difficulties should not sway us from the task of reducing rigidities and increasing efficiency so that our economies can better adjust to a rapidly changing world.

Canada has made some progress in a number of areas. The federal government has made changes to its system of unemployment insurance, trying to base the program more on insurance principles and to improve the employability of labour. Canada has also taken steps to reduce distortions in the personal income tax system and has implemented a goods and services tax to replace the outdated tax on manufacturers.

More recently, we made some major changes to our public pension system. The Canada and Quebec Pension Plans were established in 1966 using a "pay-as-you-go" system. But changing demographics put pressure on the plans, as they are doing in Europe. By 1996, the federal and provincial governments agreed to changes that would put the Canada and Quebec Pension Plans on a firmer footing. This meant some restructuring of benefits and a sharp increase in contributions—moves that were not popular, but they were certainly necessary.

The Canada and Quebec Pension Plans now generate surpluses that represent almost 1 per cent of GDP. These are set aside in special funds that cannot be touched by governments for general use. Indeed, the federal and provincial governments agreed to set up the Canada Pension Plan Investment Board, an entirely independent body. Its sole mandate is to invest the contributions in markets, in order to generate the best possible returns, with due consideration for prudence, over the long term. I should also point out, because the Canadian and Italian systems are different, that all public sector employees in Canada belong to pension plans that are fully funded.

I know that you in Italy are struggling with pension reform, and I know how difficult the issue is. But such reforms are important, and I wish you well in your efforts. The challenges you are facing serve to highlight the fact that implementing the fourth leg of the OECD policy consensus is not easy. But we must all continue to make progress and not lose sight of the four principles.

The payoff that Canada is now seeing gives me confidence in the value of the OECD consensus. Despite the global economic slowdown, despite the collapse of the share prices of many technology firms, despite the effects of the September 2001 terrorist attacks against the United States, and despite the corporate governance and accounting concerns, Canada's economy has remained strong. And most forecasters expect us to lead the G-7 in economic growth again this year.

Given all the uncertainty in the global economy, it is more important than ever that national authorities around the world stick to this policy framework. It is only by staying the course that we can establish a steady base for sustained growth over the long term.

Canada's Economic Prospects

Let me now give you the Bank of Canada's views on the state of the Canadian economy and the outlook. First, a bit of history. Following the 11 September 2001 terrorist attacks in the United States, the Bank of Canada, like other major central banks, moved quickly and aggressively to cut its policy interest rate to shore up confidence. That dramatic monetary policy action helped a great deal. By the spring of 2002, it became evident that our economy hadn't been knocked off track by the events of 11 September. Indeed, evidence was starting to build that the economy was growing faster than its production potential, taking up the remaining small amount of economic slack. So, we raised our key policy rate three times between April and July, by a total of three-quarters of a percentage point.

But by late last summer, we were seeing the effects of financial headwinds, geopolitical uncertainties, and continued weakness in the global economy. These factors remained in play through the autumn. As a result, we refrained from raising interest rates, even though inflation was accelerating.

Our initial analysis was that this increase in inflation would be temporary. However, both core and total CPI inflation remain well above target. This reflects the impact of higher-than-expected prices for crude oil and natural gas, continuing increases in auto insurance premiums, and price pressures in certain sectors, such as housing, food, and some services. The higher inflation also suggests an underlying firmness in the price-setting environment. In other words, relative price increases wouldn't be pushing up trend inflation if there was not sufficient demand.

Indeed, final domestic demand—especially household spending—has remained robust. However, economic growth in Canada moderated in the final three months of 2002, largely because of weaker exports—most notably, a decline in automotive shipments to the United States.

Even with this slowing growth in the fourth quarter, upward revisions for previous quarters leave the level of economic activity slightly higher than we had been monitoring. In fact, Canada's economy remains near full capacity.

Let me list some of the indicators that support this view: high industrial capacity utilization; near record-high labour force participation rates; a record-high employment-to-population ratio; corporate profits at their highest level since early 2001; and, as I said a few moments ago, above-target trend inflation.

While we continue to foresee growth somewhat below potential in the first half of this year, we expect increased demand in the second half of 2003 and into 2004, as global uncertainties diminish. But with an appropriate reduction in the amount of monetary stimulus, we see the level of output remaining close to capacity during this year and into 2004.

So, in making our interest rate decision on 4 March, we weighed the following considerations: domestic inflation pressures; the expectation that Canadian economic activity will remain near potential in 2003 despite geopolitical uncertainties; the stimulative stance of monetary policy; and improved conditions in capital markets. Taking all of these factors into account, the Bank raised its key policy rate by one-quarter of a percentage point to 3 per cent.

Even with this increase, the stance of monetary policy remains stimulative. Thus, over time, further reductions in monetary stimulus will be required to return inflation to the target over the medium term. But, as we have said, the timing and pace of increases in policy interest rates will continue to depend on a number of considerations. These include the strength of demand pressures; the evolution of inflation expectations; the impact on confidence of geopolitical and global economic uncertainties; and the way in which developments in the Middle East affect demand and inflation, both globally and in Canada. The Bank will continue to closely monitor all of these factors.

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So, to conclude, these are certainly challenging economic times. But we in Canada remain convinced of the merits of the economic policy consensus reached at the OECD. To reiterate, these policies are: a monetary policy aimed at medium-term price stability; a fiscal policy aimed at reducing public debt-to-GDP ratios; trade liberalization; and meaningful structural reform. Canada's positive economic experience over the past couple of years, in the face of stressful times for the global economy, is strong evidence that this framework is the right one. In Canada, there is a determination to stick with these policies which, especially during these uncertain times, are demonstrating their value.