Remarks by David Dodge
Governor of the Bank of Canada
to the Council of the Americas
New York City, N.Y.
19 April 2004

Economic and Financial Policies for Growth in the Americas: A Canadian Perspective[1]

It's a pleasure to be here today. The invitation to speak to you comes at an opportune time, as I have recently completed a round of visits to Mexico, Brazil, and Argentina. While there, I spoke on the subject of adjustment to global change and the policies needed to facilitate that change, drawing on Canada's experience. I also exchanged views with central bankers and finance ministers in all three countries about their efforts to promote economic growth and adjust to the new forces at work in the global economy.

I hope that the insights I have gained from those discussions will better inform the Canadian view that I bring you today concerning the economic policies needed for sustainable growth in the Americas.

A Changing World Economic Environment

Today, all of us in the western hemisphere face quite a different world economic order from that of a decade or two ago.

As we look across the Atlantic to Europe, there is a sense that, with countries in the Far East rising to economic prominence, trade across the Atlantic may become relatively less important than trade across the Pacific.

The giant emerging-market economies of China and India are truly changing the economic balance across the Pacific in a way that none of us can afford to ignore. The sheer size of these two economies is very impressive in itself: together, they account for close to 40 per cent of the world's population. And they produce about 18 per cent of world output. Moreover, that output is growing more than twice as fast as that of Canada or the United States.

[1] This is a more complete version of remarks delivered by Governor Dodge to the Council of the Americas, New York City, on 19 April 2004.

Here in North America, the fact that the combined population of the United States and Canada is only 300 million means that, in the future, we will account for a smaller fraction of the global, and even the hemispheric, economy. This is a good thing? not because our relative weight will be shrinking, but because that of the others will be growing. Still, this is going to be a challenge for the United States, which, since the Second World War, has been producing such a large portion of the global output. And so it is particularly important at this time, when the United States still has so much leverage, that it continue to provide leadership in building a strong rules-based world trade order. Beyond this, just as the countries south of the Rio Grande have to do, Canada and the United States will have to confront the challenges of Asian competition and find ways to seize the opportunities presented by some of these huge, growing markets.

The other major challenge that we all face is demographics. In Canada and the United States, the issue is aging populations. But south of the Rio Grande and in the Caribbean, there are large and growing numbers of young people who will be looking for jobs. Our problem in the north is how to support an aging population without placing undue strain on a shrinking work force. Theirs in the south is to grow fast enough to create jobs for the large number of young people that will be entering the labour market.

This, then, is the economic and demographic environment in which we in the Americas now have to operate. So, in this context, we have to ask ourselves, How does each country run its own economic policies to enhance growth and maximize the chances of improving standards of living over time?

Right off the top, let me make a key point. Most of the elements of good economic policies for growth apply equally to Canada, the United States, and every other country in the rest of the hemisphere. To be sure, there will always be nuances because of the particular stage of a country's development or institutional framework. But, in my view, it is very dangerous to excuse significant divergence from sound medium- and longer-term policies on the basis of short-run or apparent local political exigencies. For, over time, we have learned an awful lot about policies for growth. And we now know that any departures from good policies, even for relatively short periods of time, should be viewed with real skepticism. This is particularly true of macroeconomic policies, but it is equally true of structural (microeconomic) policies.

So with that, let me now talk about some of the fundamental policy underpinnings that apply to all of us as we forge ahead in pursuit of solid economic growth. In doing so, I will draw on Canadian experience.

Economic policies for growth

We Canadians have had our share of economic and financial ills during the past 30 years. Some of what we have learned in dealing with those ills may now seem self-evident. But it is through significant and rather costly economic adjustments that we have come to appreciate their importance.

The first lesson is that solid economic growth depends crucially on the confidence that comes from well-managed macroeconomic—that is, monetary and fiscal? policies.

The second lesson is that, given the ongoing changes that I discussed earlier, continuous adjustment will be necessary. We have also learned that, even though economic adjustments can be difficult and painful in the short run, there is really no way around them.

As a central banker, I would like to focus more on macroeconomic policies today. But structural policies that aim to increase the flexibility of our economies are every bit as important for economic growth. So, I will begin with a few points on those policies.

Structural policies

The first point relates to security. Security is one of society's most basic needs, and it is fundamental to economic growth. So, the first element of good economic policy for every government is to provide a reasonable level of security for its citizens. I know that I do not have to say more on this subject to this New York audience.

Equally important is the rule of law, particularly laws regarding the enforcement of contracts. We know that where these are unreliable, or perceived to be unreliable, even well-intentioned and well-executed macroeconomic policies can easily falter.

Nowhere is the enforcement of rules more critical than in cross-border trade. And this leads me to my next point, which is the importance of keeping our borders open? within the Americas and across the oceans.

This is not easy. There are always pressures in every country to protect domestic producers. And yet, both you in the United States and we in Canada have learned that it is through the opening of those borders and the tearing down of barriers that domestic competition and efficiency are spurred and higher living standards are achieved.

That is why Canada strongly supports efforts to extend the benefits of free trade under the Mercosur and under the Free Trade Area of the Americas (FTAA). It is also why we are, most importantly, committed to lowering trade barriers at the Doha round of multilateral negotiations.

To be sure, adjusting to strong competitive pressures, such as those now coming from China, is a major challenge. And for some countries in the Americas this may be a bigger challenge than for others. But we have learned that the way forward is to adjust to competition, not suppress it. That means not yielding to protectionist pressures, but rather continuing to focus on doing what is right for our domestic economies? providing a stable macroeconomic environment and making our economies more flexible. If we yield to protectionism, everyone in the international community will be worse off. This is one area where Canada and the United States have a real opportunity to continue to provide leadership.

The other thing we have to keep in mind is that the Asian countries that are now formidable global competitors, are also a great source of demand for our products, whether for raw materials, machinery and equipment, or high-end technology goods. And they are important investment destinations for our firms to produce increasingly higher-quality inputs and intermediate goods, at lower cost? goods that can be shipped back here, helping us to enhance our own competitiveness.

In addition to freer trade, it is important that all of us in the western hemisphere have other appropriate structural policies in place. Such policies facilitate necessary economic adjustments and help to increase productivity and raise living standards over time. Here, I am thinking of policies that, among other things, work to reduce industrial subsidies, to reform labour markets, unemployment insurance, and pension plan systems, to establish intellectual property law, and to develop rules for the efficient regulation of financial markets.

Now, we all know that implementing some of these policies may mean that certain groups in society will bear an unfair share of the adjustment. And quite naturally, some will resist? and resist strongly? changes that mean the loss of their job, even though society as a whole stands to benefit from those changes. And so it is critical that we also have arrangements in place to facilitate the training and retraining of workers, their relocation, or their movement from shrinking to growing areas of the economy. Such arrangements are vital for all countries, although their specific nature will vary depending on the structure of the individual country.

Promoting an efficient and robust financial system, including a strong banking sector, is also of the essence. This is especially so for countries that, like Canada, have a large number of small and medium-sized firms. To grow, these firms must have access to credit within a well-functioning banking system. And people need to have confidence in their domestic financial system if savings are to be efficiently recycled to help firms expand, and if governments are to obtain financing from domestic sources. Moreover, as we have learned from the Asian and Russian financial crises, a strong banking sector can be the best defence against international financial crises.

Also, let us not forget that it is through the financial system that monetary policy actions are transmitted to the economy. So, a strong and efficient financial system is critical to the conduct of monetary policy? to which I will now turn, as I talk about the role of macroeconomic policies in promoting growth.

Macroeconomic policies

Here, I can speak from the vantage point of a country that is a “reformed” past sinner, particularly with regard to fiscal management. And I can speak with a certain conviction; for, as the Chinese say, “those who fall in a pit, gain in wit”.

To put all this into context, let me quickly sketch for you Canada’s situation in the late 1980s, when we were facing serious economic and financial difficulties. Government spending was near historic highs relative to the size of our economy. Public debt was rising rapidly, as was the share of it held by foreigners. To service that debt, the government was spending one out of every three tax dollars taken in. Real estate prices were also rising quickly, adding to fears of a return to the high inflation rates of the 1970s and early 1980s. Those concerns were fully reflected in the large risk premiums that domestic and foreign investors demanded.

By the early 1990s, it had become abundantly clear that the situation was untenable, and that Canada could no longer put off major adjustments.

We started tightening monetary policy in 1989. Then in 1991, together with the federal government, we took a major step towards a commitment to price stability, by agreeing on an anchor for monetary policy. This was an explicit inflation target that would lower inflation to 2 per cent? the midpoint of a range of 1 to 3 per cent. Over the past 13 years, we have kept inflation around 2 per cent, on average. And inflation expectations have fallen into line.

The emphasis that we place on keeping inflation around 2 per cent means that we will raise interest rates when the economy looks about to overheat. But it also means that we will lower rates to stimulate demand if it looks as though the economy will be operating below full capacity, thus threatening to take inflation below target. This *symmetric* response helps to smooth the ups and downs of the business cycle. Our inflation-targeting strategy thus works to stabilize fluctuations in demand and to put the economy on a track to achieving maximum sustainable growth over time.

Most importantly? and that is relevant for all countries, including the United States? inflation targets have enabled us at the Bank to explain more clearly to business, labour, and the general public what we are doing and why. The benefits from this approach are far from trivial. Better public understanding of central bank policies and actions makes monetary policy easier to conduct and more effective. And this understanding, together with an explicit inflation target, allows citizens to better gauge the performance of their monetary authorities. Not to mention that it also makes it harder for governments to follow bad policies.

Canada and other inflation-targeting countries, including Mexico, Chile, and now Brazil, have also found that targets can be particularly useful in helping economies with a past record of high inflation to make the transition to a low-inflation environment. Targets help to establish and maintain policy credibility.

All told, we have found that a monetary policy based on an inflation-targeting approach can be particularly helpful in keeping inflation low, stable, and predictable, thus contributing to good economic performance.

Still, a sound monetary policy is a necessary, but not sufficient, condition for solid, sustainable growth. This is because monetary policy works best when it goes hand in hand with other sound economic policies, particularly a prudent fiscal policy. This is another key message drawn from Canadian experience.

Although inflation in Canada came down quickly after the adoption of the inflation targets, through the first part of the 1990s, the Bank of Canada was still constrained in its ability to reduce interest rates to support the economy. With the combined federal and provincial budget deficit close to 8 per cent of GDP, and with the overall public debt at a peak of 100 per cent of GDP, investors continued to demand large risk premiums. It was only after the mid-1990s, when federal and provincial governments made a determined, and successful, effort to eliminate their deficits, that policy credibility improved. This increased credibility led to smaller risk premiums, allowing the Bank to take action, as needed, to support economic activity.

One thing is very clear: implementing and maintaining a sound fiscal policy is fundamental to good economic performance. A sound fiscal policy means a more effective monetary policy. But it also means, most importantly, that citizens can have confidence that the authorities will manage public finances prudently and, consequently, that social programs that are important to individuals and to the cohesion of societies will be preserved. For Canada and the United States, this is especially important with regard to public pensions, in light of expected demographic pressures. We in Canada have dealt with our public pensions issue. I expect that the United States, too, would want to do the same.

Sound fiscal management also ensures that governments will not inflate problems away or renege on public debt. When the fiscal situation becomes unsustainable and is not taken in hand, confidence can be quickly frittered away. And in more extreme cases, as we have seen, savers and investors rush for the exits, triggering a crisis.

In Canada, we came uncomfortably close to a serious loss of confidence in the early 1990s. Fortunately, Canadians understood the need to take decisive action, and supported government efforts to that effect, despite the short-term economic difficulties and costs that this entailed.

One extremely important lesson that I draw from recent Canadian experience is this: whether on the monetary or the fiscal side, you need a plan, you set a target, you make sure that you hit the target year after year, and you don't change the rules when the going gets tough. This is how you earn credibility and how you provide confidence.

But I do not want to leave you with the impression that targets are mechanical rules to be followed slavishly. For example, fiscal targets must allow for inevitable shortfalls or surpluses of revenues because of unanticipated developments. What is critical here is that such targets be based on the longer-term needs of a particular country. Thus, for us in Canada and the United States, it is appropriate that we focus on a reduction, over the medium term, in the level of our public debt, so that we will be able to cope with demographic pressures 10 or 20 years out. It is for this reason that Canada's most recent federal budget sets an explicit target for reducing the ratio of public debt to

GDP to 25 per cent within 10 years. For us in Canada, this makes sense. Similar action would make sense in the United States. But, in countries with young and growing populations, different approaches might be needed.

To recap, whether it is monetary or fiscal policy we are talking about, reasonable targets are a great aid. They help citizens to understand why specific actions? and sometimes very difficult actions? are being taken. They also enable citizens to hold their monetary and fiscal authorities accountable. Most importantly, with targets, and with a good record of achieving those targets, workers and investors? domestic and foreign? can look to the future with greater confidence. And in these circumstances, macroeconomic policies can make their maximum contribution to economic growth.

Concluding thoughts

Let me conclude. Sound macroeconomic and structural policies are fundamental to achieving sustainable economic growth. Such policies are always difficult to implement. Fortunately, the current external environment is favourable for taking the steps to do what needs to be done. World demand is strengthening, financial conditions in mature and emerging-market economies have improved, and we all have a better understanding of which policies are the right ones. The best time to fix the roof is when the sun shines.

More open trade, appropriate structural policies, and sound macroeconomic policies all have an important role to play in helping us cope with, and make the most of, ongoing global changes. No single policy is a silver bullet. They are all essential and they all work together, reinforcing each other, to promote solid economic growth.