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Mr. Massimo Pacetti

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● (1535)

[*English*]

The Chair (Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.)): I call this meeting to order. I want to thank everybody for being here.

I want to thank Mr. Dodge for attending the meeting. It's always a pleasure to have you here. I was here, I think it was last spring, to hear one of your presentations.

If the witnesses can indulge me and try to stick to monetary policy and not book reviews, I would appreciate it.

I believe you have a presentation for us, Mr. Dodge. We're going to start with that, and then we'll have rounds of five minutes.

The floor is yours.

Mr. David Dodge (Governor, Bank of Canada): Thank you, Mr. Chairman.

[*Translation*]

Good afternoon, Mr. Chairman and members of the Committee.

We appreciate the opportunity to meet with this committee twice a year, following the release of our Monetary Policy Reports. These meetings help us keep Members of Parliament and, through you, all Canadians informed about the Banks's views on the economy, and about the objective of monetary policy and the actions we take to achieve it.

Since we last met, we are pleased to have issued Canada's new $20 bank note with enhanced security features. The new note began circulating on September 29. Last Thursday, we released our October Monetary Policy Report, which reviews economic and financial trends in the context of Canada's inflation-control strategy.

[*English*]

When Paul and I appeared before this committee last April, we told you that the economy appeared to be operating significantly below potential. This no longer is the case because the Canadian economy has grown faster than was projected in last April's *Monetary Policy Report* and in the July *Update*. This stronger growth was largely due to a surge in exports. The economy is now operating quite near its production capacity and continues to adjust to global economic developments.

The bank's base-case projection until the end of 2006 calls for aggregate demand for Canadian goods and services to expand, on average, at about the same rate as potential output. Given the effects of higher oil prices and the past appreciation of the Canadian dollar, the bank projects economic growth to be slightly less than 3% in 2005, slightly more in 2006.

With the economy expected to remain near its production capacity throughout this period, core inflation is projected to move back up to the 2% target roughly by the end of 2005. That's about the same projection as we made last April. However, given the path suggested by future prices of crude oil, the bank expects total CPI inflation will rise to the top of the 1% to 3% target range in the first half of 2005 before falling slightly below core by the time we get to early 2006.

Mr. Chairman, against this background the bank raised its target for the overnight rate to 2.5% on October 19. Our base-case projection assumes further reduction of monetary stimulus over time to keep the economy near its production potential and to achieve the inflation target. But I really do want to emphasize that the pace of interest rate increases will depend on our continuing assessment of the prospects for factors that affect pressures on capacity and hence inflation.

[*Translation*]

There are significant risks and uncertainties around this base-case projection, related to the adjustment to changes in the global economy, including changes in commodity prices and exchange rates. The risks surrounding global economic prospects relate primarily to the evolution of oil prices, the pace of expansion in China, the way in which current account imbalances in the United States and Eat Asia will be resolved, and geopolitical developments.

Mr. Chairman, Paul and I now will be happy to answer your questions.

● (1540)

[*English*]

The Chair: Thank you, Mr. Dodge.

Mr. Solberg.

Mr. Monte Solberg (Medicine Hat, CPC): Thank you very much, Mr. Chairman.

I want to welcome the governor and the senior deputy governor back. It's always a pleasure to have you here. We enjoy hearing from you.

We offer you the opportunity at any point to comment on the 1995 budget and the Canada Health Act. You can just go ahead if you want, but I know that's not why you're here.

Governor, according to your website the economy is basically operating at full capacity right now. Are you confident your estimate is accurate, that we're really right at the edge right now?

Mr. David Dodge: As you know, this is one of the measures that is most difficult to judge. We have really quite a wide confidence band around that measure, as you'll note from the *Monetary Policy Report*.

As near as we can judge at the moment, our conventional measure probably represents a pretty balanced view of where things are. Our conventional measure shows that we're pretty close to full capacity at the moment.

Mr. Monte Solberg: We have an unemployment rate of 7%. Of course, what we're concerned about is that it should be lower than that. We'd like to see unemployment go a lot lower than that.

Are we at a point, in your judgment, where it's really going to be very difficult to get lower unemployment than we have right now because we're running at full capacity in the economy?

Mr. David Dodge: One would always hope that we could get unemployment down. Even if there's one person unemployed who really wants to work, that is a waste of resources.

On the other hand, we have some sectors in some parts of the country where labour markets are really quite tight and other parts of the country and other sectors where there clearly is some excess supply. These imbalances, which are always there to a certain extent, are probably going to remain as we go through this adjustment period. It will be difficult to have that unemployment rate move very much. It can move lower, but it'll be hard during this period to have it move a lot.

What has been encouraging—certainly encouraging to us at the bank—is that the participation rate moved up to very high levels at the beginning of the year. We have record employment-to-population ratios. That really does auger well for rising incomes for Canadians and for rising employment, regardless of the measured unemployment rate itself.

Mr. Monte Solberg: Mr. Chairman, I'm going to split my time now with Mr. Penson. He has a question.

Mr. Charlie Penson (Peace River, CPC): Thank you.

I'd also like to welcome the Governor of the Bank of Canada here as well.

Mr. Dodge, the U.S. current account deficit is remaining very high. First of all, what percentage of that current account deficit is Canada responsible for? Do we contribute to that?

Also, do you believe that the U.S. will take policy actions to try to correct that imbalance?

Mr. David Dodge: Those are extremely good questions, Mr. Chairman. I probably will have a hard time giving you a complete answer in the time we have.

First of all, Canada represents a little less than 20% of U.S. total trade and probably about that fraction of the U.S. trade deficit as well. But the real issue, and it's an issue not just for the United States but also for the world, is how the imbalances on current account are going to get corrected.

As you pointed out, the U.S. has a large current account deficit, one that has continued to grow. At the same time, Asia, taken as a whole, has a large surplus, one that has continued to grow. Those imbalances cannot continue forever.

Financial markets are very large and can finance big capital flows for long periods of time. They certainly can finance those larger flows for longer periods of time than was the case even as recently as 15 years ago. But they can't go on doing it forever, and some correction will have to take place.

Clearly, that correction comes in several ways.

First, there's lots of room for consumption in Asia to rise. I think, Paul, it's true that in China consumption represents only about 40% of Chinese GDP, whereas it's well over 60% here. So there is plenty of room to rise. Moreover, their incomes will grow, and as the incomes grow there is room also for consumption to rise. That's number one.

Number two, it will be necessary over time for U.S. savings to rise—public sector or household or some combination of the two.

Over time, those two factors will bring about a reduction of these imbalances.

● (1545)

Mr. Charlie Penson: Would it also be fair to say that one of the options available would be lower interest rates in normal circumstances for the United States, but given that they are almost at record lows now, that is a tool that is probably not available to them?

Mr. David Dodge: No, the other mechanism to bring about this adjustment will be changes in exchange rates between Asia and North America. Those exchange rate changes can come in two ways: either through much higher inflation in Asia, which will lower the effective exchange rate of the U.S. dollar or raise the effective exchange rate of the Asian currencies; through a realignment of the nominal exchange rates themselves; or through some combination of the two. It's that latter issue that has been the subject of a lot of discussion.

Paul actually has some charts and numbers. I don't know whether you want to bring those out now or wait for a second round of questioning.

Mr. Charlie Penson: We've been seeing them at some point.

Mr. Paul Jenkins (Senior Deputy Governor, Bank of Canada): The charts relate to exchange rate movement, so maybe we can come back to that.

Just to reiterate the two or three key points that the governor mentioned, when you look at this issue it really is a global issue, not just a U.S. issue. And there certainly are clear indicators of the need for the United States to raise its level of savings, particularly in the public sector, given the large deficit there, but as well, an important factor going forward would be the strength of global demand overall to help resolve these imbalances. It really is important to look at these issues—they are very important issues for Canada and the global economy from a multitude of perspectives—and to look at all the issues that need to be addressed to correct that over time.

The Chair: Thank you.

Mr. Hubbard, and then Ms. Wasylycia-Leis.

Mr. Charles Hubbard (Miramichi, Lib.): Thanks, Mr. Chair, and welcome to our committee.

I'm not sure if the little credit card you gave us, Mr. Dodge, is going to be much good on the street, but probably a lot of small businesses are quite happy to see a new note.

Mr. David Dodge: The security features....

Mr. Charles Hubbard: Even taxi drivers are caught, losing $20 occasionally.

We do have an interest in this across the country. You might want to comment, just for a minute, Mr. Dodge, on the new note and how it will affect those who hopefully will get good money in the future, rather than one of the counterfeit pieces that are today down to the $10 range.

Mr. David Dodge: Starting roughly in 2002, counterfeiting, as members of the committee are aware, became a very serious problem, largely because of the changes in technology that are available to people. What we have done with the new series of high-denomination notes—the $100 last spring, the $20, which we started on September 29, and the $50, which will come out about the middle of November—is introduced a series of new features that are very much more difficult to counterfeit and extraordinarily difficult to counterfeit well. That's number one.

Number two, they are relatively easy to use—and that's the key thing—so the ordinary cash handler can quickly determine whether a bill is genuine or fake. They include much more of what we call intaglio printing. You can feel the print on the bill. It's more raised. That, for most cash handlers, is actually their first indication that something is wrong.

The holographic stripe here is very easy to use. It changes colour as you tilt it. But very important are two features that are actually embedded in the paper, and this makes them extraordinarily difficult to replicate: a water mark, in which, when you hold it up to the light, you can see, in the case of the twenty, the Queen's head, and in the case of the hundred, Mr. Borden's head; and this stripe, which is embedded or woven right into the paper. On the old twenties you'll recall we had a patch in the corner. It's the same sort of material, but it's woven right into the paper, so you can't sort of stick it on and make it look like a real bill.

● (1550)

Mr. Charles Hubbard: Thank you, Mr. Dodge.

Also, in your brief report today you talked about two factors that might become very important for our economy: the rising cost of oil prices and the rising value of the Canadian dollar. In terms of our economy, our economic success, how much of each can appreciate before we see a major concern?

Mr. David Dodge: With $55 a barrel for consumers the world over, the price of oil is, of course, a concern, and it's for this reason that we've reduced our outlook for growth for the United States for next year, roughly from 5% where we were last April—we thought in 2005 about 5%—to about 4.25%. This is still reasonably good growth, but clearly oil prices there are having an effect, and they have an effect on consumers everywhere.

Of course, Canada is a net exporter of oil and gas, in fact a rather larger net exporter than we were a decade or fifteen years ago. So in terms of total income, we end actually being a marginal beneficiary. Certainly over time we end being a marginal beneficiary, but in the short run it's very hard for the oil and gas companies to make the investments to punch enough holes in the ground, or to build new tar sands plants, or to build new pipelines, at a speed to absorb that. So in the very short run, the negative impacts on consumption outweigh, a little bit, the positive effects of this higher income that is flowing. This is why we said we expect the impact in 2005 on Canada to be slightly negative because of the oil price increases; probably slightly positive in 2006 going forward.

With respect to the exchange rate, as you're aware, two things are going on. First, the U.S. dollar is becoming weaker against all currencies. We have charts that are being circulated showing at least three, and you can see that the pattern of a strong U.S. dollar in the 1990s has given way to weakness in the U.S. dollar in 2003-04, and that's impacted us, Australia, Europe, in fact all the currencies.

The second factor that affects Canada in particular, of course, has been the relatively high price of energy and non-energy commodities. That acts also to create a very favourable climate in Canada and to push up the Canadian dollar. Those are the factors that have been at work. Obviously what that means is that sectors that are not producers of commodities, and it goes a lot farther than just commodities—iron and steel, for example, have been very strong. A number of manufactured products actually have been very strong. But for a number of manufacturers and service producers that are exposed to international competition, of course, the rise in the Canadian dollar vis-à-vis the U.S. dollar, or the fall of the U.S. dollar vis-à-vis the Canadian dollar, does mean increased competition.

The only thing I would add, and maybe Paul wants to add a word or two, is that we have been a bit surprised by the impact of the big appreciation that took place during 2003. The impact in 2004 has not been quite as big as we would have imagined. It's not been as big as we indicated we thought it would be last April when we were here. This may mean that there's more to come because there are lags in this process—the lags may be a little bit longer than we had anticipated—or it may well mean that indeed Canadian producers have been able to adjust more quickly than they have in the past, and probably there's a bit of both. Paul, you may want to add something.

● (1555)

Mr. Paul Jenkins: Perhaps I can just quickly talk to these charts and then add a couple of additional points to what the governor has already said.

The Chair: Can I interject? We're going to go a round and then we'll go through charts. I want to give everybody a chance to say something. All right?

Mr. Paul Jenkins: Yes, by all means.

The Chair: I have Judy, Maria, Guy, John, Rona, and then Don. Then we can do the charts. Is that all right?

Judy.

Ms. Judy Wasylycia-Leis (Winnipeg North, NDP): Thank you, Mr. Chairperson. And thank you, Mr. Dodge and Mr. Jenkins for your presentation today.

I want to talk about the issue of interest rates, because you've stated here today, and before publicly, that you see the need to increase rates because the economy is approaching full capacity. I think others use the phrase “overheated economy”.

I have a hard time understanding the extent to which our economy is overheating after coming from an area like Winnipeg North where families are struggling to make ends meet. It's not uncommon for a working family to still have to turn to a food bank just to stretch the dollar. I have a hard time accepting it when I walk from my apartment in Ottawa to here, down Metcalfe Street, and see many people with their hands out looking for a few coins. I have a hard time understanding it when I hear about youth in my colleagues' constituencies in northern Ontario, who are dealing with the problem of youth having to leave their home to find work. How is that an overheated economy? Am I living on a different planet?

Mr. David Dodge: First of all, we don't think the economy is overheated. We've been quite clear. We said we think we're approaching, and very near, capacity. That's where we think we are.

Our best judgment at this time, given what we see going on in the world, is that unlike some of the previous times, we don't see this thing growing at a hugely robust pace and becoming overheated. That is not what we see. What we do see, though, is us close to capacity or maybe moving a bit above capacity.

There are a lot of uncertainties in that. That's why we say we're pretty sure that over time we're going to have to move interest rates up. But we're very careful to point out that we're not in a situation where we see the economy driving lickety-split right through capacity. We will watch developments carefully in order to determine the pace at which we will move interest rates up.

● (1600)

Ms. Judy Wasylycia-Leis: On this you've often stated that we're near capacity. That implies, and I think you've even said the words, “reaching full employment”. My understanding of the unemployment situation in Canada today is that we still are 7% or higher, and among youth we're 13% or higher. We haven't been below 6% since the days when you were deputy minister to the present Prime Minister.

My two-part question is this. How many Canadians do you consider have to be out of work before we have high unemployment? Secondly, given what I would consider a pretty volatile market, high unemployment, and uncertainty in the U.S. and world economic outlook, wouldn't it have been more prudent from a job creation viewpoint to actually hold off on raising interest rates until some of this uncertainty is resolved?

Mr. David Dodge: Interest rates at the moment are indeed really very low. We're not at the very bottom, as we were at 2% at the beginning of the summer. We are lower than we were at the beginning of the year, though, I'll remind you; we're at 2¾%.

It is a difficult judgment call, and it's one we have to make each time as to just how rapidly we need to move those rates up. At the moment, our best judgment is we're going to have to move them up over time. But we can do this taking into account developments as we go along. If we see that the economy grows much more robustly than we foresaw, then we will have to move them up relatively quickly. If on the other hand it grows more slowly, then of course our pace would be very much more measured.

We want to make it very clear, and I hope everybody around this table understands, that we don't have in the back of our mind some lockstep increase that's going to happen every time going forward. We do have to make the judgment every time against economic developments, and it's always tricky as you're bouncing along relatively close to capacity.

Ms. Judy Wasylycia-Leis: Fair enough, although I don't think you really answered the question I posed in terms of employment levels and what you would consider high unemployment—

The Chair: Thank you, Ms. Wasylycia-Leis.

Ms. Judy Wasylycia-Leis: —so let me get you to answer that—

The Chair: Thank you, Ms. Wasylycia-Leis.

We'll go to the second round.

Ms. Judy Wasylycia-Leis: Could I get him just to answer the question about employment levels then?

The Chair: Thirty seconds, please.

Mr. David Dodge: We are at the moment at the highest employment-to-population ratio we've ever had. We're also, of course, at the highest participation rate. Both of those things I think are actually very good.

What we would like to see is employment continue to rise; indeed, we foresee that employment will continue to rise over the coming two years.

What is much harder to predicate, as you know, is the participation rate, and it's the difference between those two that you'll see unemployment bring.

The Chair: Thank you.

Ms. Minna, Monsieur Côté, Monsieur McKay, Madam Ambrose, Monsieur Bell.

Hon. Maria Minna (Beaches—East York, Lib.): Thank you, Mr. Chairman.

I would like to bring you, Mr. Dodge, to another aspect of economic investment, if you like, in terms of the impact of our economy, and that is the issue of early education.

I reread your speech on that subject recently and I was quite pleased to see that you had gone out of your way to do a fair amount of research to understand the importance of the development of what some people call the wiring of the brain in the early years and the impact this has on children and future economics, as well as the future of the children themselves in terms of health and other areas.

I raise this, of course, because it's a social issue, but it's also an economic issue, and we separate out the social from the economic issues as if one doesn't affect the other.

Our colleagues from the Conservative Party do not believe that child care—early education and care—is something we should do. They can rebut this, but I'm just trying to find a premise for something for which I want an answer from Mr. Dodge.

From the Speech from the Throne discussions, we are talking about the cutting of taxes to allow the parent to stay home a little longer—although we can quibble whether $1,000 or $2,000 will actually help anybody to stay home, if it's enough.... The point I'm trying to make here is that the issue is not about parents staying home with the child; the issue is about early education, having the child exposed to early stimulation, regardless of whether the parent is home with the child or not. Early education should start earlier.

In your speech you go as far as saying that—to some degree, and correct me if I'm wrong—increasing investment in post-secondary education is fine, as we are doing, but actually we should be concentrating even earlier than that.

I guess my question to you is, from the perspective of the economic impact and this kind of investment, given the reports we've had from the OECD, what would you see us having to invest to really get to the point we want to get to in terms of making sure every child in this country in fact does have a chance and makes a big difference to the long-term costs? Everything accumulates down the line.

● (1605)

Mr. David Dodge: I have a very hard time answering that in terms of how much, but the work I did indicated that at the margins for the next $1 million, if you will, of investment one of the most profitable investments that could possibly be made would be investment in early childhood development and early childhood education. At the margin, the returns to investing dollars there are probably higher than they are to investing dollars in post-secondary education.

This doesn't mean the returns are low in post-secondary education by any stretch of the imagination, but at the margin, if you have just a million dollars additional to invest, the most important place to invest it at the moment is in preschool rather than in school or post-secondary education.

Mr. Charlie Penson: That's not monetary policy.

Hon. Maria Minna: Well, it is the monetary policy, with respect, because we're investing in people and the returns on our investments.

The reason I raised it is I think Mr. Dodge probably gave the speech because it does have to do with the economy. Social and economic issues are not separate in those things.

The Chair: I have no problem with the question.

You still have a minute and a half, Ms. Minna.

Hon. Maria Minna: Okay.

Just to reiterate, I've never seen the two policies as separate, which is why I raised it here.

I'm assuming, Mr. Dodge, you spoke to the issue because again, of course, it goes to long-term economic sustainability, as well as health, as well as many other issues, that affect our budgets and our financial situation as a country. The reason I raised it was that I wanted to get your input on the investment side of children as opposed to the obvious, which is the child care part, assisting parents who are working, but rather than that, to expand on the actual value of investment and the returns of that to our society and economy, if you like, to put it in hard economic terms, in terms of investing in children at that stage. I just wanted to get at that.

Mr. Chairman, I think with respect, on the other issues I had with interest rates, Mr. Dodge actually answered them earlier, in terms of looking at higher interest rates and what that means, so I think I will leave it at that.

The Chair: Thank you.

Monsieur Côté.

[*Translation*]

Mr. Guy Côté (Portneuf—Jacques-Cartier, BQ): Thank you, Mr. Chairman.

Good day, Mr. Jenkins. Thank you for joining us here today.

Naturally, reducing the federal debt will have an impact on monetary policy. One can assume that it will.

However, I do have one question. The budgetary policies of recent governments have led to unexpected surpluses in the general operating fund and the government has used this money to reduce the debt. Meanwhile, the provinces are having a harder time keeping rising expenses in check. Consequently, as we speak, the government is in the process of paying down the one debt that is the least costly of all to carry.

What impact could this have in the longer term on credit ratings or on investments in the economy? How could this affect monetary policy?

● (1610)

Mr. David Dodge: First of all, government revenues, at both the federal and provincial levels, are a function of the increase in the nominal GDP. Admittedly, last year nominal GDP growth exceeded projections. Moreover, business profits were also greater than originally forecast. Revenues, in particular from corporate income taxes, were much higher than projected, whereas revenues derived from personal income taxes were also greater than forecast.

I believe five provinces came in with lower deficits or bigger surpluses than were projected. The revenue structure of the provinces and federal government has an automatic stabilizing effect. When revenues increase much faster than anticipated, this has a stabilizing effect on the economy. When the opposite occurs, revenue growth is slower than expected, which can also have a similar effect on the economy. In monetary policy terms, this structure has a stabilizing effect. That's the first point.

Secondly, I would say that in the long term, it's important for the federal and provincial governments to lower their debt-to-GDP ratio. An easing in debt servicing charges will help to maintain government services as the senior population continues to grow. In terms of monetary policy, this structure will help to alleviate inflationary pressure on the economy. It's important to remember that there will be a significant increase in the future in the size of our senior population.

Mr. Guy Côté: Earlier, you mentioned...

The Chair: You have thirty seconds.

Mr. Paul Jenkins: Perhaps I can just add something to that.

Based on our projections, all governments should expect to see their expenditures and revenues grow at more or less the same pace. A fiscal balance will thus be achieved. This is the scenario we present in our 2005-2006 estimates.

● (1615)

The Chair: Thank you, Mr. Côté.

Mr. McKay.

[*English*]

Hon. John McKay (Scarborough—Guildwood, Lib.): Thank you, Chair. Thank you, Governor, for appearing.

As you know, there's a fair bit of skepticism—some might say cynicism—about forecasting and the forecast upon which the government relies for projections of its budget and things of that nature.

This time last year and going forward, as we were putting together the budget, the expectations were that BSE, the appreciation of the Canadian dollar, and SARS would all have a bigger effect on the economy. That led to projections by you and other economists that were in the low end of the range.

You now invite us to believe that we will be somewhere around slightly below 3% in 2005 and slightly above 3% in 2006. We have a number of great unknowns in these predictions, many of which are beyond the parameters of a Canadian economy in particular, and predictions of a Canadian economy, because our economy is so trade dependent. There are so many things we don't control, and one of them is coming up on November 2, which is the U.S. election. I put it to you, Governor, that either President—whoever gets elected—is going to get religion. The religion is going to be that we have to start savings again. It's going to be that we have to raise the interest rates and stop the slide of the Canadian dollar. That will have tremendous implications for our economy and tremendous implications for the projections the government relies on for the setting of the next budget.

I'd be interested in your breaking out, if you will, the difference between the United States government getting religion, if you will, and not, for the Canadian economy.

Mr. David Dodge: That's extraordinarily hard to do.

First of all, even if the Americans were to move aggressively, they have dug themselves into such a hole that it will take really quite a while for that deficit to be reduced or eliminated, even with relatively good economic performance. As I understand, both presidential candidates have said what they would intend to do would be over four years to reduce the size of the deficit by about a half.

Whether that's enough or not remains to be seen, but it's quite clear that the U.S. is going to have to increase its public sector savings in one way or another. The fact that they begin to do so of course will begin also to restore some confidence in investors around the world and in U.S. citizens. So it is not at all clear in fact that movement will have a negative effect when you balance off the need for increased savings, the general recognition of that and hence the confidence effects, with the negative implication of slower growth in U.S. demand. It's just not clear which way that comes out.

Normally one would think that if indeed the U.S. government moves to reduce its deficit in a reasonably credible way, it means there's less pressure on the Federal Reserve to raise interest rates, so they ought to be able to proceed into the future actually with lower interest rates than they would if they did not deal with it.

Our own case is a good case in point. Ten years ago we were issuing 30-year bonds at about 9%. I can remember coughing as I had to sign warrants for those bonds at 9%. Today we issue them at 5½%, having restored that fiscal credibility. The impact won't be relatively quite as large in the United States, but directionally it would be exactly the same.

● (1620)

Hon. John McKay: Assuming that a measure of fiscal discipline comes to the United States, in theory at least, in the short term it would be the case that the U.S. would have to raise its rates and we would have to follow suit.

Mr. David Dodge: No.

Hon. John McKay: You don't agree with that.

Mr. David Dodge: No. In theory, if fiscal policy is doing the heavy lifting, then monetary policy can in fact be more relaxed. This was exactly the same point I was making earlier with respect to the stabilization impact of fiscal policy. When nominal income in Canada grew more rapidly last year than anticipated, indeed what happened was that revenues of governments were a little bit stronger, government fiscal position was a little bit better, and there was less need for the Bank of Canada to raise interest rates to prevent us shooting right through the ceiling. The two sides are not so simple as I just described, but the directions are quite clear which way they work together.

The Chair: Thank you, Mr. McKay.

Ms. Ambrose.

Ms. Rona Ambrose (Edmonton—Spruce Grove, CPC): Thank you.

I want to welcome Mr. Dodge and Mr. Jenkins. Thank you for appearing before the committee. As a new member of Parliament and as someone who has interest in these matters, I appreciate the opportunity to hear what both of you have to say on these important matters.

My question goes back to interest rates. I know you've talked at length about it, but I have a specific question. I know that the bank has raised its key lending rate twice since April 2004 when it last cut the overnight rate. As I understand it, the argument is always that this is aimed at cutting inflation. Yet I also understand, and from what I've seen on your website and other documents, that inflation is anything but a problem right now, and the current rate of inflation is actually still well under 2%. I know you've addressed so far why you were raising rates now, but I wonder if you could address what the bank's view is on the time lags between when interest rates are raised and when inflation will be affected.

Mr. David Dodge: The simple answer is that the lags are long and variable. We normally would anticipate that the full impact on the economy of changes in monetary policy take 12 to 18 months. The feed-through onto inflation takes a bit longer, say, up to 24 months. That would be the normal anticipation. It is not so simple as that, and that's why I said earlier that we have to make our decisions each time we sit down, eight times year, in light of the developments that have taken place, to try taking into account all the information that has come in.

Paul you may want to say just a couple of words on interest rate developments here.

Mr. Paul Jenkins: I think the other important factor here is it comes back to our monetary policy objective of keeping inflation low and stable and predictable at our 2% target as the contribution to sustained economic growth over time, to help the economy sustain full production capacity. If we're successful in doing that—coming back to interest rates—what it does is it not only anchors inflation expectations, but it anchors interest rates out the yield curve. So five-year bond rates, for example, and therefore five-year mortgage rates remain much more stable, while we may be moving short rates up and down. That stability of the medium to longer-term rates provides a very important stabilizing factor for the economy overall. What it really comes back to is the importance of inflation expectations being well anchored. We can move those rates up and down at the short end, but it does provide in that framework much more stability out the yield curve.

Ms. Rona Ambrose: Based on what you've just said and on Mr. Dodge's comments, do I understand you correctly that the bank thinks inflation could potentially be a problem down the road in 2006? Are you seeing something?

Mr. David Dodge: We actually operate absolutely symmetrically around that 2% target. That is the reason why we moved rates down very sharply, as you will recall, in the fall of 2001. Then again we moved them down at the end of last year and the beginning of this year, because at that time—and it's an oil price scenario that was a little different from what we're now carrying—we actually saw inflation falling below target. Indeed, we needed to provide, we thought, some additional stimulus through the economy to get up to potential. At that time we only saw it coming about the end of 2005, because we didn't foresee that growth this year, today, would have been as strong as it was.

● (1625)

Ms. Rona Ambrose: You mentioned reacting to the oil prices. I wonder if you could just quickly tell me more about how you see oil prices affecting inflation in the next year or in 2006.

Mr. David Dodge: First, let me make sure that committee members understand we're not in the forecasting business on oil prices. Every quarter we look at what the futures prices are out there in the market. We use that as our assumption as to what oil prices are going to do, and then we work from there.

If you look at page 32, you'll see at the bottom what our assumption is. You'll find that in this quarter of the year that we're now in—

Mr. Charlie Penson: What page?

Mr. Paul Jenkins: Page 32 of the full report

Mr. David Dodge: You'll see that we now expect oil prices, in the quarter we're now in, the fourth quarter, to average about $54 a barrel. When we were here in April, the comparable figure was $32, taken from the curve.

We expect that rise in oil prices, as I said earlier, to have a dampening effect on consumption, both abroad and at home. The impact, then, is to reduce growth slightly for Canada, but only slightly, in 2005.

The Chair: Mr. Bell, please, and then we'll go around again in the same order we had for the first round.

Mr. Don Bell (North Vancouver, Lib.): Welcome, Mr. Dodge and Mr. Jenkins.

As a new MP, I'm interested in your report. I want to ask a question or two about economic recovery.

On page 13 of your report, in technical box 2, you mention particularly the export manufacturing industry, that there was little change in employment despite the healthy upsurge they had. They were in effect becoming more efficient, would you say, and they reduced capital spending? And what long-term effect do you see there?

Mr. David Dodge: That's an extraordinarily good question. Certainly in the current year, in 2004, in the manufacturing sector we're seeing higher-capacity utilization. That's why output has risen even though employment has not risen, and why profits have been maintained even though the exchange rate has indeed moved up.

It's expected that over time there would be increased capital investment and some substitution—i.e., additional output will come largely from increased investment in capital as opposed to additional hiring. In the manufacturing sector we don't foresee the type of employment growth we experienced from 1995 to 2002. In fact, that was a rather unusual period. Employment and manufacturing over that period grew by almost 25% in Canada. It actually shrank in the United States over that period. It was about stable in China. It was about stable in Europe as a whole.

So we had actually a remarkable period, which we needed, absolutely needed. Governments were in fact reducing their demand, so we had to try to crowd in some other production in order to maintain employment. That will not go on in the same way, and that's why we talk about some of the adjustments that have to come.

● (1630)

Mr. Don Bell: Perhaps I can jump into a slightly different area, although it may be related. I think the economic growth in China in the last few years had been projected to be around 7% or 8%. I think that was their target. They were performing above that, originally below and then above, by about 2%.

The suggestion at one point was that the Chinese government might devalue the yuan. Do you still think that's a possibility? They indicated that they wouldn't, but if they do, what effect would that have on our trade with them?

Mr. David Dodge: I'll start, and then I'll let Paul do the difficult finish to that question.

To go back to the earlier comment about economies overheating, it was quite clear in the spring of this year that the Chinese economy was at that point. They took administrative measures to try to slow it down. Those administrative measures may now be starting to bite, although clearly it's a very awkward way to go about dealing with it. We have argued that it would be much more appropriate to allow for some revaluation of the renminbi and to allow for some rise in interest rates so that we get a relatively efficient dampening of this overheated economy rather than an inefficient one.

Paul, why don't you carry on.

Mr. Paul Jenkins: I'll start in terms of growth rates, and then I'll come back to the issue of the exchange rate.

On page 23 of our report, in the outlook section, we do give some global growth projections—the United States, the EU area, Japan, China, and other parts of Asia. You can see from the table that we are looking for a moderation in the rate of growth in Asia, largely driven by China. In fact, the very recent number that came out just last week for growth in China, year over year, was close to 9%.

This is what we have built into what we call our base-case scenario. That's the cornerstone for putting together our Canadian forecast. We are calling for some moderation. You hear people talk about a soft landing versus a hard landing. I don't necessarily like to use those phrases, but this would be closer to a soft landing, that we see the Chinese economy moderating. But we also indicate in the report that there are clear risks around that. The Chinese economy could grow much more rapidly or it could slow much more than what we've assumed here.

The issue of the exchange rate regime is indeed a critical one. We've been touching on it from a number of different points of view in terms of the global imbalances. The point we've made, and we've certainly made this point internationally, is that we do think it's in the best interest of China to move to a more flexible exchange rate regime in putting in place the macroeconomic tools that will enable them to manage their economy going forward. I believe they understand those arguments.

Then the question is, how quickly will they move in that direction? That is very hard to say. Given the size of their economy going forward, it's an economy like ours and like other economies that need flexibility to adjust. A fixed exchange rate just doesn't provide that for an economy that size. So this is something that we think will continue to be an important issue going forward.

My last point is that it's not just a China issue, it's an Asia issue. Asia as a bloc is a dollar bloc, at the moment, to other currencies either explicitly or implicitly linking themselves to the Chinese currency.

So this is an important issue that you've touched on.

The Chair: Thank you, Mr. Bell.

I have just a quick question, or I think it's quick.

In your distribution here, you state that your projection is off because there was stronger growth, due largely to a surge in exports. But weren't our exports mainly to the United States? With the dollar being higher, shouldn't there have been a different effect, or the inverse effect?

● (1635)

Mr. David Dodge: We had certainly anticipated that the appreciation of the dollar from roughly 63¢ at the beginning of 2003 to roughly 76¢ at the beginning of 2004 would have a continuing impact through 2004 that would in fact dampen our exports. That effect clearly was less than we had anticipated, so exports clearly rose more than we had anticipated.

The Chair: Mr. Jenkins, and then we'll start another round.

Mr. Paul Jenkins: I'd just like to add one other thought here. This has been an issue that has been important to us right from the start of the strengthening appreciation of the Canadian dollar.

To answer your question, I'm being somewhat general here, but there are two factors at play. One is the higher exchange rate. You're quite right, all else equal would suggest a dampening influence on exports. The point is that all else is not equal. The world economy—the United States economy, the Chinese economy—has been growing at a very, very rapid rate. With that higher growth rate, our exporters, notwithstanding this higher exchange rate, have actually been able to sell into these markets that are growing very rapidly. I think in part that's what we're seeing here, the net effect of those forces at play.

The Chair: My point is that it's easy to write these reports afterwards, because had the rate gone down, then you would have said, well, the rate has gone down because the exchange rates went up. You could have used the logic in the reverse fashion.

Mr. David Dodge: Yes, you have to look at everything that is actually going on, as Paul just said. We have had stronger world growth in the first half of 2004, certainly through the third quarter of 2004, than one would have anticipated a year ago.

The Chair: Okay.

Do you want to go over the charts, Mr. Jenkins?

Mr. Paul Jenkins: Very quickly, Mr. Chairman, I have just a couple of points really that I would like to note.

The first chart, as the governor noted earlier, is a chart that shows exchange rates versus the U.S. dollar for three currencies—Canada, Australia, and the Euro area—going back to 1993. You can see that recent upward movement in all three of those in part is reflecting the weakness of the U.S. dollar but as well reflecting, certainly in our case, the stronger price of products we sell, particularly commodity prices. You can see that in level terms. Today we're more or less back to the levels we were in 1993 before we got into the series of emerging market crises. That would be point 1 on the first chart.

Again I'll try to be very quick here. The second chart is a little more complicated. It's the same three exchange rates, but it's in what we call real exchange rate terms. What that means is we're adjusting for the relative rates of inflation in these various countries.

You can see that in fact, yes, the Canadian dollar in real terms has gone up, but nowhere nearly as much. The reason for this, if you go to the next page, is that our rate of inflation has actually been substantially below that of the United States. With the lower rate of inflation, a lower cost structure over that period, that nominal exchange rate actually, in relative real terms, rose less than the nominal numbers would suggest. It's just to give you a bit of perspective historically and to give you a perspective, on the one hand, on what you see every day in terms of nominal rate movements, and then an adjustment for the fact that Canada has actually become more competitive in terms of lower rates of inflation and rising costs over that period.

I'd be glad to answer any questions, Mr. Chairman. I can leave those charts with you and I'd be glad to come back to them at any point or if you have follow-up questions.

The Chair: Thank you, Mr. Jenkins.

We're going to have another round. We'll have Mr. Penson, then Mr. Hubbard, Judy, and then Yvan.

● (1640)

Mr. Charlie Penson: Mr. Dodge, you manage the Government of Canada's debt. I have two questions. What percentage of that debt will be rolled this year? And where have you got it? Is it in short-term or long? How have you got it managed to protect against rising interest rates?

Mr. David Dodge: Under the debt strategy that we established back in the 1990s, we had a target of roughly 66% long and roughly a third in short, and an average term to maturity, which we were keeping up at about five years. You can see this in the annual debt report.

You will recall that the minister announced in the budget last spring that because we are now in a better fiscal position, and because the curve is normally upwards sloping, that what we were going to do was take advantage of the fact we were in a better fiscal position and increase over time to 40% the floating rate portion and reduce from roughly 66% to 60% the fixed or the long portion. We're of course in the process of doing that. It does take time.

With respect to your precise question, I would have to go back and check the exact numbers, but of course treasury bills roll every three or six months—that's the nature of the bill—and there are always notes—we issue quite a few two-year notes—that are falling down into the one-year category, and always of course a portion of the 5-, 10-, and 30-year notes fall down.

The great advantage we have today, compared to exactly ten years ago, is that we are able to sell those 30-year notes at 5%, rather than 9%, and we're selling treasury bills at roughly 3%, rather than 6.5%. Hence the cost to Canadian citizens of servicing the federal debt is considerably lower on a given amount of debt, and of course we have less debt today than we had at its peak in 1996.

Mr. Charlie Penson: Just to follow up that theory then, wouldn't it be better to lock in a bigger portion of our debt into longer term when we are basically at historical lows in interest rates, rather than have so much in the floating categories?

Mr. David Dodge: Of course that is the question that every person with a household mortgage asks as well. Am I better to lock in or stay short? As we always reply, it depends on your risk tolerance. What we've done in moving down from two-thirds to 60% fixed is we've said we can take a greater risk in having more of our debt short. It is important—

Mr. Charlie Penson: Just to clarify a point, by having short, it's at lower interest rates. That's the advantage.

Mr. David Dodge: Yes. The advantage of short is that on average over time you're going to have lower interest payments, but those payments in fact are going to be more volatile, because as Mr. Jenkins explained earlier, we have a curve that normally looks like this, and it does move up and down, but it also wiggles. The short end moves up and down a lot more than the long end. We think it is prudent, and governments generally think it is prudent, to have a larger portion of their debt fixed in longer-term maturities than to have it short.

We have a great advantage today, compared to a decade ago, in that the premium we have to pay for that long debt is indeed lower (a) because inflation expectations are now well anchored and (b) because the risk premium on Canada due to high government debt has come way down as the ratio of government debt to GNP has come way down.

● (1645)

The Chair: Thank you, Mr. Dodge. Thank you, Mr. Penson.

Mr. Hubbard.

Mr. Charles Hubbard: Thank you, Mr. Chair.

It's quite evident that Governor Dodge has great confidence in the economy in terms of that short-term debt. However, in regard to consumer spending, some writers express a lot of fears in terms of the United States, and probably in terms of our own economy, at the tremendous backlog of plastic credit that's out there. Some writers will say consumers have almost exhausted their limit in terms of what can be acceptable for an economy.

Perhaps, Mr. Dodge, you could comment on this factor.

Mr. David Dodge: Yes, I'll start. In the last financial system review we put out, we actually have really quite a long article where we try to assess the state of households, because household debt relative to income has of course increased quite steadily since the big drop that took place in the early eighties. If my memory serves me correctly, it's a little over 100% of net household income.

At the same time, because interest rates are very much lower than they were, the debt servicing costs of households have indeed actually come down, so even though there is more debt outstanding, the cost to a household to service that debt in terms of the share of their income required to service that debt, on average, has come down quite steadily and is well below the long-term average, even though the total debt relative to income is now at a peak, certainly a recent peak.

The questions you're really asking are, does that make the household sector fragile, is it terribly exposed to rising interest rates, and should we really worry about this in aggregate? I'll turn it over to Paul to go through that part of the answer.

Mr. Paul Jenkins: As the governor noted, we have done what we call a sensitivity analysis around this, because again, this is an important issue. The debt-to-service ratio currently—this is across all consumers, and this would be a national number—is below 8%, which compares to numbers certainly double that back in the late eighties or early nineties.

The sensitivity analysis we've done shows that if interest rates were to go up, let's say, 100 basis points to 200 basis points, the debt-to-service ratio would go up, but it would go up maybe 1% to 1.5%. We think that's still at levels that can be sustained.

I think the other point is, when you think of the household balance sheet and you look at both sides—you look at the liability side and the asset side—and you work it down to a net worth calculation, the net worth of the household sector in Canada has actually been rising at a fairly steady rate, on average in the order of about 5%. So one needs to think about it again from that global perspective.

Mr. Charles Hubbard: Thank you, Mr. Chair.

Can I ask another question?

The Chair: Yes, you still have a minute.

Mr. Charles Hubbard: We haven't heard much today of the word “productivity”, which is so important to our economy. Are there any comments you'd like to make to us in terms of the productivity of the...?

Mr. David Dodge: You made the important comment that it is really important that we all—whether we're public employers or private employers, whoever we are—work on this, because in the end it's only through increases in productivity that we can indeed have rising standards of living.

Our assumption at the moment, our best estimate, is that if we look across Canada as a whole, over the next few years we will have productivity increases in the order of 2% and labour force growth in the order of 1%, employment growth in the order of 1% per annum, and hence our potential is growing at roughly 3%.

That will not catch us up with the best productivity performers in the world, and as a number of analysts have pointed out—in particular the Conference Board of Canada in their recent report—it really is incumbent on all of us to work hard on this if we want to have rising standards of living going forward.

● (1650)

The Chair: Thank you, Mr. Hubbard.

Ms. Wasylycia-Leis.

Ms. Judy Wasylycia-Leis: Thank you, Mr. Chairperson.

I'm wondering, Mr. Chairperson, if it may be that we might not want to let this session end without giving Mr. Dodge a chance to answer the questions about midnight faxes and changes to the Canada Health Act. Would you entertain, Mr. Chairperson, a question to Mr. Dodge about whether or not there is any truth to the allegations in Sheila Copps' book that in fact Mr. Dodge sent her the changed budget address, indicating the changes on the Canada Health Act, as requested by the then Prime Minister?

The Chair: Mr. Dodge, I let the question be asked. You don't have to answer the question. I leave it to you. I don't expect you to answer the question, if I can help you, in the answer I'm looking for, but I leave it to you.

Mr. David Dodge: I think, Mr. Chairman, it's important for me to take the opportunity at this committee to state, for the record, my best recollection of certain events. I would just begin with a tiny bit of context.

Ten years ago, as we've just been discussing, Canada was in a very difficult fiscal position. This was widely recognized by the government and by the Canadian public. The fragile nature of our financial position was driven home just about exactly 10 years ago today by the Mexican peso crisis in December 1994, which caused interest rates to shoot up here in Canada and led to heightened uncertainty. It was in this context that we were preparing the 1995 budget, and at the Department of Finance we explored many avenues to improve the federal government's fiscal balance. But I can state categorically that there was never any suggestion to modify the Canada Health Act as part of this exercise.

Members, as you know, modifications to the fiscal arrangements with the provinces were under discussion.

Ms. Judy Wasylycia-Leis: Could I just interrupt you? I asked about the Canada Health Act.

The Chair: There's a very fine line here.

Ms. Judy Wasylycia-Leis: All right.

The Chair: I'm willing to take a statement from Mr. Dodge and I'm going to drop it there. We're going to try to make the economy function at a more accelerated pace by selling more books, but I'm going to draw the line there.

Ms. Judy Wasylycia-Leis: All right. Let me ask on the—

The Chair: I'd like it if Mr. Dodge would just finish.

Mr. David Dodge: The precise nature of the rules, with respect to the amount of transfers to be withheld from the provinces for violations of the Canada Health Act, had to be addressed when it came to writing the legislation to implement the budget. But as I don't recall any suggestion during the budget process that the Canada Health Act would be abolished or modified, it shouldn't be surprising then that I don't recall any specific intervention by the former Prime Minister, as suggested by Ms. Copps.

The Prime Minister's Office, of course, was privy to the drafting of the budget, as it always is. But as modifications to the Canada Health Act were not under consideration, I remember no intervention to remove specific words referring to ending or modifying the CHA. And certainly I have no recollection of phoning Ms. Copps or faxing any document to her home before the budget was printed and tabled, as she described in her book. Indeed, as others have pointed out, such an action would have been contrary to the practices of the pre-budget document security at the Department of Finance, of which I was the deputy minister at the time.

What I do remember, Mr. Chairman, is discussions with Ms. Copps in the days after the budget's release, and these related to the wording of the draft legislation to implement the budget. Ms. Copps made a forceful argument for including the word “health” in the title of the new arrangement to transfer money to the provinces. You may recall that in the budget documents this arrangement was referred to as the Canada social transfer, but Ministers Copps and Marleau made a strong case for adding the word “health”. This was subsequently done, so in the end the arrangement was called the Canada health and social transfer when we tabled the legislation.

Minister Copps also reviewed the specific wording of a number of clauses in that draft legislation to implement the CHST. As I recall, she made some helpful suggestions with respect to the wording of the CHST provisions. While I don't remember specifically faxing to Ms. Copps reworded drafts of specific clauses, I certainly had that rewording communicated back to her as we prepared the final version of the bill for introduction in the House. That bill, as you know, provided for continued enforcement of the CHA by enabling the federal government to withhold the new CHST transfers, if necessary.

● (1655)

The Chair: Thank you, Mr. Dodge.

Ms. Wasylycia-Leis, 30 seconds, please.

Ms. Judy Wasylycia-Leis: Mr. Chairperson, on a point of order, I asked a straightforward question. I didn't ask for a long prepared statement. I hope you will give me some latitude, because this is not following any kind of decorum or set of rules.

The Chair: I'm not going to interrupt somebody from answering a question you asked. I think everybody around the table had the same opportunity to ask the question. You chose to ask it and he chose to answer it.

Ms. Judy Wasylycia-Leis: Well, we could have got an answer in a shorter form.

The Chair: It's 30 seconds, and if we're going to use it having a discussion between you and me, we'll have to move on.

Ms. Judy Wasylycia-Leis: All right. Let me ask about another issue that certainly was also touched on by Sheila Copps this week—it has nothing to do with her book—and that is the issue of pensions. You were quoted last April as saying that mandatory retirement is silly and that Canadians should be encouraged to work past 65. I'm wondering if you could indicate whether or not you believe government should reconsider raising the age for full pension benefits higher than the current age of 65 and whether or not you support raising the age for full CPP benefits above 65.

Mr. David Dodge: As I said last spring, I just don't think in this day and age that a mandatory rule on retirement has a place. I don't think it's helpful to those people who want to continue to work past the age of 65.

With respect to the CPP, the current legislation and the current arrangements around the retirement age are such that they are not evenly balanced between people who retire between 60 and 65, in terms of the early retirement arrangements, and those who want to continue to work. I think over time it would be helpful to review that, so people who want to continue to work past the age of 65 can earn additional credits, because, as you know, at the moment all they can do is defer their CPP pension, which is increased by 5% a year in terms of their entitlement, but they can't earn more entitlements past the age of 65. That is what I was referring to last spring.

As you're aware, with the changes that were made in 1996 to the funding arrangements for the CPP, it is in good fiscal shape as far as we can see into the future.

The Chair: Thank you, Mr. Dodge.

I have Monsieur Loubier, Monsieur Côté, Monsieur McKay, Madame Ambrose, and Monsieur Bell.

[*Translation*]

You have five minutes, Mr. Loubier.

Mr. Yvan Loubier (Saint-Hyacinthe—Bagot, BQ): Thank you, Mr. Chairman.

Governor, as always, it's a pleasure to welcome you to our committee. I was a little late arriving, but I did catch your opening remarks on television. I have to say that you look very good on camera.

All kidding aside, I think you failed to answer part of Mr. Côté's question about debt management. I'm certain that, as the former Deputy Minister of Finance and, even more so, as the Governor of the Bank of Canada, you deplore mismanagement of financial resources, such as the misallocation of scare resources to satisfy unlimited needs, to quote the definition of a modern economy.

We're in a situation today where one single taxpayer pays taxes to the provincial government and to the federal government. Year after year, the federal government amasses "unexpected" surpluses. I use the word "unexpected" cautiously because to be off in your estimates by 400% or 500% per year is quite a remarkable feat. You know what I'm talking about.

A sizable chunk of the unexpected surplus funds is directed to debt servicing. However, one fact remains, namely that taxpayers are taxed far too heavily by Ottawa. Witness outrageous surpluses such as $9.1 billion for the last fiscal year, and most likely $11 billion for the current fiscal year.

This money is being used to pay down the federal debt, a debt that is less costly to carry than the provinces' debts, in light of the preferential interest rate enjoyed by the federal government and the latter's credit rating. I've seen this situation evolve over the past ten years. The focus has been on paying down the debt that costs the least to carry. In the meantime, provincial government debt loads are increasing and the interest rates charged for carrying these debts are higher than those charged to the federal government.

I'm appealing to your experience and your wisdom as Governor of the Bank of Canada. Would it not be more logical to have a balanced system in place where the federal debt would be paid down but where at the same time other priorities would be weighed and a portion of the tax resources would be transferred to the provinces to help them pay down their debts which are the most costly of all to service? In my view, this would be a better way of allocating resources than the current practice.

There's only one taxpayer.

● (1700)

Mr. David Dodge: Welcome back to the committee, Mr. Loubier.

Mr. Yvan Loubier: Thank you, Mr. Dodge. We always have a good time here.

M. David Dodge: As I already said, over the next ten years, the federal and provincial governments should focus primarily on reducing their respective debt-to-GDP ratio with a view to lowering, for the benefit of all taxpayers, the portion of their taxes which in future will need to be allocated to debt servicing. Governments would thus be able to maintain services for an ever-aging population without having to raise taxes.

Mr. Yvan Loubier: We agree on that score.

Mr. David Dodge: This is a critically important measure. However, the provinces and the federal government do not have quite the same taxation powers. For instance, some taxes such as those relating to customs, are a federal responsibility. Natural resources taxation is a provincial area of responsibility. Nevertheless, both levels of government have access to the revenues derived from sales tax and from personal and corporate income taxes.

Consequently, each government has a duty to act to maintain a balance—as I've already said, I prefer a modest surplus—which, down the road, will ease the debt load.

Furthermore, as I stated in response to the first question, to my knowledge, there are now five provinces in total which as of last year, achieved positive results on the revenue side, either in terms of a smaller deficit, or a larger surplus.

Mr. Yvan Loubier: Governor, with Ontario running a deficit and Quebec facing the prospect of also running a deficit for the coming and for the next several fiscal years—a Conference Board study confirms the direction in which the federal and provincial governments' budgets are heading—one has to admit that the prevailing situation in Canada's two largest provinces is rather alarming.

In your opinion, would the federal government not be better off freeing up some tax dollars, given that it is currently running a substantial surplus? We're talking about a surplus in the order of $9.1 billion. In recent years, these "surprise" surpluses have been quite significant. Is there not some way of restoring a balance of sorts so that the most costly debts of all can be reduced?

Generally speaking, we all agree on the need to reduce debt. However, at a time when the federal government is flush with surplus funds, the goal should be to lower the debts that are the most costly to service, that is the debts of Quebec, Ontario and the Maritime provinces, instead of staying the present course.

Earlier, you mentioned that each level of government had the power to levy taxes. Are you suggesting, as Mr. Martin and Mr. Goodale suggested, that Quebec and Ontario should collect more taxes if they want more money? There comes a time when this kind of approach is no longer feasible. In terms of competitiveness, taxpayers have already been pushed to the limit.

Let me say again that ultimately, there is only one taxpayer. The fact is that the government is pressing ahead to back pay back the one debt that cost the least to service with surplus funds from taxpayers. Not enough of these surplus funds are being directed back to the provinces, which are left with costly, ever-increasing debt loads. The federal government has taken over the entire taxation field.

● (1705)

The Chair: Thank you, Mr. Loubier.

Mr. Côté.

Mr. Guy Côté: It's hard for me to fathom that our economy has reached the limits of its capabilities. I can't imagine having to explain this to my constituents who are grappling with a certain number of problems such as the softwood lumber crisis or mad cow disease. Given that we are stretched to the limit, how have these two crises impacted our economy?

Secondly, mention was made earlier of the fact that at present, inflation is not really a major consideration and that there is no inflationary crisis. If that's the case, would it not be in the best interests of the Bank of Canada to review its policies not only to try and rein in inflation, but also to ensure stable and somewhat more vigorous economic growth?

Mr. David Dodge: I'll respond quickly to your first question and then turn the floor over to Mr. Jenkins, who will field the second, extremely important question.

First of all, regardless of the national growth rate or of how well the national economy is doing, there will always be regions or areas of the country and even provinces that are not doing too well, while others are faring much better. Disparities are always greater during periods of adjustment such as the one we're currently going through.

In regions where cattle farming is an important economic activity—I'm well aware of the problem because I own a small farm myself—some real problems have emerged. Unfortunately, that's typical and it explains why provincial or national systems are in place to redistribute wealth and provide financial assistance to parties in need. Over time, different regions or ridings experience problems of this nature.

I will now ask Mr. Jenkins to answer your second question.

Mr. Paul Jenkins: As we indicated this afternoon, the goal of a monetary policy based on low, stable inflation is to enable the economy to operate at virtually peak capacity. In other words, the goal is to sustain a level of economic activity that is near capacity. The 1970s, 1980s and early 1990s were very difficult years, to my mind, because inflation rates were very high and, most significantly, they fluctuated. Monetary policy can help to keep the economy running at near maximum capacity.

Our target rate of inflation is two per cent. This goal would contribute to the global economy which is also very important. It is no longer just a question of the economy operating a near capacity, but a question of sustaining this level of activity in the medium term.

● (1710)

The Chair: Thank you, Mr. Côté.

Mr. McKay.

[*English*]

Hon. John McKay: I want to continue on with the issue of debt reduction. It's pretty well known that over the course of the last seven years—

[*Translation*]

Mr. Yvan Loubier: On a point of order, Mr. Chairman.

The Chair: Can you hold off for two minutes and thirty seconds, Mr. Loubier? There were 10 seconds remaining.

Mr. Yvan Loubier: I have a point of order, Mr. Chairman, to which you are obliged to respond. I have no wish to delay these proceedings with the Governor of the Bank of Canada, but in future, we need to come up with a more equitable system for political parties.

For a while now, all things being equal, many more Liberals have had an opportunity to speak than have opposition party members. That's not normal.

The Chair: After the meeting, we'll do the math to see if what you're saying is true. case.

Mr. Yvan Loubier: After tomorrow's meeting, we'll have to clarify things, because this approach is no longer acceptable to us.

The Chair: It was clearly decided at the last meeting that each party would be allocated five minutes during the round of questions.

Mr. Yvan Loubier: We intend to suggest a far more equitable system than this one.

The Chair: I don't doubt that.

[*English*]

Hon. John McKay: The federal government over the past seven years has paid down about $61 billion worth of debt, and that's resulted in net savings of somewhere in the order of $3 billion to $3.5 billion in interest. The direct happy consequence for you is that you're borrowing money at 3% instead of 6% on short and 5% instead of 9% on long.

But the other indirect consequence is that $61 billion is now back into the economy for Canadians to deal with as they see fit, whether they choose to purchase consumer goods or do housing or borrow money for business and things of that nature.

In my riding we have 130 apartment buildings, two of which probably can be described as luxury. The rest are middle income and sometimes social housing. What is obvious in my riding is that people are moving out of those apartments and moving into housing—affordable housing—because housing has become affordable in the last number of years that the government has run surpluses and debt has been paid down.

I'm wondering whether you have given thought to some of the, how shall we say, non-governmental consequences of this particular fiscal policy on the part of the government that actually puts money back into the economy and allows Canadians to deal with the money as they see fit.

Mr. David Dodge: Yes, it certainly allows us, because there is greater confidence—and I think it is important to point out here that it's not just the federal government that has been reducing debt; the debt of the public sector as a whole has come down. The ratio of public debt to GDP has come down. Or putting it differently, what we've had over the past few years is savings from the government sector as a whole. That enables us to have monetary policy that is a little bit more accommodative because of the good fiscal structure. It means that the risk premium on Canada, whether those are corporate bonds or government bonds, is lower, so it enables us all to enjoy a higher standard of living, because after all, servicing debt is not a government's prime service to its citizens.

What it has meant is that we have been able to have very high rates of residential housing construction, both for rental and for owner-occupancy over the last three years. That high rate of construction has meant that there is now in many cities, although certainly not all, actually downward pressure on rents, and that is very advantageous. That, of course, has been matched by upward pressure on house prices. But looking forward to 2005 and 2006, we think those pressures will abate. With respect to housing construction, while continuing at high levels, we won't see the growth that we've seen before over the past three years. That's why you'll see in the table on page 26 that we do not expect housing to make a contribution to growth overall in 2005 and 2006.

● (1715)

Hon. John McKay: That's a curious comment in light of, if you will, what's driving my local economy. We have vacancy rates in Toronto now of 3%, which is unheard of. I think the real vacancy rate is closer to 5%. My observation is that currently people are simply banging up houses and renovating about as fast as they can, yet you say you don't expect that to continue.

Mr. David Dodge: This is a very important issue, and it goes beyond this. I think it's really important and it is something that is always a bit of a problem understanding. We're not saying that the level of activity will decline over the next two years; it's just not going to grow. But it's going to remain at a very high level. This is really important, this distinction between growth rates and levels. It's important because our outlook for 2005, in terms of the level of economic activity, is exactly the same as it was when we were here last April. The growth rate won't be as high, because we're starting from a higher base, given the stronger growth that took place in 2004. The level of activity will be just the same as we talked about last April. It's not that we have a weaker outlook, it's just that more of the growth occurred this year than we anticipated. This means that to achieve that level next year, we need less growth. This is the same issue in respect to housing. We have a very high level, but it won't continue to grow.

The Chair: Thank you, Mr. Dodge.

Ms. Ambrose.

Ms. Rona Ambrose: Mr. Dodge, if you don't mind, I wanted to pick up where I left off. I'm looking at the chart you pointed to on page 32, "Projection for Core and Total CPI Inflation", relating to developments in the markets for crude oil. As I recall, about a year ago oil was about $31 U.S. a barrel and now it's trading at about $55 U.S. a barrel. This is up about 75%. So based on the assumptions in the paragraph that you've made below the chart, my question to you is, would you agree that the inflation risk has obviously jumped significantly?

Mr. David Dodge: We think the impact on core inflation will be very little, if any. So you'll see in the line for core inflation, if you had last April's report, that it would be almost the same. What's in brackets here is what we had in the update last July. So core inflation has been tracking almost exactly as we anticipated. But it certainly makes a difference to total CPI, and because we use this as a year over year measure, you can get big variations in this, quarter to quarter. You'll see then that actually, in the first half of 2005, we are looking for a total CPI that will be right at the top of our band of 3%. But by the time we get to the first half of 2006, we end below roughly 1.5%. So it really does affect the total, because it affects not only the gasoline and fuel oil and so on, but it affects inner city air fares, trucking charges, and so on. So it does move the total around.

I think what is very important—and this makes the first half of this decade very different from the first half of the 1970s—is that expectations about future inflation are well anchored now, so we're not getting the feed-through that we got back then of the higher oil and natural gas prices into all prices and wages in the economy, because people do expect that over time we will keep inflation well anchored at 2%. That is the real advantage of where we have got to compared to those awful days when I worked for the anti-inflation board and so on, back in the 1970s.

● (1720)

Ms. Rona Ambrose: Just to follow up, though, I know you are suggesting this would be based on a decrease in the second half of 2006 to $43 U.S. a barrel for costs. If oil does remain, based on what you said, in the mid-$50 U.S. territory much longer, what do you think the risk is that we will be surprised by a jump in inflation? More specifically, I'm wondering whether Canadians should expect a further rise in interest rates to pre-empt this kind of inflation based on oil prices.

Mr. David Dodge: That is why we track, for purposes of looking out into the future and thinking about monetary policy. While our target is always to have total inflation come to 2%, for purposes of thinking about what's actually going on in the economy, we watch the core a lot more carefully. As you can see, we think the core line is on track to stabilize at about 2%, even though these oil prices are likely to bounce around. The only thing we know about a forecast is that it's going to be wrong—and those oil prices that we've assumed will never actually come to pass. They will either be higher or lower; we just don't know which.

The Chair: Mr. Bell.

Mr. Don Bell: Mr. Jenkins, when you went through the graphs, I notice you didn't comment on the compensation graph. I was curious about the difference between Canada and the United States in compensation per hour. I notice that as you go into 2004, the Canadian one is coming down and the American one is climbing.

Mr. Paul Jenkins: First of all, the reason for including that is another indication of the labour cost component going into the overall cost structure of the Canadian economy. It's just another way of measuring the fact that prices and costs in Canada over this period—and this is a cumulative chart—were rising at a less rapid rate than in the United States. I wouldn't put a great deal of weight on particular movements in any particular year. Certainly the trend shows relative to the United States that those costs have risen much less rapidly, and they therefore indicate a gain in competitiveness from that perspective. It's a mirror image, if you like, of the CPI number, but looking at it in terms of wage rates as opposed to consumer prices.

I just have one quick comment in response to the earlier question. It comes back to the governor's emphasis on inflation stability and it circles back to Mr. Côté's point that through the seventies and eighties, when we had that high and variable rate of inflation, it led to those years of what we call booms and busts. That's why the stability of the rate of inflation is so critical going forward, because it does anchor expectations and it does provide a much more stable macroeconomic environment overall.

● (1725)

The Chair: Thank you, Mr. Bell.

Mr. Loubier, *deux minutes*.

[*Translation*]

Mr. Yvan Loubier: Governor, I asked you a second question, but you did not have time to respond to it.

You alluded to the taxation powers of the provinces and of the federal government. If the provinces are in a difficult situation and want to help pay down their debt, are you telling them to raise taxes to accomplish this goal, despite federal surpluses and the prevailing fiscal imbalance? Is that what you meant when you said they had the power to levy more taxes to meet their priorities?

Mr. David Dodge: It's up to each provincial government to decide for itself. Every time I meet with the provincial first ministers, I emphasize how very important it is for the future of Canada and each province to maintain some balance in provincial and municipal finances, just as it's important for the federal government to strike a balance as well.

Mr. Yvan Loubier: But Mr. Dodge, are you not offended by such sizeable federal government surpluses at the same time as the two biggest provinces in Canada are grappling with deficits?

Mr. David Dodge: It's not easy because each province finds itself in a somewhat different situation. Alberta, for example, has an enormous surplus. British Columbia, which had a massive deficit two years ago, has now managed to balance its budget.

Mr. Yvan Loubier: Governor, it's almost as if the Prime Minister were talking. I know that you worked for him for years, but I hope the two of you are not one in spirit.

Mr. David Dodge: Have-not provinces like Prince Edward Island have also continued to maintain a balanced approach, despite certain problems. Various factors always come into play. Mention was made of mad cow disease which has hit some regions very hard. In cases like these, it's important to have in place programs that can be qualified as national but which are geared to regions and areas of the country hard hit by a particular disaster such as mad cow disease.

Mr. Yvan Loubier: Would you be in favour of a transfer of tax points from the federal government to the provinces, like the initiative agreed to in 1964 at the Quebec City conference, as a means of balancing out fiscal capacity? The decision made at the time allowed the provinces that so desired to avail themselves of additional tax points.

Mr. David Dodge: Everyone would prefer to pay less tax. As Governor of the Bank of Canada, it is not my place to comment on the balance between taxes and expenditures. However, I must continue to stress the importance of balanced budgets. This goal is important today, but it's even more important to the future of all taxpayers.

● (1730)

[*English*]

The Chair: Thank you, Mr. Dodge.

I just have a quick question. The usual question is, I understand you're predicting 3% growth. What happens if you're off by half a percent either way, let's say, towards the surplus or employment numbers?

Mr. David Dodge: We have a base projection of a little less than 3% for 2005 and a little more than 3% for 2006.

Again, it is always useful to turn to that table on page 26, because you can be off by half a percent, and if all that means is that you have a difference in the inventory swing, that really doesn't have all that much of an immediate impact. It does depend a lot on what actually drives it. So if you look at the line here “Final domestic demand”, that is what is really affected by monetary policy.

When we were here in the spring, we thought, for example, that final domestic demand would be about 2.8%—that is, below something that we would consider healthy. That is why at that point in time we were reducing interest rates, because we thought that over this period the final domestic demand was indeed poised to fall and that by reducing interest rates we could indeed support final domestic demand.

In this event, it has turned out to be a bit stronger, which is good news, but that has not been fully reflected in GDP growth, as you'll see at the very bottom of the table, because some of it has come out of inventories.

So it's not really very easy to answer a question when you're talking about half a percent. If you're talking about 2, the composition at that point doesn't matter so much. That is something that is really quite significant. But with half a percent, I don't think any forecaster feels all that bad in the end if they're off by only half a percent.

The Chair: Mr. Dodge, on behalf of the members, I want to thank you and Mr. Jenkins for paying us a visit. It was enlightening and informative. Have a good day.

The meeting is adjourned.

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