House of Commons
CANADA

Standing Committee on Finance

FINA • NUMBER 117 • 1st SESSION • 38th PARLIAMENT

EVIDENCE

Tuesday, October 25, 2005

Chair

Mr. Massimo Pacetti

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● (1535)

[*English*]

The Chair (Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.)): I call the meeting to order.

Good afternoon everybody.

[*Translation*]

Today we're meeting to hear the testimony of the Governor of the Bank of Canada, Mr. Dodge. Pursuant to Standing Order 108(2), we will proceed to the study of the Report of the Governor of the Bank of Canada on Monetary Policy.

Mr. Dodge, you'll no doubt need a few minutes to make your opening remarks. You have three minutes.

[*English*]

The floor is yours. And then we'll go to the members.

Mr. David Dodge (Governor, Bank of Canada): Thank you, Mr. Chairman, and good afternoon, members of the committee.

Paul and I appreciate the opportunity to meet with you twice a year following the release of our monetary policy reports. These meetings are really helpful to us, and we hope we can keep you, members of Parliament, and through you, Canadians, informed about the bank's views of the economy, the objective of monetary policy, and the actions we take to achieve it.

When we appeared before this committee last April, we said the economy appeared to be operating slightly below its production capability, but that we expected it to move back to full capacity by the second half of 2006. In our October report, which we published last Thursday, we said that economic growth in the first half of this year was somewhat stronger than we'd expected. Indeed, global and Canadian economies have continued to grow at a solid pace, and our economy now appears to be operating at full production capacity.

Past and recent movements in energy prices and in the exchange rate for the Canadian dollar, along with competitive pressures from China and other newly industrialized economies, are giving rise to significant ongoing adjustments in the Canadian economy. Given these adjustments and the slow growth of productivity in recent years, the bank has slightly reduced its estimate of potential growth for 2005 and 2006. We project that the economy will grow in line with this production potential through 2007, with growth averaging somewhere around 2.8% this year, 2.9% next year, and 3% in 2007.

[*Translation*]

With the economy operating at capacity and with higher energy prices, pressures on consumer prices are somewhat stronger than they were at the time of the July monetary policy report update. Assuming energy prices evolve in line with currently prevailing futures prices, CPI inflation is projected to average near three percent through the middle of 2006, before returning to the two percent target in the second half of next year. Core inflation should remain below two percent in coming months, returning to two percent by mid-2006.

The Bank of Canada raised its key policy interest rate to three percent on October 18. In line with our outlook, some further reduction of monetary stimulus will be required to maintain a balance between aggregate supply and demand over the next four to six quarters, and to keep inflation on target. Short-term risks to this projection appear to be balanced. But as we look further out to 2007 and beyond, we see increasing risks that the unwinding of global economic imbalances could involve a period of weak world economic growth.

● (1540)

[*English*]

In light of this, the bank will continue to assess the adjustments and the underlying trends in the Canadian economy as well as the balance of risks as it conducts monetary policy to try to keep inflation on target over the medium term.

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

The Chair: Thank you.

Before I hand the time over to the members, Mr. Jenkins, I was remiss in not welcoming you to the committee. It's like when I go out with my wife; my wife always gets the recognition.

On that note, Mr. Solberg, before I get into further trouble.

Mr. Monte Solberg (Medicine Hat, CPC): I don't know what to say to that.

Thank you very much, Mr. Chairman. I'd like to welcome both the deputy governor and the governor to the committee.

Thank you for your presentation. I want to talk about something that is in the news a lot these days, and that's the issue of productivity. I know you've spoken about this yourself many times. In your monetary policy report you made the point that productivity growth in Canada was zero in 2003, zero in 2004, and only 0.7% so far in 2005. Can you explain why that's a bad thing? Why do we need to do better in terms of productivity growth? Maybe you can also reflect a bit on what we can do as a country to enhance our productivity growth.

Mr. David Dodge: That's a short question but one that has a lot of importance to it.

First of all, let me say that we were a little bit surprised that, over this period, productivity growth has not been somewhat higher. As you know, we think trend productivity in the economy is running somewhere around 1.75%, so that potential over the medium term should be running around 3%, given the growth of the labour force.

First of all, these numbers get revised a lot, so one ought not to be surprised to see some revisions as we go through time. In part, at least some of the reason for the rather poor performance in the last two and a half years has been that the economy has been going through a fair bit of adjustment as relative prices have changed and as the Canadian dollar has appreciated against the U.S. dollar. In periods of adjustment, as we know from past experience, low productivity, low potential enterprise and activity, tends to shrink and disappear faster than we can put in place the new higher-potential enterprise. It's kind of normal for that to happen during periods of adjustment, so it's not surprising that we've had somewhat below-trend productivity growth over this period of the last two and a half years as we've been adjusting.

We think that adjustment still has a little bit more to come, hence you can see from our report that we've marked down productivity a little bit for the next couple of years. Whether that's precisely the right amount is very difficult to estimate, and I certainly wouldn't be held to the nearest tenth of a point as to what it should be.

However, over the longer haul, unless we can get higher productivity growth, which means that in a given hour of work a member of the labour force on average produces more output and in particular produces more value, then the standard of living of Canadians can't rise over the time, of course. So it's absolutely fundamental at all times that we focus on improving productivity. We can't have higher standards of living simply by working harder or adding more hours of work to the work week. The way we really benefit is by getting the productivity up and by thus getting our potential to consume up. That's why it's important over the long haul.

Let me add one final point, if I might, Mr. Chair. I think this is important. When relative prices are changing, as they are at the moment, one has to be very careful with the standard measure of GDP per capita, if you will, in real terms, because the value of some work is increased quite a bit. Indeed, if you look at it in value terms, while our GDP per capita output is only growing by about 2% a year over this period—and that's because of added workers, not because of added productivity—the value of what we produce has grown by about 4%. This is because we have had quite an improvement in our terms of trade over this period, hence the national income of Canadians has actually been rising faster than the national output. That gives rise to all sorts of things, including higher government revenue, higher profits, and so on.

● (1545)

Mr. Monte Solberg: One of the concerns we have is that the economy is roaring along right now at capacity, but we still have 7% unemployment. I guess this really goes to the productivity issue. We're in a situation in which we're now facing inflationary pressures, but we still have a lot of people who are relatively quite poorly off. Isn't this the best possible example of how poor productivity performance hurts the economy?

We're in a situation in which—you've said it yourself—we're going to have to raise interest rates down the road, and that's obviously not conducive to improving people's living standards, but we still have lots of unemployment in this country. Pretty clearly, this is an area that is really coming home to roost in a way that really makes a difference in people's lives.

People may not always understand what productivity is, but they're certainly seeing the effect of not having the economy as productive as it can be now, when we're facing rising interest rates. We're really in a situation that we probably don't want to be in right now.

Mr. David Dodge: There are a lot of components to trying to give a full answer, so I'm afraid we'll be very partial in the answer we give.

First of all, we have had really quite sharply rising employment in the country, and indeed we are at historic highs in terms of the employment-to-population ratio. While we think there is still some room for that ratio to grow and some room for the participation rate to grow, there's probably not very much.

Certainly, as we look out to 2020, for example, it becomes extraordinarily important that we get the productivity up, because the employment-to-population ratio will probably peak at some point between now and then, and then it will actually come down. So unless we can get productivity up, we will not be able to have higher standards of living.

The second thing is that periods of adjustment are always difficult. We do have to release resources from some sectors of the economy to flow into other sectors of the economy, and that is not always a smooth process. In fact, I can't ever remember that it was a smooth process. It's absolutely necessary, but we have to go through it.

During that period, as we're making that transition, there clearly are a number of people who are unemployed because they don't have the particular skills, they're in the wrong location or whatever, to flow in. But they will flow, and it then becomes very important that we have appropriate training programs and so on to help that, but that does take time.

What is key is that the economy be flexible, that all of our markets be flexible in order to make that adjustment. In that regard, let me just conclude by saying that in comparison to the last time, in the 1970s and early 1980s when we had major change in the relative prices of products, or in the late 1990s when we had the opposite change in the relative prices, the adjustment this time, while always painful, does seem to be going better than it did in previous periods.

● (1550)

The Chair: Thank you, Mr. Solberg.

I have Monsieur Loubier, then Mr. MacKay, Ms. Wasylycia-Leis, and Mr. Penson.

[*Translation*]

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

Mr. Dodge, it's always a pleasure to see you here, for years now. That's also the case for Mr. Jenkins.

Mr. Dodge, there's often talk about ferocious competition from the emerging countries, China and India, among others. In the face of this competition, which is growing year after year and is starting to be felt in a number of sectors of the economy, a number of instruments are available to the Bank of Canada to mitigate these shocks somewhat.

When you look at interest rates and the value of the Canadian dollar, which is partly linked to Canadian interest rates, we're entitled to ask ourselves some questions, in view of the fact that we're now facing this ferocious competition in a number of sectors. The talk isn't just about soft sectors, but increasingly about high technology.

For example, hasn't the increase in Canadian interest rates bringing them into line with the U.S. Federal Reserve rate been a bit of a factor in increasing the value of the Canadian dollar, which otherwise would have been a little lower? If so, haven't we somewhat shot ourselves in the foot in the face of competition from the emerging countries, since the high value of the Canadian dollar is currently becoming a barrier, for a number of sectors, to the adjustment that needs to be made with regard to those countries?

Mr. David Dodge: Yes, it was in order to facilitate the investment that has to be made to improve our competitiveness vis-à-vis the Asian and other economies that we allowed a greater than normal easing of monetary stimulus when the economy is operating near capacity. In fact, it's in order to facilitate the adjustment and promote investment.

Currently, short-term interest rates are approximately 70 points lower than U.S. rates. Over 10 years, there's a gap of approximately 40 basis points. So, for more than a year now, our interest rates have been lower than those of the Americans, but not lower than those of the Japanese.

Mr. Yvan Loubier: How big can the gap between Canadian and U.S. rates be without it affecting the economy? Couldn't we go a little further, let the gap widen, have a smaller impact on the value of the Canadian dollar and help the sectors that might be in trouble as a result of the emerging economies? Have we really reached the limits of that gap?

● (1555)

Mr. David Dodge: I'm going to start answering your question, then I'll turn the floor over to Paul.

As you know, a lot of factors naturally influence the exchange rate of the U.S. dollar and other currencies. In January, we published a short side bar in our report illustrating two factors that we have to consider. One is overall demand for our product, and the other is independent currency movements. However, it is always hard to judge to what extent changes in exchange rates are of the former or latter type.

In general — at least right now — we feel that most movements are caused by increased commodities prices.

I'm going to turn the floor over to Paul.

Mr. Paul Jenkins (Senior Deputy Governor, Bank of Canada): I'd like to add two things, Mr. Loubier.

First, as regards the monetary policy framework, a flexible exchange rate plays a very important role. As the Governor mentioned, it is crucially important that we have a flexible economy and flexible markets. The exchange rate plays the role of a shock absorber in order to facilitate the movement of resources from one sector to another.

Mr. Yvan Loubier: That's called a buffer zone.

Mr. Paul Jenkins: I also want to mention that it's true the interest rate has increased slightly, but, if you look at Chart 14 in the report, you'll see that medium- and long-term interest rates have been stable or declining for six months now. So the key factor here is the importance of controlling the inflationary trend, which does a great deal to help markets, such as the mortgage market, for example, as well as maintain stable medium-term interest rates.

Mr. Yvan Loubier: Can we say that the Canadian dollar will continue to appreciate over the next year? Has it achieved its maximum value, or does it risk falling back a little? I know it's hard to answer that question, but, in view of your inflation and interest rate projections, you no doubt have some idea of where we are with regard to changes in the stock market.

Mr. David Dodge: Actually, we never know that. We don't try to make predictions. Our reference scenario assumes that the value of the dollar will stay at between 84¢ and 86¢. There may be upward pressure, particularly if commodities prices continue to increase. Downward pressure is also possible, if crude oil and natural gas prices fall. It's really hard to predict these things.

However, we have said that the exchange rate between the U.S. dollar and other currencies could decline, particularly after 2006, thus contributing to the global adjustment that must be made. In 2005, the value of the Canadian dollar has increased relative to that of the U.S. dollar, more than the other major currencies. That can mainly be explained by the fact that we produce commodities.

● (1600)

The Chair: Thank you, Mr. Loubier.

Mr. McKay.

[*English*]

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

Like my colleagues, I look forward to your presentation on a semi-annual basis, Governor, along with Deputy Governor Jenkins. I always appreciate your contributions.

I wanted to follow up on Mr. Solberg's dialogue with you, which I find to be quite interesting because it is this productivity conundrum that we've been studying and trying to get a handle on. I don't know that we in fact have that much of a handle on it, because there seem to be some contradictory signals. Employment participation rates are up. Canadian income is up. Canadian net worth is up on a per capita basis and on a gross basis. The economic fundamentals of the government are pretty solid. You've got rising standards of living. Yet the productivity seems to remain flatlined.

I read recently about this concept called command GDP, which I didn't frankly understand a great deal, and when you were speaking to Mr. Solberg you were trying to unpack that somewhat with respect to GDP per capita and the value you take out of GDP per capita. I wonder if you could expand on that thought, whether those are the issues we should be looking at, and indeed, I can't disagree with the whole notion of the improvement of productivity as the way out of our demographic challenges. On the other hand, are we measuring the right thing? Are we looking in the wrong places?

Mr. David Dodge: Income and output are indeed two different measures. This so-called command GDP is essentially a measure of what we produce times the change in terms of trade, i.e., the price of what we produce versus the price of what we import, what we export versus what we import. That is really determinant of our national income. Obviously, if we get $60 a barrel for oil rather than $30 and we're a big net exporter of oil, and we pay $100 for a suit instead of $125 and we're big importers of suits, then we have to give up fewer barrels of oil to get a suit than we used to, and hence, in income terms, we are richer. Now those changes won't go on forever, but they certainly have worked in our favour since the beginning of roughly 2003, and there's been quite an improvement in our terms of trade.

It's very different from the situation between 1997 and 1999, for example, after the Asian crisis, when we had a big fall in the prices of a number of the commodities we produce. We had excess supply, and indeed our terms of trade fell, so that even though our productivity was improving over that period, we didn't have extra national income. The change in relative prices was hurting our national income. If you're looking at how rich we are, you've got to look at both productivity and what's happening to terms of trade. That's point one.

Point two, if we take an industry—let's take the oil industry for a moment. We've had the price go up from, say, $30 a barrel to $60 a barrel, and that makes it worthwhile to produce extra barrels of oil. But in order to do that, in fact, we're having to use lower-grade deposits, we're having to use secondary and tertiary recovery, we're having to exploit the oil sands, all of which requires more man hours of work per barrel of oil we get out of the ground. Now it's still, in value terms, really worthwhile doing it, because while we might have spent one man hour of work to get a barrel of oil, we now have to, say, spend 1.1, but the value of that production has gone from $30 to $60. So in physical productivity terms, productivity in the oil patch actually goes down, but value added per worker goes up a lot.

I've just taken this example, but we could take a number of others within manufacturing industries, within service industries, and so on. The really important point is that we're always trying to move resources to those areas where the value added per worker is highest.

Within any given industry, what you always want to do is try to augment the amount of output you get from an hour's worth of work at a given technology. That is the productivity as we conventionally measure it. And over a long period of time that's what is going to give us the real increases in output per worker and hence our ability to maintain our living standard.

But it is a little complicated when you try to work through the particular measures. I don't know whether I've helped you or hindered you by some of these files.

● (1605)

Hon. John McKay: No, that's actually quite helpful, because you have the ironic effect of having value increases and productivity decreases on a barrel of oil, to use your example. And since we are so dependent for our prosperity on those kinds of things, like barrels of oil, exporting commodities, that may go some way towards the explanation of flat-line productivity, which leads me to question whether we should live and die on our productivity measurements. Certainly long term we do, but short term, I'm not quite sure what could or should be done.

Mr. David Dodge: I think it's absolutely clear that long term we die if we don't have more productivity. That is absolutely clear.

Let me just say a couple of words about things that have been worrying us. Obviously, since we're the Bank of Canada, one of the sectors we watch closely and worry a lot about is the financial services sector, which is a rather large sector of the economy. It employs I think about 12% or 13% of Canadians in some way or another, in finance, insurance, real estate—in one of the components. This sector is one that has done surprisingly badly over a period of time in Canada, not only relative to other Canadian sectors, but most importantly, relative to how that sector has performed in other economies. And that isn't due to turns in trade shifts or any of that. The performance has not been as good as it should be.

So right at the moment we are actually engaged in some work to try to understand a little bit better why that is. But it's very difficult, and you have to go really sector by sector and try to dig through to understand what it is that is going on. Sometimes you find out that it's a change in composition of output within the sector, so it's really a statistical figment. Sometimes you find that it's rules, regulations, and other policies that are holding the sector back. Other times, and very often, what we find is that firms in that sector have not been as quick to adopt new technology that is productivity enhancing.

So you really do have to go at this piece by piece. This is one particular sector we're working on, and other people are working on other sectors where they have knowledge.

The Chair: Thank you, Mr. McKay.

Ms. Wasylycia-Leis.

Ms. Judy Wasylycia-Leis (Winnipeg North, NDP): Thank you, Mr. Chairperson.

Thank you, David Dodge and Paul Jenkins, for again appearing before us.

I've only got a little time, so I'm going to get right to the point. I'm actually very worried about your decision to raise the bank rate again. I guess I'm not satisfied with the analysis behind it. It seems to me that it's hard to accept the argument that the economy is running at capacity when in fact there are 1,175,000 Canadians who want to work and are looking for work. It's hard to say it's running at capacity when you've got so many people in low-skilled jobs who are trying to get out of them into meaningful work. It's hard to accept that we're running at capacity when in fact the private sector has only created 28% of all the jobs in the last year. So that's one problem I've got.

The second is, it's hard to accept that we've got an inflationary problem. If we're looking at an inflation rate of roughly 1.6% without energy costs, and going up to about 3.4% with energy costs, it is still within a reasonable level that should not warrant any kind of overreaction.

So I worry about the analysis and I question the remedies. In fact, it seems to me that we could actually create more problems than you think you're trying to help or solve. We've heard from manufacturers who are very worried about this decision when in fact they've just been hit with rising fuel costs and the higher dollar and who believe this is just going to kill more jobs. We've already lost 200,000 manufacturing jobs since the dollar started to rise in 2002; we could lose a lot more because of this interest rate hike. I think many have raised the issue of the Dutch disease, which is a real possibility here, of allowing manufacturers to suffer in a period of an oil boom.

The second concern I've got has to do with individual home-owners, who have really been involved in a house-buying spree, and that's been good in many parts of our country. They're using their life savings to buy housing because mortgage rates are low, which has helped in many communities, especially in Winnipeg, which has had a pretty stagnant housing market for a long time. I don't think they're able to handle the inevitable change in mortgage rates that will happen as a result of the increase in the Bank of Canada rate. So I worry about that.

I'm now reading from an article in the *Winnipeg Free Press*, which says that Canadians, so far, have been keeping up with the rising mortgage debt load. Only 0.25% of mortgages are in arrears compared with 0.5% during the 1990s, but many households are in fact operating on very narrow margins and don't have much room for manoeuvre; even a modest increase in interest rates will hurt, especially given the fact that 30% of homeowners have variable rate mortgages.

So I have two big concerns.

I guess my question to you is, why do we act so quickly in a way that may actually cool off the economy at a very critical transition phase, punish manufacturers that are trying to compete in this additional fuel cost economy, and hurt individual homeowners who are just now trying to get into the home ownership world, or to update their housing, and who may lose everything if this continues?

● (1610)

Mr. David Dodge: Perhaps, Mr. Chairman, I can take the first part and turn to Paul for the housing question.

First of all, you asked why we've moved now when we have core inflation below 2% and whether we aren't jumping the gun a little bit. This is always the judgment issue, because what we're doing is looking forward roughly 18 months to two years. We're looking forward because our policies don't have much impact immediately on inflation, but only have an impact over a period of time.

We have been running a monetary policy with a lot of ease: we have a high degree of liquidity out there, and we have interest rates across the board—not just short-term rates—that have been at historic lows now for a couple of years.

We've been very cautious about removing that degree of monetary stimulus while we're going through this adjustment period, and we're still very cautious. A number of observers would say that we have been too cautious.

But as we look out over this period, assuming that the world unfolds roughly as the IMF projects, roughly as we've shown here, the upward risks on inflation, were we to leave in place the very high degree of monetary stimulus that we have had up until recently, would be much greater. So it's the looking forward that is the reason we're moving.

Now, it is absolutely true that we still have over a million people unemployed, and it is undoubtedly going to be the case that we will have some further reduction of employment in some parts of the manufacturing sector—in part because of competition from China, in part because there are just more productive uses that these folks can be put to, and in part because relative prices have changed a lot. So in some industries, such as pulp and paper, we would certainly expect the contraction of both employment and capacity; we simply have overcapacity, not just in Canada but worldwide.

So we think there will be some further employment losses in manufacturing, but we think the economy as a whole—as a whole—will in fact be generating jobs and indeed that we are likely to remain or exceed the current historic levels of employment to population.

Let me pass it to Paul on housing, because we look at this carefully.

● (1615)

Mr. Paul Jenkins: Absolutely, Governor. We're very sensitive to the concerns you've raised in terms of the exposure of the household sector and their debt levels. The first point I would make comes back to my observation to Mr. Loubier, and it ties in a bit to the governor's comment about the need to be forward looking in setting monetary policy and the absolute importance of anchoring inflation expectations at that 2%. The more successful we are in doing that, the lower and more stable you're going to find medium- and longer-term interest rates, including mortgage rates. Again, referring to chart 14 in our report, although interest rates at the short end have gone up, you actually see these medium- and longer-term interest rates either flat or having come down a bit over the last six months.

That element of needing to provide certainty and stability for investors and borrowers is important. Therefore, it is important to look out over the yield curve in terms of what we're doing at the short end and how it's influencing these longer-term interest rates. So that would be the first point.

Again, being very sensitive to the issue you've raised, the other point is we do sensitivity analysis around the household sector balance sheet in terms of movements in interest rates. We've done work, we've published this work, and we'd be glad to send it to you. We looked at what the implication would be if short-term interest rates were to move up, let's say by a hundred or two hundred basis points. What you find is since the debt service ratio was so low because of the low interest rates, and if you keep the stability of low interest rates through a well-anchored monetary policy, you would see that service ratio moving up, but very little, and certainly remaining well below the levels it got to in the late 1980s and early 1990s.

So the importance of anchoring inflation expectations—keeping inflation well under control—does play out quite importantly in terms of providing some stability to the household sector balance sheet. But again, we do look very carefully at the issues you have raised.

● (1620)

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

Mr. Penson, and then I have Mr. Holland.

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

It's always a pleasure, Mr. Dodge, Mr. Jenkins, to have you here and to have this kind of discussion.

I do hope I get a chance to ask you a question about productivity. But before I get to that, I want to pick up on issues that have been raised by my colleagues, Mr. Solberg and Ms. Wasylycia-Leis, and that's the labour market.

Mr. Dodge, you did say when you talked about barriers to labour market adjustment and the importance of having those flexible markets—well, I can attest to that. Out in Alberta we have an industry that's crying for people to work—not just in the oil industry but in all the service industries. There are signs up on every business looking for help at good wages, and yet we still have a 5% or 6% unemployment rate in our own backyard.

So the question I have for you in that regard is, do you think Canada's EI system, in the way it's currently structured, is one of those barriers to the labour market adjustments you were talking about?

Mr. David Dodge: I've talked about this extensively over my career, and going back 25 years I wrote a report on it. Unemployment insurance is both a help and a hindrance to flexibility. It's a big help in the sense that workers, who have worked away for quite a while, get laid off, and have to make an adjustment, need to have income support while they're making that adjustment. Otherwise, they have to resist change because they'll be without any sort of support while they make adjustment. In that sense, unemployment insurance plays a very important role in actually facilitating adjustment.

On the other hand, it can be very damaging if in fact it's used to hold people in industries where they only work short periods of time during the year and then stay on unemployment insurance for the rest of the year.

So unemployment insurance per se is actually quite a facilitator of adjustment and very important. The structure we have had, and may continue to have, may not be ideal in getting all the positives without.... There is some moral hazard always in any insurance, so without getting that....

Mr. Charlie Penson: The concern I have, as I said, is that people are still coming into my office wanting to get insurance benefits when there are jobs out there at every place—you can't walk around the corner without finding a job opportunity, and it just amazes me that these people can't seem to find jobs.

I want to talk about the productivity issue. You've identified it. I think you're also sort of sounding the alarm bells. At least that's what I took out of your being involved in this. The problem is that it is a concept to the average Canadian. People think, "What's going on here? We're working harder than ever. Don't tell us we're not working as hard as people in the United States." Somehow they're getting the wrong impression. But it equates to living standards, as you just said.

It seems to me that we have a bit of a ticking time bomb here. The gap between us and the United States is now growing. Three years ago it was $6,000 per capita. Now it's $9,000. The gap between us and Sweden is $20,000 per capita, and the concern I have, and I'm just wondering if you share it, is this gap growing the way it has been. If it was always that way, that would be one thing, but the gap seems to be growing. At one point, 25 or 30 years ago, Canada and the United States had roughly the same productivity.

The fact that Canadians could be making $3,000 a month more on their mortgage payments if they had the same productivity levels they have in the United States...that says something to me. I'm just wondering how big a concern that is. What's the urgency here, I guess, in trying to correct this and get us back in line with some of our major competitors?

Mr. David Dodge: First, let me just go back and caution you about using those figures too easily. It goes back to the earlier question. It does depend on the value of the output you produce, so the fact that we've actually been producing more things that have higher value actually adds to our income. So you can't go directly from output per hour, or GDP per hour, to income of Canadians.

Income can grow without GDP per hour growing, and conversely, GDP per hour can grow quite a lot without incomes growing. We've had two experiences: the last three years on the good side, the three years from 1997 on the bad side.

● (1625)

Mr. Charlie Penson: What about the trend, the divergence?

Mr. David Dodge: The trend is a different issue. And it is worrying that over a period really since the late 1980s, early 1990s—of over a decade—that in fact the trend productivity growth in Canada has not been as rapid as it has been in the United States. We do have to remember that the United States has not been the king of productivity growth over that period either. We have countries such as Ireland that have done very much better than the Americans have done over that period.

So yes, it is a very real issue. I don't think it's a simple issue and there's some silver bullet that deals with it. Productivity really is what happens on the shop floor. It's a workplace issue, to start with. It's about the rate at which new technology is adopted.

Mr. Charlie Penson: Mr. Dodge, I'm sorry to interrupt you, but isn't it also an issue of investment for machinery and equipment?

Mr. David Dodge: Yes, that's exactly it. It's the rate at which new technology is adopted. One of the key drivers of that is investment, i. e., you're bringing in the newest machinery and equipment, and Canadian investment in machinery and equipment has in fact lagged over that period. And one of the reasons, we think, that we may have had somewhat less productivity growth in the finance, insurance, and real estate sectors is that we haven't made quite the investment in computer software and putting in new systems that the Americans have, who have seen really rather rapid growth in service sector productivity.

So there's that set of reasons. There's another set of reasons that may be there, and that is the precise industries we have. There has been some good analysis done out of the University of Toronto that would indicate that probably that has not been the long-term reason for the difference here. But there are a lot of things that go into this, and as I said earlier, you really have to go sector by sector and look at exactly what's going on.

Mr. Charlie Penson: We're just talking averages here. Individual sectors may be doing a lot better than others, of course.

Mr. David Dodge: Some are, but some of our big sectors are not doing as well.

The Chair: Thank you, Mr. Penson.

Mr. Holland.

Mr. Mark Holland (Ajax—Pickering, Lib.): Thank you very much.

And thank you to Mr. Dodge and Mr. Jenkins for appearing before us today.

First I have an observation before I get into some questions and eventually move to the issue of productivity as well. The first observation—just for the benefit of the committee—is that looking, as you have, to 2007 and beyond, the significant risk of weakening global economic performance and its implications upon Canada obviously will also have implications upon our own fiscal policy and the need for us to have additional elements of prudence when we're making considerations of program expenditure.

My first question, though, has to do with the situation just to the south of us, with the ever-growing deficit and debt problem the United States is facing and its implications upon growth in Canada on a go-forward basis. I wonder if you have any thoughts you could give the committee on that particular issue and on the potential impact upon U.S. productivity and in turn our productivity going forward.

Mr. David Dodge: Let me start, and then I'll pass it to Paul.

First of all, I think it's very important to think of things in global terms. As I've said other places, I think we should all thank God for U.S. profligacy over these past few years, when the rest of the world, in particular Asia and more recently the oil-producing nations, have seemed hell-bent on saving. Without that American demand, the global economy would not have grown as rapidly as it has, and we wouldn't have grown as rapidly as we have.

That having been said, we all know that the adjustment has to come at some point in the United States. It doesn't have to come tomorrow or even next year, but it's got to come. What we hope, and what is in our scenario here, is that they will begin to make adjustments to increase their national savings, both government and household, at the same time as the rest of the world will take steps to increase their domestic absorption. Hence global growth and demand for our exports can continue to grow.

We know the Americans have to make corrections. What we are worried about, and this is the downside risk, is that they will have a correction, in particular on the household side, that may be unexpected or unanticipated and the rest of the world won't pick up the slack. Hence we will have slow global growth, and that will reflect badly on us.

To tie that to productivity is a little bit more difficult, so I'm going to pass that one to Paul.

● (1630)

Mr. Paul Jenkins: First of all, just to lay out our scenario for the United States, we do see continued, I would say, solid growth in the United States. Embedded in that is a view that actions will be taken in the United States to raise their levels of savings. You can think about that either in terms of savings at the public sector level or at the national level.

You noted the fiscal deficit and the debt levels on that side. Of course, the United States is also running a large current account deficit, and that gets very much into the global issues the governor is talking about. I think there is a general view amongst analysts—a view that we share—that U.S. savings rates do need to rise and that current levels of savings and accumulation of debt at these rates are unsustainable. That's why when you think about it from a global perspective, if higher savings have the flip side in the U.S. of lower consumption, you'd like to see some of that world consumption being picked up elsewhere in the world economy.

Bringing it back to productivity, I think the key point here is getting the United States economy back on a sustainable path in terms of deficit and debt levels. In turn, that facilitates investment in productivity-enhancing areas. You're using what savings you have to go into investment as opposed to consumption, and that in turn would help sustain productivity growth in the United States.

These sorts of questions are always difficult from a counter-factual point of view, as I call it. The United States could take action on the fiscal side, but of course not all else would be equal. It could result in action by the Federal Reserve, and we hope we would get policy actions elsewhere in the world as well.

So the scenario we've laid out is one where we are assuming that these policy adjustments do in fact take place and that you continue to see productivity growth in the United States as well as a pick-up here.

Mr. Mark Holland: Thank you.

I raise that only because it has been mentioned a lot and is something I have a concern about. Obviously, given the size of our trading relationship and its dynamic, I think it's important that we understand its implications on us.

I want to come back to productivity for a moment, and recognize that we have before us some difficult decisions to make. We have a lot of people coming in front of us and giving us recommendations about what direction we go to address the relatively soft growth in our productivity levels.

I recognize that it's always dangerous to venture into fiscal policy —one only needs to ask Alan Greenspan when he endorsed tax cuts —but I wonder if we could get some observations from you, Mr. Dodge and Mr. Jenkins, on where you think Canada should be focusing most to increase productivity. What actions do you feel the federal government should be taking in that regard?

● (1635)

Mr. David Dodge: As I said earlier, there is no magic bullet and there is no one set of policies or a single policy that will do the trick, and productivity increases come at the workplace. They come piece by piece, firm by firm, sector by sector.

What we do know is that there are some general principles that ought to guide policy, without getting too specific. First of all, policies to enhance flexibility and to allow adjustment from low-productivity activities to higher-productivity activities are very important.

On the labour side, that means continuing to focus on having training available to workers who move between firms, but, equally importantly, that firms concentrate on the continuous upgrading of the skills of their own staff. Without the skills to move to higher-productivity occupations or higher-productivity activities, we're just not going to get there, so skill quality is really very important.

Second, we know new technology comes with higher levels of investment. The way you get new technology is by making new investments in machinery, equipment, software, and so on. Policies that generally encourage investment are indeed appropriate in this circumstance.

Third, we know public infrastructure, whether it be transport, whether it be communications, or whatever, is very important. To the extent that we can produce products but can't get them out to market, we are in trouble. To the extent that we have workers who are available twenty or thirty miles away but we don't have appropriate public transport to get them to the place where they want to work, it's not very helpful. To the extent that we have long tie-ups at the border to get goods flowing back and forth to and from the United States, that's not very helpful. To the extent that we have restrictions on the flow of skills across borders, that's not very helpful.

So we do know there are a number of things. We also know that innovation, as opposed to just straight investment, is really quite important. Innovation comes in a number of ways, but in part it's a mindset that you always need to be struggling to find new ways to do things, to invest in the development of new products, and so on. We need to encourage that through providing the public component.

On the tax side, it's inappropriate for me to get into details, but there are some very simple principles that are important. We should try to have a broad base for our tax system, and low tax rates. Low tax rates, statutory rates, are important not just because they facilitate appropriate action on the part of individuals and firms, but because —if we think of the corporate side of things—a low statutory rate that is lower than your competitor's statutory rate means income actually gets declared in Canada and we can tax it rather than somebody else doing so.

So there are a number of these things, but I would emphasize that there is no magic bullet and there is no substitute for entrepreneurial and innovative spirit at the level of the individual enterprise.

The Chair: Thank you, Mr. Holland.

Ms. Ambrose.

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

Welcome, Mr. Dodge and Mr. Jenkins, to the committee.

I want to pick up on what my colleagues Mr. Holland and Mr. Penson were speaking about, as well as what you just spoke about, and that was investment and the connection between taxes and innovation and productivity, but specifically corporate taxes.

As you know, this has been something we've been debating. In the original budget last year, there were corporate tax cuts, but those were subsequently removed with the NDP budget. I want to ask you a direct question. Do you see the loss of these tax cuts affecting productivity?

● (1640)

Mr. David Dodge: I don't think we could ever do analyses that would be good enough to ascertain an answer to that question. Just from an analytical point of view, I don't know how we would do it.

Ms. Rona Ambrose: I'll ask it in another way: Do you recommend that these kinds of tax cuts...? You talked about the need for lower taxes and the connection with innovation. You talked about investment. We're looking here at additional spending and investment in machinery and equipment with lower corporate taxes. Do you recommend or do you see that it would be a positive thing for us to reintroduce these kinds of tax cuts?

Mr. David Dodge: As I've said before, analyses across time and across countries will show that the most efficient tax system is one that has generally low rates and a broad base. That's not to make any comment at all on the appropriate level of revenue that is raised, but that it is the appropriate structure. That's number one.

Number two, with respect to corporate taxes, again the one thing we know, and this is not to cast any aspersion on our tax collection agency, is that if we want corporate revenue to be declared in this country and for there be an incentive to declare corporate revenue here in Canada, we get that incentive by having a corporate tax rate that is a bit lower—that's a combined federal and provincial corporate tax rate—than the state and federal rate in the United States. That is actually how we maximize our revenue.

Ms. Rona Ambrose: That was the other thing I wanted to ask you about in terms of what you were discussing. On the notion of foreign direct investment, it seems to me that you're suggesting that our corporate tax rates right now are a barrier for capital mobility.

Mr. David Dodge: No, I'm not sure that is absolutely the case at all. The attractiveness of an investment depends on a lot of things. The rate of tax on future income is only one of the factors. It is a factor, but it is only one of the factors. I think one has to look, broadly speaking, at the climate for investment here in Canada, both for our own firms and for foreign firms.

Ms. Rona Ambrose: I just had one more question on EI. I agree with you, and I think many economists do, that it's both a barrier and a facilitator. There's good and there's bad. From what I understand, you obviously have a great deal of knowledge on the issue. On balance, do you see it as a barrier or a facilitator?

Mr. David Dodge: In some cases, it's much more a barrier than a facilitator, but in other cases it's clearly a facilitator rather than a barrier. I think one can point to particularities in the system that tend to be greater barriers than facilitators, and one can point to things that are facilitators as opposed to barriers.

Ms. Rona Ambrose: I know there's the agreement on internal trade and other issues around labour mobility, but specifically on labour mobility, do you see the present system as a barrier or a facilitator, on balance?

Mr. David Dodge: Again, it's very hard to make that on balance. It depends on where the disequilibria are. Generally speaking, if we take reasonably skilled workers, then it actually tends to be a facilitator because it provides the opportunity for those workers to have income support while they move physically or upgrade their skills to move to a new job.

But let's be very clear. In some cases, it will not be helpful to mobility. Those cases tend to be the very difficult ones. And we do face difficult issues. I mentioned the paper industry earlier. It tends to have mills in scattered places, and the cost of mobility for workers in those mills may be very high because the towns are essentially shutting down. That's a very difficult situation, regardless of the employment insurance program.

● (1645)

Ms. Rona Ambrose: Do I have more time?

The Chair: Yes, one more minute.

Ms. Rona Ambrose: This is another direct question about taxes.

I just want to know your opinion on this, and again, this is back to the connection between taxes and productivity and innovation. Do you think personal income tax rates and levels have anything whatsoever to do with innovation and productivity?

Mr. David Dodge: It's very hard to answer generally. One can look across the world and find fairly high-innovation countries with high rates of tax, and one can find high-innovation countries with very low rates of tax. So in some sense it's harder to give a general answer to that than it is on the corporate tax side, because you're not really ever comparing apples to apples.

Ms. Rona Ambrose: I was thinking of the example of Sweden. My understanding is they have very high productivity. They also have low corporate tax rates, but high income tax rates. So I wondered if you could maybe...but I see what you're saying.

Mr. David Dodge: Sweden is an example of a country with high personal tax rates that is very innovative. Denmark is another example. On the other hand, if you look at the Irish, the Irish have done it with pretty low personal tax rates. I don't think one can generalize terribly easily, because there are so many other variables other than just tax rates.

Ms. Rona Ambrose: I'll ask you one more tax question, just to add another variable to the equation.

Could you comment on payroll taxes, their effect on productivity and job growth?

Mr. David Dodge: Again, it depends on level. Clearly, for countries with very high payroll taxes—and here I'm thinking more of the continental European countries—they have not been very helpful at all in encouraging employment. In fact, they've been rather unhelpful in encouraging employment. Whether one reads the OECD, whether one looks at the IMF analysis, whether one goes to all the meetings that we go to, it's quite clear that at that level, and given the degree of immobility that they impose, it is an extraordinarily high level.

If we look at Canada, we are actually a relatively low payroll-tax country. We have not relied excessively at all on payroll taxes to finance those benefits. So I think it would be very hard in the Canadian case, since we sort of sit in the lower middle band of countries with respect to payroll taxes, to say that they have either been encouraging or discouraging of productivity growth.

The Chair: Thank you, Ms. Ambrose.

Monsieur Côté, then Madame Boivin.

[*Translation*]

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

Thank you for being here, Mr. Dodge and Mr. Jenkins. Roughly a year ago, you mentioned that inflation was a major concern for the Bank of Canada. In view of the fact that we were approaching the upper limit of your range of one to three percent, I asked you at the time whether the Bank of Canada intended to revise it.

Today, roughly one year later, we've witnessed a one-point increase in interest rates. We're now at the upper limit of that range. Today, I'll ask you the same question, that is whether the one to three percent range is still valid? If so, why? If not, do you intend to revise it?

Another question that I asked you last year concerned the strength of the Canadian dollar relative to the U.S. dollar. At that time, you mentioned that it was a major concern for the Bank of Canada. You'll understand that, if a strong Canadian dollar can have certain benefits for exports and the competitiveness of our businesses in the international market, it can also have certain consequences that make our businesses less productive. Here I'm making a connection with the theme before us today.

So, one year later, the Canadian dollar is still at a very high level. What's happened in the past year at the Bank of Montreal? Is it time to revise the range?

● (1650)

Mr. David Dodge: I didn't understand the last question.

Mr. Guy Côté: Do you intend to revise the one to three percent range? Is that still your objective?

Mr. David Dodge: I'm going to start, and then I'll turn the floor over to Paul.

As you know, next year, we have to renew our inflation agreement with the federal government. So we're currently conducting research at the Bank on all aspects of our agreement with the government. For the moment, it's too early to say. It's important to bear in mind that both of us are party to that agreement. So it's not just up to us to make a decision.

We've done some research and we're conducting more. We've had a few conferences here. Everyone was very interested in this issue. I'm sure we'll be ready for our discussions with the government in 2006.

Perhaps I can ask Paul Jenkins to say a few words on the subject of our research.

Mr. Paul Jenkins: As you mentioned, Mr. Côté, we have a range of one to three percent for the overall CPI growth rate.

I want to emphasize that monetary policy will continue to be based on maintaining an inflation rate of two percent. As I mentioned this afternoon, it is crucially important to have agreements for an inflation rate based on our target of two percent.

In the context of our monetary policy implementation framework, the inflation rate is the object, not the dollar. We have a framework with a flexible exchange rate. At the same time, it's still very important to analyze the reasons for the dollar's movements. That's why, in the January report update, we presented our analysis concerning the two types of movements in the dollar, type 1 and type 2, and the size of the impact of the various types of dollar movements on the economy.

So in response to your question, I would say that, yes, it's still two percent. However, it's important to analyze dollar movements in the context of that framework.

The Chair: Thank you, Mr. Côté.

Ms. Boivin.

Ms. Françoise Boivin (Gatineau, Lib.): Thank you, Mr. Chairman.

I'm attending my first meetings of the Standing Committee on Finance. I'm finally getting a chance to hear what you have to say. In previous years, I followed this somewhat like all Canadians, who listen to us and who must at times wonder what language is being used because it's very technical.

I was pleased to hear the Prime Minister speak, in the context of his speech to senior officials, about an issue of concern to me, demographic change. Many people tell us that we are an aging population. This isn't simply a phenomenon that's being felt here in Canada, but one that will affect the entire economic world, both inside and outside Canada.

I'm curious to learn your opinion on the subject. What effect will this demographic change have on our economic growth and on the monetary policy of the Bank of Canada? Perhaps you could talk to us about that.

As well, if any time is left, I'd like to ask you this question. In your report summary, you say in the highlights section that the Canadian economy appears to be operating at full capacity.

Since I'm a very optimistic person who never believes that we can reach the limits of our capacity, I'd like you to explain to me why we're operating at full capacity.

● (1655)

Mr. David Dodge: I'll answer the first question, then turn the floor over to Paul Jenkins so that he can answer the second.

The aging of the population will result in a decline in our growth rate, in our future potential, as a result of a reduction of the labour force. That will start around the end of the next decade.

Currently, we feel that the labour force is probably growing at a rate of 1.2 or 1.3 percent per year. In the middle of the next decade, that figure may be 0.2 or 0.3 percent. In the early 2020s, the figure will probably be negative, but perhaps not. That will depend on the retirement age and all kinds of other factors. But it will probably be in that range.

So to maintain potential at a higher level, it's extremely important that our productivity increase in the future, hence our emphasis on productivity.

As for monetary policy, our purpose is to ensure that the economy always grows to its full potential. Inflation will therefore remain at two percent. That's our goal. If we manage to maintain greater productivity, our potential will continue to increase; otherwise, there will eventually be a problem in keeping a growing economy. So that's extremely important.

How to facilitate this increasing productivity? That's another issue. Lately, the aging of the population has had significant impact on financial markets, since not only pension funds, but overall ability to save are becoming extremely important in economic terms. This also has serious effects for governments, both federal and provincial, because of future pressure on spending. We must prepare for that situation.

Whatever the case may be, I'll turn the floor over to Paul Jenkins, so that he can answer your second question.

● (1700)

Mr. Paul Jenkins: It's an excellent question.

First, as you mentioned, one of the facts stated in our report is that the Canadian economy appears to be operating at full capacity. That's a judgment of the board of directors of the Bank of Canada.

The ability to operate is a very important measure because, if the economy is operating at a level higher than its potential, there will be upward pressure on the inflation rate. Conversely, if the economic is at a level below potential, there will be downward pressure on the inflation rate. So it's a very important measure.

At the same time, there are a lot of judgments about the world economy, and the global situation is the most important factor with regard to monetary policy. In addition, we analyze a number of indicators, and we present the various indicators in the report. This is a judgment that, upon analysis of all the indicators, represents the decision of the board of directors. For example, the bank conducts a survey of business prospects. Every quarter, we talk to businesses in all provinces about pressures on their production capacity. That's one of the indicators; there are others, which are the subject of Statistics Canada publications.

Ms. Françoise Boivin: When you say that the Canadian economy appears to be operating at full capacity, does that mean that, as we speak, and when you do the verification, we can't do anything about it?

Mr. Paul Jenkins: In fact, it's a judgment that is a factor that we take into account in our decision on monetary policy. As the Governor mentioned, what is crucial is future inflation. So if the economy is near capacity right now, there's a risk that the growth rate will be stronger and therefore that there will be an increase in the inflation rate.

Ms. Françoise Boivin: Do I have a little time left? Since there are no Conservatives here, perhaps I could take their time.

The Chair: No, I'm sorry.

Ms. Minna.

[*English*]

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

I'm going to take you to something a little bit different from the standard discussion we've been having. I'm glad to hear your comment with respect to the fact that the payroll tax in Canada is relatively lower than what a lot of people think. There are always arguments about how it's so high.

There's a great deal of discussion on taxes, and there's one side that seems to suggest taxes are the only solution to the productivity issue. I'm not suggesting that there isn't any benefit to that, but there's the other side, of course, which deals with, in my view, the human capital—education skills, early education, a skilled labour force—and interprovincial barriers, I imagine, also have some effect on that.

I wanted to take you to something else that may be a bit unusual, but it came up earlier on another panel when we were discussing women's issues a bit more. I wonder if the bank has done any analysis at all as to the impact on productivity as a result of not having gender-based analysis on women or not having the proper maximization of the participation of women in the labour force, in terms of various tax situations, part-time work, the inability to do certain things, and the way policy affects them.

Mr. David Dodge: I don't think we've done any recent work.

Mr. Paul Jenkins: We certainly look at participation rates by gender and by age to understand what is happening to the aggregate participation rates. So for example when we look at the participation rate of adult women, we would look at the trends in that, and that would be one factor that would feed into our views of what the aggregate participation rate would be. But it's at that level; it's not at a more micro level, if you like. But that is one area where we do factor in what is happening to the trends, both by gender and by age.

● (1705)

Hon. Maria Minna: It would be helpful if there were some study done by the bank, maybe together with the Department of Finance, that would deal with the fact that we do not have a proper gender-based analysis of our policies in this country. I suspect it would impact the extent to which policy impacts on women in the labour force, and I think it does affect the productivity level. I don't have data; I don't have a study that's been done. But I think I would like to see something like that done. I would think it would be actually beneficial to this country to see where, because we know that things that affect productivity.... We're looking at things like good infrastructure, producing good roads and everything related to that, and the labour force, labour skills, and I could go on. The list is long. I think we've discussed a lot of these before.

I think that is a sort of invisible area that tends not to be addressed, and I'm wondering whether you would be interested in actually tackling something like that, Mr. Dodge.

Mr. David Dodge: Basically, as Paul said, we do the analysis at the macro level. We do watch very carefully, and we do comparisons with other countries. I guess one of the key things we've been working on recently is looking at the participation of older workers, what the trends are there, for males and females.

Hon. Maria Minna: I understand what you do. I'm talking about, for instance, women in the EI not being able to take advantage of the whole of it. That is, women in terms of utilizing, maximizing the potential of women in the labour force, given some of the negative impacts that some policies have on them in terms of poverty levels, housing, skills, education levels, what have you, and what that does.

I know we're trying to get the government to do a gender-based analysis on our policies and certainly our budget, but as we talk about productivity, I think that is a big chunk that maybe we're leaving out. That needs to be looked at, as well as all of the other pieces we're looking at.

Mr. David Dodge: It's certainly worth considering.

Hon. Maria Minna: It's a challenge, I know.

Thank you.

Mr. Paul Jenkins: It's an important issue.

The Chair: Mr. Paquette, Ms. Wasylycia-Leis, Mr. McKay, then we'll wrap it up.

[*Translation*]

Mr. Pierre Paquette (Joliette, BQ): Thank you, Mr. Chairman.

I'd like to ask you a question about productivity. I'm quite suspicious when it's talked about, because workers are usually made to bear responsibility for it. Productivity in the work place is the easiest thing to measure.

We know that investment is still a major source of productivity growth. However, we see that profits a percentage of national income are distinctly higher than the historical average, which is 10 percent. And yet, there does not appear to be any phenomenal growth in investment.

Even though you say that investment is strong, how do you explain that...? They have money, and over a number of quarters. I've rarely seen that. I'm expecting serious negotiations in the private sector in the coming months. However, we know that there have been better years for bargaining. So the profits are there. Then how is it that investment growth is less than one percent? You say it's strong, but I think it's still inadequate to meet the challenge you referred to earlier regarding productivity.

Mr. David Dodge: I'll give you a very brief answer. We're surprised at the level of profits in Canada, but it's exactly the same thing in the United States, Japan, Great Britain and Europe. There are variations in the euro area, but it's almost exactly the same thing.

Why is the level of investment so low, if we consider interest rates, profit levels, liquidity in all economies and the fact that there are a lot of economies and sectors in the world economies that are nearly operating at full capacity? We wonder why. Are there any special factors? There is speculation.

I believe that there's at least one factor in North America, and I don't know exactly how significant it is. Corporate boards are preoccupied by legal matters, new reporting requirements. All these things take a lot of directors' time. It's impossible to travel in Canada — and even less so in the United States — without hearing that directors and CEOs spend too much time protecting themselves against lawsuits and so on, and not enough focusing on business. That surprises us, and our equations did not predict investment levels as low as what we have today.

● (1710)

Mr. Paul Jenkins: This is a very interesting phenomenon. It's hard to analyze all the factors.

Today we discussed the fact that productivity has been more or less stable for three years. The employment rate rose very sharply over the same period. Now that the economy is virtually at capacity, wage growth rates may begin to increase a little more sharply along with investment.

We anticipate that the investment rate will be higher in 2006-2007 than in 2004-2005. We think that, as a result of the present dynamic of the economy, investment will get stronger more quickly.

Mr. Pierre Paquette: You concluded your presentation by saying:

> But as we look further out to 2007 and beyond, we see increasing risks that the unwinding of global economic imbalances could involve a period of weak world economic growth.

I imagine you're thinking of the U.S. budget deficit, the trade deficit, and of China as well.

At the same time, you say in the summary:

> In line with the Bank's outlook, some further reduction of monetary stimulus will be required.

That may be valid for 2006, but from what you say, it's far from a sure thing that growth will continue through 2007.

How do you reconcile those two statements?

● (1715)

Mr. David Dodge: That's a good question. It's hard for us to make judgments. It's important to consider the risks, even if they're not very great. Based on our reference scenario, we currently estimate that the average growth rate will be four percent in 2007, which is quite high. However, the risks remain.

For that reason, we have to proceed with care, always analyzing the risk of a global slowdown in 2007. We mentioned those risks in order to indicate that, in the spring and summer of 2006, we'll have to enforce our monetary policy in a disciplined manner. There are indeed risks, and we're very aware of them.

[*English*]

The Chair: Thank you, Monsieur Paquette.

Ms. Wasylycia-Leis-Leis and then Mr. McKay.

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

I want to come back to the question about inflation and the need to change the bank rates. It still seems to me that, based on everything you've said, we're still within sort of acceptable core inflation. Looking at the all-items index, excluding the eight volatile components as defined by the Bank of Canada, the index remained stable. The 12-month increase was 1.7%, below the target of 2%.

So I ask again about that particular issue. Considering that some of the forecasters actually suggested to us yesterday, in our fiscal forecast session, that the high value of the dollar will actually put downward pressure on domestic demand by cheapening imports, which will dampen inflationary tendencies, is there a likelihood of going in the other direction, as opposed to seeing a possibility of increasing inflation? That's one question.

Then, back to the issue of the manufacturing sector, I'd like you to respond a bit more on that point, because you've received, as well as we have, the CLC document on this matter in which they suggest that

> ...it would seem most appropriate for the Bank to remain accommodative so that it does not add further exchange rate pressures, and help maintain a labour market that will facilitate job transition for those who have the misfortune to become unemployed.

They go on to say: “We question the high ‘physical’ capacity utilization rate that has been invoked to justify a rate increase.”

In a globalized economic context, wouldn't the appropriate policy response be to encourage investment, rather than discourage it through higher interest rates? So all in all, I still wonder if we're not doing more harm than good and whether or not we're actually creating a self-fulfilling prophecy around low productivity.

Mr. David Dodge: Let me take the manufacturing sector, and I'll ask Paul to take a crack at the more general question.

I think it is undoubtedly true that as we look forward to the next couple of years, unless there's some major change in world developments that we don't see, we should not expect many parts of the manufacturing sector—not all, but parts—to not have a very difficult adjustment. It's going to be there, in part because we're finally having to face up to the competition from Asia, in part because we've got weak demand globally, in some areas where we're actually big producers—paper is a good example.

Finally, it's because if we take an industry like automobiles and parts, which is an extraordinarily important industry for us, we have global excess capacity, and while some of our plants and some of our parts producers are producing either models or pieces that are state-of-the-art and in high demand, others are not. So there are some industries that have a medium-term outlook that is not very strong, where we're going to have to make adjustment, and the investment that's going to go into those industries is largely going to be to increase productivity rather than to increase output.

● (1720)

Ms. Judy Wasylycia-Leis: So you don't think that the increase in the interest rate would in turn put upward pressure on the Canadian dollar, and that in turn would put more negative pressure on the manufacturing sector?

Mr. David Dodge: As we said earlier—and I'll turn this one to Paul, because it really leads into that question—in fact we are going through a period of time, rather unusual, when we have interest rates, both at the short and the long end, well below those of the Americans. Certainly vis-à-vis the United States, if anything, our accommodative monetary policy at the moment is working in the other direction. But I think we do have to be very cognizant that in order to anchor those five- and ten-year rates, which are really important for investment, much more important than the overnight rate when it comes to investment, there has to be reasonable confidence that we will do what we need to do in the short hold to ensure that we don't have a lot of inflation down the road.

Let me to pass it to Paul, because this is really getting into your first question.

Mr. Paul Jenkins: The first point I would make is that our inflation target is for the total CPI. We do look at core as an important indicator because it breaks out volatile components, which historically have been energy and food. Of course, what we're seeing today is really a stepped increase in energy prices, which is likely going to persist for some time, reflecting the fact that we're seeing very high global demand for energy products. Indeed, we are beginning to see some pass-through of those higher energy prices to elements of our core measure.

That's the first point, that it is the total CPI we are concerned about and these energy price increases do not appear to be temporary; they appear to be more permanent. It is true, as you've suggested, that we are seeing some offsets in a few areas. We are seeing a bit of evidence, although not very much, of exchange rate effects on prices. In fact, again, this is a global phenomenon where the so-called pass-through of exchange rate movements to prices is really quite small.

Where in fact we are seeing more impact, from a global perspective, is on traded goods prices, and this again comes back to the issue of competition from China. If you look at the total CPI, and you start to break it down, you do see some areas where competitive pressures, particularly these traded goods prices, are putting downward pressure on prices, and we certainly discussed that in our report. But at the same time, we are seeing upward pressures in areas such as energy, and then linked to that the view that the economy is operating at capacity, which is beginning to show signs in other price pressures across the economy.

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

Mr. McKay.

Hon. John McKay: Thank you, Chair.

In the absence of other opposition questions from members of the Bloc and the Conservatives, I have one comment and one question.

I think it's a fair observation to say that tax relief is disproportionately in favour of females at the lower end than it is at other sections. In other words, because there are more female tax filers, any tax relief at that end is therefore skewed in favour of females. I think that's correct. That's just a contribution to the conversation you were having there.

The economists yesterday I think were universally more optimistic about the prospects of the Canadian economy than you are. They saw GDP in particular, both basic GDP and GDP with inflation on top, as somewhat higher than the way you see it. I wonder whether you've had an opportunity to review their analysis. Could you tell us what you see as the major discrepancy between their analysis and what you're presenting here today?

● (1725)

Mr. David Dodge: I don't know what they actually talked to you about yesterday. We do obviously monitor the analyses that the private sector economists are carrying out. I think we may have shaded down next year a tiny bit more than they have, but I wouldn't have thought the differences are very large.

Paul, can you respond?

Mr. Paul Jenkins: In terms of growth rates, they're not all that different. Our base case scenario from the consensus forecast, I think.... Again, not knowing exactly what was presented to you, Mr. McKay, I suspect our slight downward revision to potential output may be one difference. As well, more generally with our projection out to 2007 in these global issues, it's not certain to me, in terms of the risk analyses the private sector economists have been looking at, whether all of them have moved out in terms of their forecast to look at some of these issues. As the governor indicated, it's the risks around the outlook, particularly as you get to 2007 and beyond. I'm not sure whether the private sector economists in their presentations to you actually got into the 2007 and beyond period, or whether it was just 2005 and 2006, but for those two years the numbers are not all that different.

Hon. John McKay: Thank you.

The Chair: I just have a couple of quick questions.

I just want to go back to the fundamentals. From what I understand, if we raise interest rates, will we not be encouraging foreign dollars to come into the country? They'll be invested in higher-return products, even just small-interest-generating products like term deposits, and that in turn will cause demand for our dollar, will it not? You don't have to answer. This is the way I understand it. And then if the bank's projections are even slightly off—and the predictions of some of the other economists are telling us that they're expecting a 90-cent dollar by the end of next year—will we not be asking for trouble by increasing interest rates?

Mr. David Dodge: First of all, the impact of interest rates on exchange rates is the case of relative interest rates and expectations going forward, rather than absolutes.

For example, the fact that we are now running 75 points below the U.S. at the short run, as compared to a number of years, like 2003 and 2004, when we were running over 100 points above the U.S. at the short end, all other things being equal—and there's the catch—ought to mean that in fact we have less pressure on our dollar coming through monetary policy than we had a couple of years ago, even though the dollar has strengthened, and that's for reasons totally unrelated to monetary policy. I don't think you can do the analysis quite as simply as your question would indicate.

The Chair: So you're saying that the slight interest rate would not encourage additional foreign investments because it's too low. It's almost immaterial.

● (1730)

Mr. David Dodge: No, foreign investment is, as we said earlier, a function of a lot of issues. The main thing is whether the prospect looks good to make profits in Canada in terms of direct foreign investment. In the case of portfolio investment, it is how you stack up against the alternatives.

The Chair: I guess it would be the same question as when we were talking about productivity, but at what point do interest rates cause the foreign investment to come in, making the dollar even stronger and making the U.S. dollar weaker? I guess I'm asking—

Mr. David Dodge: There is no single point. All one can say is that when interest rates are lower in Canada than they are in the United States, it tends to put downward pressure on the dollar. When interest rates are higher, all other things being equal, it would tend to put upward pressure on it. That's all one can say.

The Chair: Okay. Another quick question I have is about the elimination of the deficits. As we're reducing the national debt, what is the effect on the Canadian financial markets? Is it a good thing? There's decreased demand for foreign dollars, I understand, from the Canadian government.

Mr. David Dodge: Look, I know from our analysis that the effect of having healthy public finances is very positive for Canada both in terms of the interest rates that we have to have in the economy, which makes it better for homeowners and everybody else who's a borrower, and in terms of giving Canadians and foreign investors confidence going forward that we are managing our affairs well. There are very few countries that have made as much progress as Canada has since the early 1990s. There are very few countries now, in terms of their preparation for their aging populations, that are in as good shape fiscally as Canada is.

The Chair: So, just to rephrase, it's a good thing; but when does a good thing get too good? Is it possible that can happen?

Mr. David Dodge: Can you ever have too much of a good thing? The Australians, for example, have no public debt, and they continue to grow quite strongly.

The Chair: Okay, I guess that answers that.

Mr. Dodge, Mr. Jenkins, thank you again for taking time out of your day. We appreciate it.

That brings me to another question. On the monetary report, how do you determine what day to release it? I'm wondering if you can make it a tradition to release in front of this committee, so we can get some high profile along with you. Is that a possibility?

Mr. David Dodge: We always release on a Thursday. That's just the physical constraint. We can't get it out earlier than a Thursday, given that we make our interest rate decision on the Monday. But if you had your committee hearing that Thursday afternoon, we'd be happy to appear.

The Chair: Great. I might take you up on that.

Thank you, Mr. Dodge and Mr. Jenkins. Thank you again.

The meeting is adjourned.

Published under the authority of the Speaker of the House of Commons

Publié en conformité de l'autorité du Président de la Chambre des communes

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