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Mr. Brian Pallister

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● (1530)

[*Translation*]

The Chair (Mr. Brian Pallister (Portage—Lisgar, CPC)): Pursuant to subsection 108(2) of the Standing Orders, we are studying the Report of the Governor of the Bank of Canada on Monetary Policy.

[*English*]

We are honoured today to have as our guest, committee members, the Governor of the Bank of Canada, David Dodge, and with him Paul Jenkins, senior deputy governor.

Welcome, gentlemen. Proceed. The floor is yours, sir.

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

It's a real pleasure to be back at this committee. It's been a year since we've been here, so I want to say that we do appreciate your taking the time to meet with us, and hopefully we'll be back on track, meeting twice a year, at the time we release our monetary policy reports. We think this is an important way to keep you informed and, through you, to keep the Canadian public informed of the bank's view on the economy and about the objective of monetary policy and the actions we're taking to achieve it.

When we appeared before this committee last October, we noted at that time that the global and Canadian economies were continuing to grow at a solid pace and that our economy appeared to be operating at full capacity. In our last monetary policy report, which we released this morning, we judged that the Canadian economy is currently operating just above capacity. While global economic growth is expected to be a little higher than we had previously anticipated, a weaker near-term outlook for the U.S. economy has curbed near-term prospects for Canadian exports and growth. The bank's outlook for growth in the Canadian economy has been revised down slightly from what we outlined in our July monetary policy report update.

[*Translation*]

The Bank's base-case projection now calls for average annual GDP growth of 2.8% in 2006, 2.5% in 2007, and 2.8% in 2008. Weakness in labour productivity growth has lead the Bank to lower its assumption for potential growth to 2.8% for the 2006-08 period. Together, these factors imply that the small amount of excess demand now in the economy will be eliminated by mid-2007.

Core inflation is expected to move a bit above 2% in the coming months but return to the 2% target by the middle of 2007 and remain there through to the end of 2008. Lower energy prices have led to a downward revision of the near-term projection for total CPI inflation. Total inflation (which includes the temporary impact of the GST reduction) will likely average about 1.5% through the second quarter of 2007, before returning to the 2% target and remaining there through to the end of 2008.

● (1535)

[*English*]

Mr. Chairman, as we noted at the time of our interest rate announcement on September 6, the risks around this base-case projection, which I've just gone through, are judged to be a little greater than they were at the time of our July update. The main upside risk relates to the momentum in household spending and housing prices here in Canada, while the main downside risk is that the U.S. economy could slow more sharply than expected, leading to lower Canadian exports. The bank judges that these risks to its inflation projection are roughly balanced.

Finally, I just note that on Tuesday we left our key policy rate unchanged at 4.25%. The current level is judged at this time to be consistent with achieving the inflation target over the medium term. We at the bank will continue to pay close attention to the evolution of these risks, as well as to economic and financial developments in the Canadian and global economies.

Mr. Chairman, that's a very quick overview. Paul and I now would be very happy to answer your questions.

The Chair: Much appreciated, sir.

We'll begin with Mr. McCallum.

Hon. John McCallum (Markham—Unionville, Lib.): I am very interested in the risks around your projection, not just the inflation projection but also the GDP growth. With the troubles in the U.S. housing market, my sense is that if a housing bubble bursts it would be more serious than a stock market bubble bursting, because of the greater portion of most people's wealth in housing. That's just my view. But how do you see the risks up and down vis-à-vis your GDP forecasts?

Mr. David Dodge: Let's start with the world at large. If you look around the globe, growth is probably going to be a little better than we had thought at the time of our July update, and certainly a little better than we thought last spring. That's largely due to a continued strong performance in Asia. There has been a clear recovery in Japan and Europe. In both of those areas, domestic demand is growing and looks like it's set to continue to grow a little more strongly. So that's the upside in the world. Of course, it puts continued upward pressure on global prices, particularly for resources.

On the other side, clearly the U.S. economy has slowed a little faster than we were expecting. This is largely owing to two things: housing and automobiles. If we look at the structure of our exports, housing and automobiles are very important. Housing is important not just because of lumber but also because of the windows, doors, and other things made primarily in Ontario and Quebec, together with furniture, which we see through the whole manufacturing area of the country. Automobiles are particularly important for southern Ontario.

So that's the main reason that we've downgraded our outlook for Canada over the next four quarters or so. Two questions: have we downgraded the outlook for the U.S. enough, and have we downgraded the outlook for Canada enough in respect of these factors? Actually, we don't know. The risks in our U.S. outlook are on the downside. I'm not sure, though, whether this is because of huge further deteriorations in the housing market, or whether it's because of the possibility that the significant deterioration that has already occurred could spread through other parts of household demand.

We've flagged that risk. We think that risk is clearly on one side: there's not much risk that our U.S. forecast, at least in the short term, is going to turn out to be too high. But global demand is quite strong and offsets some of that.

Now there's the other side—the upside risks. The upside risks are important and we've flagged a couple of them.

First, domestic demand, both by business and households, could well be a little stronger. We haven't upgraded our forecast, but the amount of income out there is a bit higher than we had anticipated. Second, there is a risk that the strength we've seen as being confined largely to Alberta and B.C., with a bit in Saskatchewan or Manitoba, could well spill back to a greater extent than it has so far.

So we think there's an upside risk there. There is also a risk that wages and prices, which have moved up very sharply in Alberta, could spill back. That's why we think the risks are roughly balanced, but we'll watch it over time and see.

● (1540)

Hon. John McCallum: Thank you.

Now if I could turn briefly to fiscal policy, the economic prudence component of the safeguard against return to deficit has been removed by this government. So I suppose by definition that means fiscal policy is less prudent if the prudence is no longer there. Would you agree with that statement?

As a corollary, if there is greater risk—as I think you said in your forecasts—then maybe there's a greater need than in the past for prudence, because we have had a long string of surprising surpluses on the positive side. If the risks are greater, those days may be over, and there may be a stronger need for prudence than in the past.

It is a double question. Do you agree it's less prudent, and is there a greater need for prudence than in the past?

Mr. David Dodge: Let me go to the underlying factor here. What's happened, of course, is that we were surprised with the strength and growth of nominal GDP, in particular in 2004 and 2005, largely because of improvements in terms of trade.

As everyone around the table knows, we tax nominals, not reals. So revenue strength, whether it's tax revenue or royalty revenues, in Alberta in particular, has been stronger than we would have anticipated.

Now, it is absolutely true that looking forward we expect this to turn around. The bit better than 6% growth in nominal GDP, which we saw last year, we think will be below 5% this year and could well be 4% next year. So there are clear risks in terms of nominal GDP growing much more slowly than growth in real.

I think this is an issue. There are risks both on the federal level and in the provinces, which rely fairly heavily on corporate income taxes or directly on royalty revenues.

Hon. John McCallum: Does the removal of the prudence component mean that by definition fiscal policy is now less prudent?

Mr. David Dodge: What we have assumed is that governments as a whole will adjust their spending and taxes in order to stay in fiscal balance over the period.

● (1545)

Hon. John McCallum: I see. It wasn't a direct answer, but I'll move on.

Some hon. members: Oh, oh!

Hon. John McCallum: I know in the Department of Finance they have various economic models showing that the effects on productivity or wealth are significantly greater for an income tax cut than for a GST cut. I know that OECD and IMF economists all converge on that point.

Do you agree that from a competiveness or productivity point of view, income tax cuts are more efficient than reductions in consumption tax?

Mr. David Dodge: This is always tricky, because at the bank we really don't work on that, and I have to be here to speak about the work we do.

What we focus on is the importance of fiscal balance, and in particular we focus on this at a time when we have stronger than anticipated growth. Clearly, then, we would look for governments to be running surpluses.

That's what's critical for us. Over the longer term, tax structure is critical to the economy's potential growth rate, but we are not experts in this.

Hon. John McCallum: Thank you.

[*Translation*]

Le président: Let us now continue with Mr. St-Cyr.

Mr. Thierry St-Cyr (Jeanne-Le Ber, BQ): Thank you very much, Mr. Chairman.

Thank you for your presentation. This is an entirely new concept for committee members. Now we will have ten minutes to exchange, which will allow us, I hope, to go a bit more deeply into the issues on the agenda.

For a long time, it has been taken for granted that the Bank of Canada has a policy whereby it maintains a target inflation rate between 1 and 3%. Is this a theoretical figure, or is it based on empirical data? How was this decision made at the time? How is it implemented today? Should it be revised? Is this still the best target range for Canada?

Mr. David Dodge: This is a good question.

Let me answer you first and then I will give the floor to Paul.

In 1991, the government and the Bank of Canada tried to find a formula for slowing down inflation, which was very high at the time. Thus, deflation targets were established until 1995. This is how the inflation rate went from 4 to 2% at the end of that period.

In 1995, we agreed to keep the target at 2%; we have renewed it twice since then. A range of 1% either way was provided, because of normal variations in inflation.

Canada was the second country to adopt this kind of system. It was a pioneer in the field. The 2% rate was not based on past experience, because the system was new, but after a few years, other countries followed our example and adopted targets. The European bank, for example, adopted a target rate of 2% or less. England also adopted a 2% rate. In other countries, the rate is 2.5 or 3%. Japan and the United States are also considering adopting such a system.

Paul might have something to add.

Mr. Paul Jenkins (Senior Deputy Governor, Bank of Canada): We have set a target of 2% with a range of 1% either way, but we are aiming for a total CPI growth of 2%. A large contributing factor to the efficiency of monetary policy is the expectancy regarding inflation. By setting a specific target, inflation is expected to be about 2%. This is a very important factor.

As the governor mentioned, we studied a 2% target. There are some factors, but currently, we are very satisfied with this rate.

● (1550)

Mr. Thierry St-Cyr: If I understand correctly the current 2% rate is rather arbitrary. This target was set at a given point in time. It seems to be working quite well. The others then followed.

What is the mathematical origin of this figure? This is more or less what I am trying to understand. Why should the target not be set at 2.5, 3 or 1.75%?

Mr. David Dodge: This was not mathematically set, but a target was chosen that would give the best economic performance. After 10 years, namely after we established a 2% target, expectations have stayed steady at 2%. It still remains to be known whether there is a target that could be even better for economic performance.

Given our own experience and that of other countries, we will study this question. This is more of an empirical question than a mathematical one.

Mr. Thierry St-Cyr: All right.

Let me put some questions regarding the components of inflation. I would like to know the impact of the recent cut in GST on inflation, and the impact of a further potential cut. On the other hand, what are the causes of inflation? In what areas could we anticipate serious causes of inflation in Canada over the coming years?

Mr. David Dodge: Let me begin to answer and then I will give the floor to Paul.

The impact of the recent cut in GST on inflation — this time we are dealing with mathematics — is a little over 0.5%, which is between 2.5% and 2.6%, and will last from July 2006 until July 2007. After July 2007, we think that the effect will disappear. But there are other factors that are much more difficult...

Paul.

Mr. Paul Jenkins: There is a conceptual difference between the factors affecting inflation in the medium term, such as the balance between supply and demand, and factors such as a cut in the GST, which have a temporary impact on prices.

As the governor mentioned, we see a current effect of 0.5% on the CPI, but within a year, this impact on the growth rate should no longer be visible.

● (1555)

Mr. Thierry St-Cyr: All right. How can you reconcile the demands for job growth and the fight against inflation if, for instance, the job situation were to deteriorate? Could we temporarily go beyond the target inflation's range, and throw away some ballast in order to stimulate employment and growth? How do you manage these three concepts? How do you reconcile them?

Mr. David Dodge: In the medium term, the best contribution that monetary policy can bring to economic performance is to maintain a low and stable inflation rate and to have very clear expectations in this respect. In the medium and long term, this is the best thing to do.

Of course, the short term inflation rate is very much influenced by pressures on the economy, either upward or downward. When there are upward pressures, when the economy is working at a level higher than its potential, there is inflationist pressure. This is when monetary policy must be tightened up.

On the other hand, when there is a great deal of slack in the economy and pressures to bring inflation down then we must exercise more expansionist pressures on monetary policy, but...

The Chair: Excuse me, sir.

Mr. David Dodge: It seems simple, but it is quite difficult.

[*English*]

The Chair: We must move now to Madam Ablonczy.

Ms. Diane Ablonczy (Calgary—Nose Hill, CPC): Yes, thank you.

Welcome, Mr. Dodge and Mr. Jenkins.

The theme of our consultations has been increasing Canada's competitiveness and productivity, so we certainly want you to be able to weigh in on that. You know that with the appreciation of the Canadian dollar over the past few years, it's become tougher for Canadian businesses to remain competitive and of course to maintain Canada's standard of living. So I wonder what suggestions you would have about increasing productivity to make our businesses more competitive. I'm sure there are many things you could suggest, but what would be the main ones you'd want to emphasize?

Mr. David Dodge: First, just let me say that, as you'll note from the lack of hair on the top of my head, I've been through a number of these cycles before. I remember very well the cycle of the 1970s and then the early 1980s and then the early 1990s, when adjustment in the Canadian economy was slow, when in fact at all levels we tried to cushion the adjustment process, and the result was not great. I've got to say that as I have observed what's happened over the past three or four years, I think one has to be impressed with the resiliency of firms, with the resiliency of workers in adjusting to really rather abrupt changes. And we've adjusted in a way that we certainly didn't 35 or 30 years ago. I think in that sense we have learned from history.

The real question, then, is what we do going forward. The first lesson—and Paul has spoken about this, so I'm going to turn it over to him—is that we have to stay flexible. The second lesson is that we all—whether we're employers, whether we're governments, or whether we're individuals—have to focus on ensuring that we continue to upgrade our skills and be in the forefront.

But Paul's done some work on this, so let me turn to him.

● (1600)

Mr. Paul Jenkins: Let me start by noting that the governor referred to the 1970s and 1980s and the boom-bust cycles we went through in those years. If you compare the last 10 years to that earlier episode, we've actually gone through substantial shocks. A lot of those have had an international origin or dimension to them. You can think back to the Mexican peso crises; the Asian crises; Russia, long-term capital; bursting of the high-tech bubble; SARS; BSE; corporate malfeasance in the United States. These have all had impacts on our economy. And as the governor indicated, we've really shown quite a bit of resilience in terms of being able to adjust to those shocks.

So the issue here is what we can do to continue to promote the ability of our economy to adjust to what will continue to be developments, probably a lot of them outside our borders. Therefore, policies at the macro level, and, from our point of view, maintaining a low, stable inflation rate are actually very critical. As well, promoting training and mobility of factors of resources—labour—across the country is also very important. So that flexibility to respond to economic developments is very important, and I think we've made some good progress, but we continue to see the need for that.

Ms. Diane Ablonczy: Are you concerned at all about the efficiency and productivity of the financial markets? And if so, what would you suggest for policy actions there?

Mr. David Dodge: The answer is yes; we are concerned. We face real competition from the rest of the world, and unless we stay in the forefront in terms of the legal and regulatory structure for our markets and the structure of our industries, then we are going to suffer.

For a number of years, starting from the Porter commission back in the early 1960s, and then with revisions to our structure in 1967, Canada was actually a leader. In that process, we created for ourselves a comparative advantage. We've been slipping, quite frankly, in the last decade in that regard. Or let me put it differently: other countries have been making progress a lot faster than we have been; hence, our competitive position has deteriorated a bit. So yes, we think it is very important that from a legal and regulatory point of view we do everything we can.

Secondly, what we do know is that competition in markets is the real way that innovation is promoted within firms, so we have to ensure that our markets and our institutions really do face enough competition that they're spurred to do the very best. No one likes competition very much, but it certainly is an incentive to enhance productivity.

Ms. Diane Ablonczy: Mr. Dodge, I have a final question. I know that you have an interest in defined benefit pension plans and Canada's pension plans in general. Of course they're a huge element of future security for Canadians. I wonder if you could share with us some of your thoughts on actions that might need to be taken to strengthen this area of our economy and of our security.

Mr. David Dodge: Pensions are probably the most complicated area from a technical point of view, and I am not the expert from a legal drafting point of view or from an accounting point of view, but clearly it's very important that firms and workers do have the option and the ability to have defined benefit plans. They may choose not to; that's a different story. But we should have a framework that is not biased against the establishment of those plans.

For various reasons, in terms of accounting and the way some of the judgments have gone in courts, we've created a bias against employers sponsoring these plans and what we've seen is employers increasingly back out.

Now, that's a free choice that people have, but our view is that it is important because these are very important sources of savings for the economy, and for stability in the period going forward. So what we have simply argued is that we ought to have a legal accounting and regulatory framework that is neutral to this, that it doesn't bias the choice of employers against setting up these plans.

With respect to the Canada Pension Plan, we're kind of leaders in the world in having a public pension plan that is pretty sound. But as we all get older, we really have to look, I think, at the way the CPP is structured in terms of the transition from full-time work to full-time retirement. When it was set up back in 1966, that wasn't really thought so much about. That is a difficult issue and one that increasingly we will have to think about if we're to have the right incentives for older workers to continue to participate in the labour force to the extent they want to.

● (1605)

Ms. Diane Ablonczy: I'd like to pursue that, but I suspect I won't have time. But thank you very much.

The Chair: Thank you, Madam Ablonczy.

We'll move to Madam Wasylycia-Leis.

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

Thank you very much for your presentation today.

Let me pursue the issue of pensions, specifically back to the defined pension benefit plans that you publicly stated are important. You've identified the need to address the fact that so many firms are moving to contribution plans as opposed to benefit plans.

We had presentations at our committee from a number of people on this issue, but one in particular was Pam Went from the Bell Pensioners' Group. She suggested that what we need is legislation to ensure that there must be solvency at all times. She says there's such a law in the Netherlands and it's been successful. Also suggested is something similar to what the Province of Quebec is legislating currently, and that is the creation of a reserve fund. That would be available when times are bad and yet, in the short term, can be used as an asset of the company.

Should we move in that direction? Do you see any pitfalls? How do we advance in this area?

Mr. David Dodge: These are really difficult issues.

First of all, I think we have to be very careful about saying that there should be solvency at all times, because that solvency calculation is based on a whole bunch of hypotheses and a whole bunch of rules. Quite frankly, I worry that we've defined it so tightly that we have plans that are going to be perfectly solvent over a period of time and at another point in time may appear to become insolvent because of our rules.

So I think we have to be quite careful here. The task of trying to find a way to do it, to smooth through the wiggles that take place, is not easy. But the situation we currently have, where everything depends on the interest rate that exists on the last day of a calendar year, is not a very sensible way to look at it. It allows for comparability, but it doesn't make sense from a pension point of view.

The Netherlands one is a bit of a different thing. I think there are lessons in what the Dutch have done. They started with a total disaster and experimented with a way of going about this. I think there are lessons there for Canada that are worth looking at.

Finally, there's one thing I would caution very strongly against, and that is having something like the American Pension Benefit Guarantee Corporation. It really rewards the folks who don't manage their plans well and penalizes those who do. That's really quite a dangerous way to go at it. On the other hand, very clearly, if we run into a real economic or financial disaster, we would want to look at ways to try to stabilize through that. But I don't think the historic way of doing it, through something like the Pension Benefit Guarantee Corporation, is a sensible way.

● (1610)

Ms. Judy Wasylycia-Leis: Thank you for that.

I'll switch topics now and go to the broader matter of the state of the economy, the state of the nation, and what I see as a looming crisis based on the loss of manufacturing jobs, our growing inability to compete with the flood of products from Asian markets, and the lack of programs to actually help workers adjust to new demands and new scenarios.

I don't see that we have the tools to deal with a massive adjustment crisis. In the past when we had economic crises, the manufacturing sector played a role in recovery. We don't have that any more.

What do you see as a way through this?

Mr. David Dodge: Okay, let's deal with that. There are two issues here, short term and long term. I think we really do want to separate those.

In particular in the automobile industry and the industry that makes the bits and pieces for housing, we are going through a short-term cycle, which we certainly do expect to recover. That's why we have things like unemployment insurance. That is exactly what we expect to happen. That's cyclical. But there is a structural problem, and I think that's really what you're referring to. That structural problem differs across different industries, but clearly, industries that generally rely on lower skill labour—furniture and textiles being two classics—are ones where we are going to cede employment to lower-cost countries, and those industries will in the future likely have fewer employees than currently, although not necessarily as much as we think, because we still retain capacity in design and the specialized end of that. That's one set.

Secondly, we have industries like the forestry industry, which is one that I think concerns all of us, where in terms of pulp and paper we have enormous competition from the Brazils and Indonesias of the world and we have declining demand for our classic product, newsprint. At the same time, particularly in eastern Canada, we have increasing wood costs. So that industry is one that, over time, is going to have to be a bit smaller than what it currently is. It doesn't mean that it needs to be unproductive but that it's probably going to be smaller than it currently is.

The issue then is—and particularly in those industries, since they tend to be located in northern Manitoba, northern Ontario, northern Quebec, in smaller communities—how do we deal with the fact that there won't be in those communities jobs for all the workers who are displaced? In part, this is dealt with, at least in the short run. Since these people are highly skilled and very useful in industries that are expanding, in part that means temporarily working outside of the community. That's easy in a place like Prince Albert, where you can jump on a plane and in half an hour be in Fort McMurray. It's a little tougher in Fort Frances or in Témiscaming to do that. So that is a real issue. I don't have all the answers of how to do that, but it's on the workers in those communities that we have to concentrate.

Finally, over the long haul, of course, what we have to concentrate on is, through education and training, to ensure that younger workers have the skills and flexibility to be flexible across different industries.

Ms. Judy Wasylycia-Leis: As part of this, the other problem that I see looming, and you've touched on it a bit, is the heated-up housing market. Do you not see, the way things are going, that we could be into a serious crisis with people going in over their heads, turning to some of these, as I understand it, fly-by-night companies to get mortgage insurance when they can't get it anywhere else, or to get mortgages when they can't get one anywhere else, and risking a huge loss and critical downturn for many communities?

● (1615)

Mr. Paul Jenkins: Let me address that. This is an important area and one we've given quite a bit of attention to in terms of looking at the balance sheet of the household sector and working through different scenarios in terms of how that balance sheet might be affected, for example, by increases in interest rates or declines in house prices.

At the aggregate—and I emphasize at the aggregate—when you look at the household sector balance sheet, and in particular, debt service ratios, which remain very low, we are not concerned that we are in some sort of a serious situation at all. Indeed, although interest rates have gone up somewhat, interest rates, including mortgage rates, remain relatively low, and that's a byproduct of low and stable inflation. We can't forget that.

We also do analysis in terms of the distribution to ensure that even though at the aggregate there is not the risk that across the distribution of households there is a vulnerability. That's an area in which we haven't done as much research as we would like. We have done some. In fact, in our upcoming financial system review that will be out in a month and a half, this exact issue gets addressed. The research to date again suggests, from a distributional point of view, there is not a serious problem.

The third element—

The Chair: I'm sorry, I'll have to interrupt you prior to that important third element. We do have to move on, because we have a number of other members who would like to ask questions as well.

I'd like to conclude, with the committee's acceptance, at five o'clock. We have approximately 40-plus minutes, which would allow everyone who is currently on my list five minutes. I'll move in that direction.

Mr. McKay.

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

Thank you, Governor. Thank you, Deputy Governor.

I know you've thought long and hard about productivity. Let me put a question to you that I put yesterday to the executives of Canada's large corporations. The government, over the past 13 years, has done many things that the corporate business community has asked to be done. Debt to GDP is down, interest rates are under control, you could include fiscal stimulus, or contractions—you get it within a band—interest rates are under control, and taxes have been substantially reduced—pretty well everything on the shopping list. Yet year after year our productivity seems to decline, both absolutely and relatively.

I know you've done a lot of thinking about this, and I know you've done a lot of thinking about it with respect to the financial services sector even, which should be a strength. I'd be interested in your opinion as to where we look now.

We arguably have the most generous R and D credits in the world. We have publicly funded research—arguably the most advanced in the world. We have reversed the brain drain, and we are now in a brain gain. What's left is business. So what's the issue?

Mr. David Dodge: Well, if I knew all the answers to that, I think I would be either a hero or I'd be rich—one or the other. Sorry, we don't know all the answers. This is very hard work as you plow through it.

When we appeared a year ago, we thought we were getting back on track to a long-term productivity gain of about 1.75% per year. We thought so, because we had seen a substantial pickup in investment in machinery and equipment, which is generally a precursor to higher productivity. We thought that a fair bit of adjustment had already taken place. An adjustment, while you're going through that, is actually a negative for productivity.

When we looked at it again in September, as we were preparing this report, we saw two things. First of all, the numbers weren't coming through as strongly as we thought, in spite of the fact that we made more investment in machinery and equipment. Secondly, the adjustment process was clearly more protracted than we had anticipated. For that reason, we said we were maybe a bit too optimistic last year and that we would go back to 1.5%, which is what we had been assuming in the earlier part going forward. For the next couple of years, we still have potential for 2.8% rather than 3%.

Now, it may just be that the adjustment period is more protracted. Certainly if you had to place odds, that is it. We do know that during periods of adjustment, the productivity numbers end up not showing as good a performance.

That having been said, however, and especially since an increasing share of employment is going to be in the services sector—I mean, compared to the United States we have a rather low share in the service sector at the moment—clearly we have to put real emphasis on ensuring that our services sector, which is everything from financial services through to the hospitality sector, community services, health services and so on, is as efficient as possible. It's in that area that I think we're going to have to put more emphasis going forward.

Now, as to what to do, I can't give you any more answers than the ones we talked about earlier.

● (1620)

The Chair: Again, Governor, I'm sorry. I'll give you an indication when there's about a minute remaining in time, so as not to cut you off and allow you to round up your response.

[*Translation*]

Let us continue with the next speaker.

Welcome, Mr. Bellavance. You have five minutes.

Mr. André Bellavance (Richmond—Arthabaska): Thank you, Mr. Chairman.

Thank you, Mr. Dodge and Mr. Jenkins, for your presentations. Today, I am pleased to replace Mr. Paquette, for whom I have already worked.

I will continue in the same vein as Mr. McKay. When I was working for Mr. Paquette, the Bank of Canada would present its report to the committee by putting great emphasis on productivity. Currently, it is much more about inflation.

Has your strategy changed or, as you said, has the productivity or your projections been perhaps too optimistic? You spoke quite vehemently of these things, but it seems that they are less important now.

Mr. David Dodge: In the medium term, productivity is the biggest challenge, because after 2011-2012, there will be a period of decline in labour. This is why productivity is extremely important.

However, in the short term, we try to stick to our inflation target and we take the evolution of productivity into account for the projected period.

Mr. André Bellavance: What worries me very much and what worries the people in my riding, where there are paper mills like Domtar and Cascades, is the appreciation of the dollar. We often hear that a government cannot have much influence on the appreciation of the dollar. Obviously, there are bad consequences for exporters, but it is also obvious that this is not as bad for importers.

You have a certain leeway regarding inflation rates. Do you also have some leeway for the appreciation of the dollar? What can the Bank of Canada do in such a case?

● (1625)

Mr. David Dodge: In the middle term, the appreciation of the dollar slows down the rise in domestic prices, which helps us to deal with the situation. This means that we could loosen our monetary policy during periods of appreciation and tighten it up during depreciation periods.

Half a century of experience has taught us that a floating dollar is the best way to facilitate the adjustment of the economy. There are various monetary practices, but since 1950, we chose to have a floating dollar, and it has served us well.

Mr. André Bellavance: Since 2003, from a macroeconomic point of view, how was the Canadian economy affected by the appreciation of the dollar?

Mr. David Dodge: Since 2003, the gap between interest rates in Canada and the United States has diminished. In the beginning, there was a gap of more than one percentage point. We had a higher rate than that of the United States, but as of now, it is lower or just about the same.

Thus, we can say that there is an interaction between monetary policy and exchange rates.

[*English*]

The Chair: Merci, monsieur.

We continue with Mr. Del Mastro.

Mr. Dean Del Mastro (Peterborough, CPC): Thank you, Mr. Chair.

Mr. Governor, I wanted to ask a question, first of all, with respect to interest rates. We have regions of the country, probably the west, where there is more inflation than in others, and in Ontario, I would argue, we don't see the inflation, the interest rates.... Certainly, if anything, we've seen energy prices come down a little bit. Commodities such as automobiles have actually come down in price, not gone up in price. Is there an opportunity here, moving forward, where we might see interest rates actually relax? That would also see a little lower dollar, which would also create more demand for Canadian-produced goods.

Mr. David Dodge: I'll be very quick here. The answer is yes, we do expect inflation to be below our target over the next period of time, for reasons we explained right at the beginning. We think we're on track to come back to about 2% nationally. That means the rate of inflation is a little higher in the two western provinces, a little lower in most of the rest of the country, but on average it is 2%.

Will there be a point at which interest rates will come down? There well could be. It goes back to the very first question Mr. McCallum asked. If indeed the economy ends slowing a lot more than we anticipate, then we will react.

Mr. Dean Del Mastro: Last week there was a report that Canada was actually expected to lead the G-8 growth over the next year. Is that consistent with your view?

Mr. David Dodge: I'm sorry, I didn't—

Mr. Paul Jenkins: I don't have all the details of growth rates across the G-8 countries, but certainly we are expecting Canada to be one of the better-performing economies among the G-8, based on the projection we presented in today's monetary policy report.

Mr. Dean Del Mastro: Okay.

What was the bank's position on the recent debt paydown announced a couple of weeks ago by Canada's government?

Mr. David Dodge: As I said earlier, in periods when revenues are a little stronger than anticipated, I think it's extraordinarily important to use that opportunity to pay down debt. That's how the system is supposed to work. Indeed the accounting rules mean that if you get more revenue, you don't spend it; you have to pay down debt.

It is important to take advantage of strong periods to do that. As I've said before, it's very important—important not only for the Government of Canada, but important in provinces where there is very large revenue growth—to take the opportunity to either pay down debt or put money aside for the future. That helps in the short run; it really helps in the long run.

● (1630)

Mr. Dean Del Mastro: That's great. Thank you.

Do I still have some time, Mr. Chair?

The Chair: Yes.

Mr. Dean Del Mastro: Great.

I just wanted to ask you about the GST cut. When we announced the GST cut last spring, a lot of people were saying we were adding a stimulus to an overstimulated economy, and it would result in much higher levels of spending. We really didn't see this, though, did we? We didn't overstimulate an overstimulated economy, did we?

Mr. David Dodge: No, for us the issue is balance, the fiscal balance. Indeed last year, because it turned out that we had higher nominal income growth than we had expected, it was important that the government actually ran a bit larger surplus. That was unintended, and our job at the bank and the area in which we have to cooperate very closely with the governments—not just the Government of Canada but governments in Canada—is to have an understanding on the fiscal balance and what we're doing on our side.

We've been pretty successful since the early 1990s in that regard. I think the system works pretty well. The Government of Canada and the provinces, with whom I talk regularly, really do understand what each of us is trying to do.

The Chair: Thank you, sir.

We'll move to Mr. Pacetti.

Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.): Thank you, Mr. Chairman.

Good afternoon, Mr. Dodge and Mr. Jenkins. It is always nice to have you.

I was just reading your opening comments. I might be repeating myself, but where do we go with this capacity? Last year you talked about how we appear to be operating at full production capacity; now you're saying we're operating just above capacity. I think some of my colleagues addressed the fact that we're not operating at capacity in some of the industries, as you stated yourself, such as in the forestry industry. In the forestry sector, we're having some problems with employment; it's the same with the automobile or manufacturing sector in central Canada. We seem to have good numbers coming only out of Alberta. There seems to be some declining. Is it just an aberration?

How do we determine, first of all, what is operating at full production capacity? If we are operating above capacity, how long can we continue operating above capacity?

Mr. David Dodge: Well, capacity here is not a kind of physical limit so much as an economic limit. Basically, capacity is the point at which, essentially, demand is outstripping supply enough that we're getting an upward movement in prices. That's essentially where we are; there's still a little bit of upward movement in prices.

Mr. Massimo Pacetti: But when we talk about supply, is it goods and services supply or monetary supply?

Mr. David Dodge: No, no, goods and services.

Mr. Paul Jenkins: What's being produced in the economy.

Mr. Massimo Pacetti: Okay. So are we almost at our limit or a bit above our limit?

Mr. David Dodge: Well, look, there's always a structure—

Mr. Massimo Pacetti: We can't produce more cars?

Mr. David Dodge: There's always a structure out there, and not every industry will be at capacity. Some will be over capacity, in the sense that they're producing inefficiently because they're having to use either machinery that's outdated or labour that hasn't fully got the skills, or whatever. So it's an economic concept, it's not—

Mr. Massimo Pacetti: Not a physical concept.

Mr. David Dodge: —so much a physical concept.

Mr. Massimo Pacetti: It's not something we can touch and feel. I can't understand how we cannot—

Mr. David Dodge: No, it isn't, and that makes it very difficult.

Mr. Massimo Pacetti: I cannot understand how we cannot produce more cars and cannot produce more airplanes, especially Bombardier not at full capacity. I'm only talking about some of the bigger manufacturing sectors that I can think of. I'm sure there are others. We're back to what we were discussing before, in terms of productivity. I don't know if that has anything to do with it.

But if we're saying that if we're operating above capacity then everything is fine, the other side of the medallion is where do we try to peg the dollar? Do we want to peg it so that it's low and try to protect inflation, because we are going at full capacity, or do we peg the dollar to the American and try to simply sit on our saddle? Where's the correlation in terms of our monetary policy?

● (1635)

Mr. David Dodge: Well, the really difficult thing is that somehow we have to move real resources out of industries where the value added is lower and into industries where the value added is higher. That's how we'll become wealthier over time.

That process of adjustment is not easy. It takes time, it takes investment, it takes retraining, and it takes mobility. All of those factors have to be there to thus relieve some of the bottlenecks. And for supply bottlenecks, in areas where value added is very high, we really do have to take capital and labour from areas where it's lower. That takes time, and it's difficult—

Mr. Massimo Pacetti: I'm sorry to interrupt, but it's because our time is limited.

So to put it in layman's terms, if producing a car in Canada is not efficient or doesn't add enough value, is it not important? Probably "important" is not the right word, but it's not something that we should be targeting toward? Maybe jobs that create more value—is that what we should be heading for? This is going to lead to my question: how do we balance that? Because of the regional differences, there are not the same resources, both physical and human resources, in one area of the country compared to another. How do we address those as well?

The Chair: I'm sorry, sir, but you're going to have to address that in a very short—

Mr. David Dodge: Thirty seconds.

It's quite easy, or relatively easy, in very deep labour markets, like southern Ontario, the Montreal plain, the lower mainland in B.C., or the Edmonton-Calgary corridor, because people can move the costs of movement. You may have to drive further, but you can move around. The firms are next door, and so on. Where it's difficult, and what we're really struggling with, and what you have to struggle with, as members of Parliament, is the fact that we have a lot of people in industries where we do have to release labour but where these are smaller communities, far from alternative employment. That is the real struggle we have.

The Chair: We'll move to Mr. Wallace.

Mr. Mike Wallace (Burlington, CPC): Thank you, Mr. Chairman.

Before I start, I'm happy to be here and joining the committee on a permanent basis, which is—

The Chair: Welcome, Mr. Wallace. Bravo.

Mr. Mike Wallace: Mr. Dodge, you're the first person I've spoken to officially as a member of the committee.

I want to tell you, Mr. Dodge, that one of the areas I was interested in at university twenty years ago was macro-economic stuff and banking, and it's an honour that I get to address my first question to the head of the bank.

Here is my first question—nothing to do with banking, in a sense. Part of the role for us as a committee is to look at what you'd like to see in the next budget. You can answer as the head of the bank, or you can answer as an individual if you wish, either one of you. Are there a couple of things you'd like to see the finance minister do? I'd be interested in hearing what your answer is. As a Canadian, what would you want to see in the next budget?

Mr. David Dodge: That's a question I'm not going to answer.

Mr. Mike Wallace: I tried.

The Chair: Not an impressive start for our new committee member.

Mr. David Dodge: I'll tell you why.

At the bank we are very privileged, in that we have direct access to the Government of Canada to give them advice privately and quietly. We are their banker. We serve the Government of Canada, and we'll serve the provincial governments, in terms of giving them advice on a confidential basis. If we are to do that well, then we have to give them the advice and let them make the choices.

Mr. Mike Wallace: I appreciate that. I thought I'd try.

Mr. David Dodge: It's a good try.

Mr. Mike Wallace: You mentioned a couple of times today that you're forecasting a reduction in productivity in the future—not in the short term, but maybe in the long term. Am I accurate?

Mr. David Dodge: No. A year ago we were looking at our productivity assumption moving up from 1.5% to 1.75%. We made that adjustment in our forecast a year ago. What we've discovered over the past year is that maybe we were a bit too optimistic, so we've moved back to 1.5% for the period through to 2008.

● (1640)

Mr. Mike Wallace: It's back to 1.5% and not 1.75%, which you had for last year.

Regarding this process of forecasting, which is obviously important to us in where we're going as an economy and as a country, can you explain in layman terms what goes into that forecast, so I understand how you came to one conclusion, then changed it again?

Mr. David Dodge: The short answer is a lot of judgment, and I'll let Paul give you the factors.

Mr. Paul Jenkins: Let me be brief, but talk generally and then more specifically about productivity.

When we put together the projection that goes into our monetary policy report, we draw on analysis from a number of different sources, including our regional offices that are constantly in contact with provincial governments and businesses across the country.

We gather quite a bit of input as we make our decisions and in the end come to a judgment as to what we think are the trends in the Canadian economy. Of course, as you rightly point out, we need to have a sense of what the future looks like, because monetary policy operates with lags. What we do or might do today would affect the economy out over a year to a year and a half.

On the productivity side, we look at the history of productivity growth. We are out talking to businesses and associations, trying to get a sense of what they are doing.

In the end, a lot of it is judgment. But it is critical for us is to have a well-defined paradigm to think about these issues, so that as events unfold, we can assess them in a very logical, coherent framework that leads to judgments about monetary policy.

Mr. Mike Wallace: One question I'd lined up was asked previously, about paying down debt and surpluses. In my previous job the issue we had on a surplus—basically we treated it as one-time money that wasn't to go back into programming for government services. I worked at a different level of government.

Does the Bank of Canada have a position on the role of the surplus? Is there a prudent level, as the previous speaker mentioned, or is this something you keep to yourselves and discuss privately?

The Chair: Unfortunately, there's only time for a very brief answer.

Mr. David Dodge: The surplus occurs when your projected revenues exceed your projected spending, and it automatically goes to pay down debt.

How much debt should one aim at paying down? The answer is that it depends on where you are in the business cycle. When you have unexpectedly strong revenues, you should aim to use that to pay down debt. In years when revenues are weak, you would not be paying down as much debt. Indeed, it could well be that for one or two years you actually run a deficit, even though you're on track over time to bring it down.

All we've said is that it's really important over the remainder of this decade, given the demographics of this country, to aim to reduce the burden of the debt, both for the federal government and the provinces.

The Chair: Thank you, Mr. Wallace, and welcome.

To conclude, we'll go to Mr. McCallum.

Hon. John McCallum: Thank you, Mr. Chair.

I think this is the first time I've had the privilege of asking on a second round. I thank you for that—not that I scored any political points last time, or would expect to this time.

The Chair: Perhaps if you had, sir, you wouldn't have had a second round.

Hon. John McCallum: Yes, perhaps.

I'd like to ask you a purely non-political question—I might get further—on the housing markets. You mentioned the weakness in the U.S. affecting demand for Canadian lumber and all of that. I would like to ask you about the possible link running straight from the U.S. housing market prices to housing prices in Canada.

There is a lot of concern about housing bubbles, in the literature and in the press, especially in the U.S. As, again, a double question, how concerned would you be about Canadian housing markets? Are there reasons to be a lot less concerned about Canada than the U.S. in this regard?

Related to that, if there were a real housing bubble burst in the U. S., would you see a direct transmission to a similar phenomenon in Canada, or do you think our housing markets march to totally different drummers in the two countries?

● (1645)

Mr. David Dodge: To take your second question first, the link would be indirect. The link would be that with a collapse in the U.S. housing market, U.S. demand really slows down, our exports slow down, income growth in Canada slows down, and then that affects the housing market. I don't think there's a direct link at all.

Going to the first question, how concerned are we? We watch this pretty closely.

The third part of the question, which we didn't get to answer earlier on, is that in fact what we've seen is that household debt to income rises, but debt service costs to income actually have fallen fairly sharply. They've been flat over the last couple of years. They haven't been rising. That is quite a different story than is the case in the United States.

So from the household side, we don't see a particular problem. The question is, are there particular markets?

First of all, I think one has to note that up until 2003, Calgary and Edmonton had one of the lowest ratios of house prices to median incomes in the country. In fact, even though they recently had a very rapid increase, they only got back to where most of the rest of the country is because of their high incomes. Vancouver's lower mainland is probably the one market where the ratio of house prices to incomes clearly looks out of whack. But that would be the one.

Hon. John McCallum: Thank you.

On pensions, I think a number of us might be somewhat concerned that as our private pension system shifts increasingly from defined benefit to defined contribution, the risk of stock market corrections and things of that nature becomes increasingly borne by the individual. Especially with the aging population, that might be a concern, in that public policy might wish to slow down or reverse such a shift.

Mr. David Dodge: Or at least not contribute to.

Hon. John McCallum: Or at least not contribute to out of their non-neutralities, such as treatment of surpluses and this type of thing. I used to work for a bank, and was on the pension committee, so I know a little bit about that.

Do you think there are good public policy actions that could be taken to reverse or slow that trend towards defined contribution?

Mr. David Dodge: Yes, I think there are. There are actions that would certainly help to at least make public policy neutral. I talked about one of those in answering Judy's question.

I really am worried about a system that jerks the valuation all over the place. Any prudent corporation doesn't want to have his earnings jerked all around by assumptions that accountants force him to make about an interest rate to value liabilities, for example.

So I think there are clear things that can be done. Exactly how to do them is a much more difficult question, however.

Hon. John McCallum: Thank you very much.

The Chair: Thank you on behalf of the committee, gentlemen. It's much appreciated. It's always a pleasure to have you here.

We are adjourned and look forward to seeing the committee on Monday.