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Chair

Mr. Brian Pallister

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● (1105)

[*Translation*]

The Chair (Mr. Brian Pallister (Portage—Lisgar, CPC)): Pursuant to Standing Order 108(2), we are considering the report of the Governor of the Bank of Canada on monetary policy.

[*English*]

We are pleased this morning to again welcome to our committee Mr. David Dodge, the Governor of the Bank of Canada. Sir, we're pleased to have you.

We're also, I'm sure, of mixed emotions in learning of your intention not to continue in your role, and we hope it was nothing we said or did that contributed to your decision.

We welcome you. Please proceed with any introductory remarks you deem appropriate.

Mr. David Dodge (Governor, Bank of Canada): Thank you very much, Mr. Chairman. It's always a great pleasure for Paul and me to meet with members of this committee.

We really do appreciate the opportunity to meet with you a couple of times a year, following the release of our *Monetary Policy Report*. Certainly we think these meetings provide us an opportunity to keep you informed and, through you, to keep the Canadian public informed about what we are doing at the bank, about our objectives for monetary policy and how we're accomplishing them.

[*Translation*]

When Paul and I appeared before the finance committee last October, we noted then that the Bank of Canada's projections fore growth in the Canadian economy had been revised downward slightly from earlier expectations. In our latest Monetary Policy Report, which we released last Thursday, we noted that Canada's economic growth did indeed slow, but recently, inflation has been higher than expected. After considering the full range of indicators, the Bank of Canada now feels that the Canadian economy was operating just above its production capacity in the first quarter of this year.

We expect that, over the projection period, domestic demand will continue to be the main engine of growth in Canada. With the US slowdown now expected to be somewhat more prolonged than previously forecast, net exports should exert a slightly greater drag on Canada's growth in 2007. The Canadian economy is now projected to grow by 2.2% in 2007 and 2.7% in both 2008 and 2009. This will return the economy into its production capacity in the second half of 2007 and keep it there through 2008 and 2009.

[*English*]

Core inflation under this scenario should remain slightly above 2% over the coming months, given pressures on capacity and the impact of higher core food prices, but with the economy projected to return to its production capacity in the second half of this year, and with further easing of pressures from housing prices, upward pressure on core inflation is expected to moderate, bringing core inflation back to 2% by the end of 2007.

Total CPI inflation is projected to rise above our 2% target in the second half of this year, peaking below 3% near the end of this year, before returning to target by mid-2008.

Mr. Chairman, we at the bank continue to judge that the risks to our inflation projection are roughly balanced, although there's now a slight tilt to the upside. Last Tuesday we left the key policy rate unchanged at 4.25%, and this level is judged at this time to be consistent with achieving our inflation target over the medium term.

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

● (1110)

The Chair: Thank you, sir.

We'll begin with Mr. McCallum.

Hon. John McCallum (Markham—Unionville, Lib.): Thank you, Mr. Chair.

First of all, I'd like to congratulate the governor for his great service to the country and for hitting the inflation target right on, I think, in his period in office, and for bringing a certain humanity to the Bank of Canada. I won't go on further in this laudatory way, because I do have a couple of questions I would like to cover.

First of all, you were saying that, if anything, the inflation risk was a little bit on the upside. As you may have noticed, Andrew Coyne, in particular, has been saying that this is the biggest spending budget —a $25 billion increase in spending over two years—and that the percentage increase in government spending has been greater than the average under the past few years of the Liberal government.

So I guess my question is, in view of the fact that we have near record low unemployment and you're saying that the inflation upside risk is a little bigger than the downside risk, do you have concerns that the budget, with its large increase in spending, might be contributing to an overheating of the economy at this time?

Mr. David Dodge: That's a very good question.

What we do is project on the basis of government balance. Our assumption, as we've prepared our report, is that governments at all levels will basically bring in balanced budgets and operate in balance over the course of the projection period, which runs to 2009.

Now, that is an assumption, but it seems to be largely consistent with what has happened both federally and provincially, provided our projections, in terms of nominal GDP growth, actually turn out to be right. As all members of the committee know, government revenues are largely contingent on nominal GDP growth, and that has been running, up until recently, considerably higher than real because we've had favourable terms of trade.

Our projection, actually, has those favourable terms of trade flattening out and coming down, which ought to mean that the very good revenue performance that we've seen both federally and provincially ought to flatten out a little bit.

Now, that's purely a projection. So far we, in Canada, as a number of other countries, have been a bit surprised at how fast personal income tax revenues have grown relative to the growth of personal income. We don't fully understand why. In part, it may have to do with income distribution. We're not absolutely sure. But probably, at least for 2007, if there were a risk on the government balance side, the risk is that government balances will be a little more favourable than our assumption of being in balance.

Hon. John McCallum: Thank you.

On the question of interest deductibility, it seems to me that the acid test for Canada is not what is necessarily the best policy in some academic sense, but that what other countries do is critical. On the question of interest deductibility, as you know, denying our companies that, given that in foreign acquisitions most European countries and the United States and Japan are allowed to do it, puts us at a very significant disadvantage, in terms of Canadian-based companies.

As Bruce Flexman of KPMG put it, this would lead to more “foreign takeovers of Canadian companies, stifling of Canadian investment in global markets, an exodus of head offices and...a weaker long-term Canadian economy over all”.

I guess my perspective would be that one shouldn't throw the baby out with the bathwater, that it's very important for our homegrown companies to be on a level playing field with foreign companies and not to have it tilted in favour of the foreign companies. But at the same time, there may well be abuses or things to fix, in terms of this rule, technical things like capitalization rules, income being attributed to passive versus active business income, all of these things, which could be fixed.

So my question is, would you agree that rather than what might be described as a nuclear bomb approach on this issue, it might have been better—and it still is not too late—to have a more surgical approach, wherein we don't penalize our leading companies, but, at the same time, to the extent there are abuses or problems in the application of this law, we clean those up?

● (1115)

Mr. David Dodge: As you know, I've been before this committee several times over the last two and a half decades on this issue—in the mid-eighties when we tried to deal with this problem and again in the mid-nineties when we looked at it.

First of all, I think all members recognize that this is a very technically difficult area of the Income Tax Act, and trying to deal with abuses without throwing the baby out with the bathwater is just very difficult. We should deal with the abuses, but we have to be careful as we go.

I know that the department and the minister recognize this, and great effort will be taken to try to deal with it in drafting the legislation. The abuses are not something one can condone. On the other hand, as long as we don't deal with the issue of offshore tax havens globally—and they have to be dealt with globally, we can't deal with them individually in Canada—there will be a real problem in drafting the act. I'm sure the minister is aware of that.

Hon. John McCallum: Thank you.

[*Translation*]

The Chair: Thank you very much.

Mr. Crête, you have seven minutes.

Mr. Paul Crête (Montmagny—L'Islet—Kamouraska—Rivière-du-Loup, BQ): Thank you, Mr. Chair.

Good day, Mr. Dodge, good day Mr. Jenkins. Mr. Dodge, I wish you every success for the remainder of your term. I hope it is smooth sailing.

The rising dollar is a matter of concern at this time. Economist Clément Gignac sums things up by saying that we are no longer wondering if parity with the US dollar will be achieved one day, but rather when that is going to happen. Could you tell us your thoughts on the possibility of parity between the two currencies? Obviously factors other than the value of the dollar are at play here, but will the dollar continue to appreciate as it has been doing for some time now?

Mr. David Dodge: As you're aware, there's a lot of volatility when it comes to exchange rates. We've estimated that in the first quarter of this year adjustments in the rate of exchange were more or less in keeping with the movement in commodity prices and the strength of the Canadian economy. Over the last two or three weeks, we have seen some volatility, and it is hard to comment on this. We'll have to wait and see what happens over a longer period of time. What we can say is that during the first quarter, the movement observed was more or less in line with changes in our economy and world prices.

Mr. Paul Crête: You know as well as I do that this has a major impact on manufacturing activities in Quebec and Ontario. Do you think that the tools we have are enough? People have told us that the main reason they've been forced over the past two or three years to make very costly and incomplete adjustments is the rapid rise of the Canadian dollar. We're not only talking about jobs being transferred elsewhere, there are people being affected in their daily lives. Will the current trend you've referred to require a much bigger response and can we continue to expect substantial job losses in the manufacturing sector in the months and years ahead?

● (1120)

Mr. David Dodge: I'll take a stab at that and then let my colleague respond. As we stated the last couple of times we appeared before this committee, we expect the percentage of jobs in the manufacturing sector to drop during this period of extremely high commodity prices coupled with a strong services sector. So, this is no surprise. Now, it is not easy to adjust, especially in the most remote communities, but this is part of an important progression towards optimal value-added in Canada. There are many factors at play, and the dollar is one of them. Asian competition is another extremely important factor. So, there are a lot of factors, but not the...

Mr. Paul Crête: If I can just make one comment. It is true that China is keeping the value of its currency pegged at an unrealistic level. This heightens the affects of Asian competition which benefits from political decisions that may or may not be justified, but that nevertheless also have an impact.

Mr. David Dodge: And that's why we have worked very hard with the IMF, the International Monetary Fund, and other organizations in order to convince the Chinese authorities that it is in their best interests to have a far most flexible exchange rate than what they currently have.

Paul, you have the figures.

Mr. Paul Jenkins (Senior Deputy Governor, Bank of Canada): Yes I do and I'd like to make a few other comments. The exchange rate is an indigenous variable insofar as there are several factors which determine the dollar's movement. A rising dollar reflects, for example, the strength of the world economy, and the progression towards higher-priced commodities. It's impossible for an economy like Canada's to avoid these global factors. Our economy's flexibility, and its resilience to structural changes resulting from global forces play in Canada's favour.

Mr. Paul Crête: At what point would a common currency be more economically advantageous than two separate currencies? When the Canadian dollar is worth 85 US cents, there is still enough of a difference in the rate. However, as we head towards parity, the cost associated with having two currencies would be higher than for a single common currency. Have you already looked at this? When would it become more advantageous? Where would the exchange rate have to sit?

Mr. David Dodge: That is an excellent question, and I'll take a stab at it. There's no exact figure. It will depend on the relative change in the prices of all commodities versus the prices of the manufacturing products. It will also depend on cost adjustments in Canada and on how these costs compare to costs worldwide. To date, cost adjustments in Canada have been less marked than the increase in the nominal exchange rate. Therefore, especially in relation to the US, our real exchange rate hasn't changed. Thus far, the situation in relation to China has been completely different and may change even more down the road, especially since productions costs in China and, generally speaking, across Asia are on the rise. Also, the price of consumer goods that Canada and other countries import is not increasing, but in fact decreasing. So, we may currently be observing a slight change which we are duly taking note of and which may affect our inflation projections.

● (1125)

[*English*]

The Chair: We continue now with Mr. Del Mastro for seven minutes.

Mr. Dean Del Mastro (Peterborough, CPC): Thank you, Mr. Chair. It's always a pleasure to have Governor Dodge and Deputy Governor Jenkins before the committee.

You've brought forward very interesting information.

I just want you to comment. One of the things that was very interesting was that you predicted that domestic demand will be the key driver of economic growth in Canada, whereas in the past we've seen exports actually being the key driver of economic growth in Canada. There were a couple of things that occurred to me on this. The government has brought in a couple of tax measures that I think may well be contributing to the economic growth. One is the reduction in GST, which also helped to mitigate inflation. We've also brought in an accelerated capital cost allowance adjustment for corporations, which should increase domestic demand on fixed assets. I just wondered if you might comment on that a little bit.

Mr. David Dodge: It's hard to comment on all those specifics. Let me just go back one step. During the period of the 1990s and the very first years of this decade, it was exports that were the key driver. We had rather weak domestic demand as federally and provincially we were getting our fiscal situation in shape and we really were relying heavily on foreign demand through that period to drive growth. That was also following the 1997 Asian crisis, when the price of raw materials plummeted, so the relative prices of manufacturers went up.

So we went through a period when it was the external sector that was the key driver. We now move to a period when we've had a big correction in commodity prices, and that is driving up incomes here in this country, so we are seeing the domestic sector be the key driver.

We expect that will continue, but as we get to the end of our projection period, we come much more into balance. You'll notice that by 2008 we expect net exports to be a kind of “net wash”, to not be a negative influence on growth, and maybe as we get out a little farther, this situation will actually turn around again.

Through all of these changes, the thing we've always emphasized is the importance of maintaining flexibility in the Canadian economy. In that regard, our performance in this decade, compared with our performance in the 1970s, when we had to adjust to massive changes in relative prices, has been extraordinarily good. Indeed, we've moved from being a bad performer globally in that regard to being an excellent performer globally.

What's really important in terms of policies both at the federal and provincial levels is that we maintain the drive to keep that flexibility, which allows us to adjust, because as a very open economy we're always going to be subject to pretty large swings and shocks. This time, the last decade looks pretty good relative to our historic performance in that regard.

Mr. Dean Del Mastro: Thank you.

You mentioned “swings and shocks”, but having said that, it looks as though the bank is projecting a fairly long period of stability over the next three years. Reading from the report you brought forward, it doesn't seem to me that we anticipate a lot of changes in interest rates and so forth or in inflation over the next few years.

In the U.S., the story is a little bit different. Their growth isn't quite so good. Is there a potential that the Fed in the U.S. could actually reduce interest rates, which would have the probable effect of increasing the value of the Canadian dollar against the U.S. dollar? Could we see a further rise in the Canadian dollar?

● (1130)

Mr. David Dodge: While the Fed doesn't have explicit targets such as we have, the basic objective of every central bank is to keep the economy operating reasonably close to potential and to hold inflation at very low levels. That's essentially the game we're in.

Going back to your previous question, that becomes much easier to do, from the standpoint of monetary policy, if the economy is very flexible and adjustments can take place. While we've had a lot of success, as Mr. McCallum pointed out, over the last decade, a lot of that success is not due to absolute brilliance on the part of the Bank of Canada but is due to the fact that a lot of Canadians worked very hard to make this economy more flexible over that period. This doesn't mean life is easy, but there's been a lot of hard work going on, and that is really the key to success.

Mr. Dean Del Mastro: If I could, I'll add a supplementary.

I noticed that there was a survey by Canadian Manufacturers and Exporters. A lot of them are anticipating a better year in 2007 than they had in 2006, with higher demand and potentially more employment. It would seem to me that maybe that could be pointing, even though the dollar is higher, towards their actually improving their productivity. Or is it just a little bit of optimism on their part?

Mr. David Dodge: The productivity measure remains to us a bit of a puzzle, as we say in our report. We don't fully understand why it is that productivity has been so weak over the last couple of years. It may be that there was actually more output there. When we get all the revisions and statistics, we may find that there's more output there. It may be, with these big intersectoral shifts going on, that we have been going through a period of time when productivity is depressed as people have to make these shifts from one sector to another.

Finally, of course, within the primary sector, particularly in oil, gas, and mining, when prices are high, the optimal way to use the resource is to actually low grade, and that means that the unit cost of production actually goes up when prices are high.

So there are a number of factors. But I would stick with it. It's still a bit of a puzzle to us.

The Chair: We'll just leave it at that mysterious level and move on to Madam Wasylycia-Leis. You have seven minutes.

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

Thank you, Governor.

First, like my colleagues, I would like to thank you for your years of public service, at least as far as I know, in the Department of Finance, the Department of Health, and then as Governor of the Bank of Canada. You've given a great deal of your life to this country, and we thank you for that and wish you well in your retirement.

Having said all those nice things, I want to question you where I actually first started questioning you when I became the finance critic and you were at committee. And that has to do with the failure of you and your office to really address the crisis in manufacturing.

You continually talk about Canada operating above capacity, or at full capacity, without acknowledging or addressing the fact that the bottom half of Canadians haven't seen any change in their wages. We also have this serious crisis in jobs in the manufacturing sector, with, obviously, the rise in the Canadian dollar—again today—hurting rather than helping that situation.

I think the fact that we've lost one in ten manufacturing jobs in the last seven or eight years, that we've lost good-paying jobs, and that we have many people struggling to make ends meet and not seeing much hope for the future is something we have to constantly focus on. I think that is something you could address as Governor of the Bank of Canada.

I'd like to hear from you if there are some parts of monetary policy that could actually address these concerns.

● (1135)

Mr. David Dodge: There are really two issues you've raised, and they're both important but different. The first is the evolution of income distribution in this country.

For the last 20 years we have seen the distribution of earned income actually grow more unequal. Now, we are certainly not a world leader in this increasing inequality, but earned income is clearly more unequal as we sit here in 2007 than it was in 1987, or in particular than it was in 1977, at the end of the last long productivity boom.

This is a global phenomenon. Part of it is obviously due to technological change, part of it is due to the fact that markets have gone from being local to national to being global, and that tends to pull the income distribution apart.

In this recent issue of the IMF *World Economic Outlook* there's an interesting chapter on that, but it is quite clear—and this isn't a manufacturing/non-manufacturing issue—it doesn't matter what sector you look at, you see this pulling apart of earned incomes. This is a real issue going forward.

Historically we've gone through periods like this, and it tends to reverse itself over time, but it is certainly one that is worthy of study and reflection on the part of this committee and on the part of Parliament.

I think that actually is an issue that is quite different from the relative shares of employment we have in manufacturing services and primary industries. We had really quite a sharp increase in the share in manufacturing employment in the 1990s, when we had really rather depressed resource prices and when we had to crowd in some employment because governments were subtracting from the economy over that period. So it's actually not surprising that when those conditions reverse, we would see some decline in the share of manufacturing.

I guess what I would say is it's not the fact that there's an absolute decline in manufacturing employment; that is, in a sense, part of the normal working of the economy. What is really critical is, is that being driven because we are becoming globally less productive than others, or is that driven, as I said, simply by the evolution of prices? That is a serious question, and it is a serious issue for Parliament and for the government as to what policies ought to be in place to support reasonable levels of investment in the manufacturing sector so that we can actually increase the productivity.

● (1140)

Ms. Judy Wasylycia-Leis: I appreciate all of that. I guess I still wonder if there wasn't something that could have been done over the last few years from your office in terms of using monetary policy to lessen the impact or to help address the looming crisis and the present crisis in the manufacturing sector. There are those who think that was possible.

I just want to quote from Andrew Jackson, who has said he appreciates all of the consultations between your office and labour and people who have been raising these issues, but he does say that he thinks monetary policy as a whole should and could have somewhat lessened the scale and severity of the current manufacturing jobs crisis.

I guess I'd like to know if there are regrets you have around not addressing this issue, or if there's anything you would say to your successor on this front. Or is it only something you think Parliament can address and it's not related to monetary policy, and if there isn't in fact—

The Chair: Your time is well past.

Regrets, you have a few. You can mention them later, Mr. Dodge, in response to another question, perhaps from Mr. McKay, who has five minutes for his questions.

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

I too want to add my thanks for your public service, Governor, but I also want to thank you for your personal decency over the number of years that I've been here, on both sides of the table. Your willingness to engage particularly those of us who are not formally trained in economics and try to explain to us some of the intricacies is much appreciated. I personally want to thank you for your efforts to help educate us all.

I want to go back to Mr. McCallum's question with respect to interest deductibility. What we have at the present time is a statement in the budget that says interest deductibility won't be allowed. We read in the press that the minister seems to be backing down on this rather blunt statement in the budget, and now, instead of having an immediate application, maybe he'll extend it over 10 years, or phase it in over 10 years. But it's kind of hard to see how the statement as recorded in the budget can actually be modified.

He has certainly caught an earful from the business press and he has certainly caught an earful from those of us who actually think about these issues. As you've rightly pointed out, this is an extremely delicate area. One can't just simply blunder into it and hope that, somehow or another, all the rest of the countries in the world will go along with us.

So I am encouraged by your remarks. What I'd like to hear is whether you think the minister's statement, the statement that he seems to want to prolong this process, is actually a viable solution or whether he should actually be going back to the drawing table and dealing with those abuses that would offend all of us.

Mr. David Dodge: Look, no minister of finance wants to throw the baby out with the bathwater, and I'm sure this minister of finance doesn't want to do that either.

This is a technically difficult area. At the same time, it is annoying, it is revenue loss, and it brings the belief of Canadians that we have a fair tax system into question when there are some practices that actually go on. The great difficulty is to try to contain those practices that are clearly abusive and not within the spirit of the act, while ensuring that the act does encourage Canadian companies to grow globally. That's the very difficult technical job of actually writing the law to accomplish the goal that I think the minister stated, to stop what appear to be abusive transactions.

All I can say is, from my own experience, that is something that we definitely ought to go at, but it's not going to be so easy from a legal, law-writing, regulation-writing perspective, and the minister is perfectly aware of that.

● (1145)

Hon. John McKay: I don't disagree that this is an extraordinarily complex area—issues of extraterritoriality, the application of the income tax provisions to other jurisdictions. There are ways in which companies conduct their other business. But it seems to me that the minister has chosen to use the bluntest instrument possible in putting the statement in the budget and then leaving everybody to wonder how in heaven's name this is going to affect them, particularly with respect to, say, businesses contemplating the acquisition of foreign assets. It does strike me as something less than a nuanced application of what we all agree is an extraordinarily complex area.

Mr. David Dodge: I won't comment on nuances. It is complex. I guess all I would say, from my conversations with the minister, is that he fully recognizes the complexity of dealing with it, but also the importance of having an Income Tax Act that appears to be reasonable and fair, because after all, we rely largely on voluntary compliance. So I think it certainly is an issue that is very much worthy of being dealt with. But it's not easy, and certainly I did not take the statement that everything would be done in a blunt manner. The intent is to move forward to find a way to do this efficaciously, I think.

Hon. John McKay: Thank you.

The Chair: Thank you, Mr. McKay.

Certainly we recognize, Governor Dodge, that the issue of deductibility is complex. We know it has been an ongoing issue for some time. Members of this committee are aware of numerous reports of auditors general who have highlighted this as a serious and growing concern. And despite that advice and the advice of others, such as Jack Mintz, in his business taxation report, no action has been taken to date.

Mr. McKay's comments pertaining to the degree to which the minister is communicating his concern about the issue are quite valid. But I wouldn't want anything that Mr. McKay or others have said to indicate that it was the position of this committee that action should therefore not be taken because this is a communications challenge. I don't think that should be the message going out.

We'll have Mr. St-Cyr for five minutes.

[*Translation*]

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

I'd like to come back to the fight against inflation. Canada's economy is not homogenous. It is diversified and economic conditions in Quebec's industrial sector are different from conditions in Alberta or the West. In many cases, we are currently experiencing an overheating of the economy, major expansion, a high inflation rate, rising rental and commodities costs, etc. Everything is going through the roof, except in Quebec, where conditions are quite the opposite. Many sectors, including the manufacturing sector, are facing major problems in terms of growth.

Bearing this in mind, by definition, any anti-inflation policy will necessarily benefit, and be more useful, to Alberta and other provinces in the West which are facing problems with inflation, than it will be to provinces like Quebec or even Ontario, where these problems don't really exist.

In developing your anti-inflation monetary policy, how do you reconcile these two realities, these two different economic structures, so that everybody fairs well?

● (1150)

Mr. David Dodge: You're entirely right, it's always hard when there are major fluctuations in the relative prices of commodities. The manufacturing sector is indeed far more concentrated in the Montreal region, in southern Ontario and in Winnipeg. That means that when the price of manufactured goods drops, in relative terms, the situation is much worse in these regions which have to bear the burden of the adjustment. The situation was completely the opposite in the mid 90s when the price of commodities slipped. It was harder at that time for Alberta and the other regions in Canada which rely on the mining industry. There are always these kinds of adjustments, and in Canada, given that the various sectors are concentrated in certain regions, it's even more difficult because you can't simply quit a job that is 10 kilometres from your home and find another one that is five kilometres away.

This has always been the case. And in that sense, this answers Ms. Wasylycia-Leis' question. These kinds of adjustments are important. And it is important to have policies which facilitate, rather than hamper, these adjustments.

Mr. Thierry St-Cyr: So if I've understood you correctly, you can try and maintain the inflation rate at between 1% and 3%, at Canada's traditional level, but it's possible that in certain regions our policy won't be aggressive enough because of higher inflation, whereas in another region, the policy will be overly aggressive. There's no real way of regionalizing our policy. This is why it is a national policy.

Mr. David Dodge: We cannot do things differently. It would not be a good idea to have a regional policy because it's important that less profitable industries' and companies' resources be transferred to more profitable industries. That's how we maximize our financial well-being. Such transfers are nevertheless difficult, especially in Canada, because the industries are concentrated in certain regions.

Before I hand the floor over to Paul, I'd like to point out that the services sector is extremely important. The value-added component of the financial and engineering sector is very high. These industries are concentrated in the Montreal region and south of the St. Lawrence. Some of them required specialized workers and some jobs were transferred from manufacturing industries to services industries. Such transfers are important.

The Chair: We'll continue with Mr. Wallace.

[*English*]

Mr. Mike Wallace (Burlington, CPC): Governor, thank you for coming today, and of course thank you for your service to Canada.

I just have a few questions for you. I did read over your monetary report that you had given me. To be frank with you, I didn't understand everything completely, but that's part of the learning process that I'm here for.

One area that I found of interest was household credit. You say in your report that you don't really have a great model to capture household credit, but you're using other people's information. When I look at the chart, household credit is going up significantly, but you say that despite higher indebtedness, households remain financially sound. Can you tell me, from an individual Canadian's point of view, what the effect of larger debt is in terms of your overall view of how the economy is working?

● (1155)

Mr. Paul Jenkins: Perhaps I can respond to that. We do track these credit numbers very, very carefully, both household credit and business credit, in terms of other indicators that we look at, in terms of the overall performance of the Canadian economy. In the case of the household sector, in looking at the growth of household credit, we take a balance sheet perspective, so we look at the rate of growth of household sector credit, but we also, obviously, look at what that credit is being used to purchase, what's on the asset side of the household sector balance sheet. You then need to drill down to the net worth of the household sector. You want to be satisfied that if they're taking on additional credit, the assets they're acquiring, whether they be financial or real, retain their value so that the overall net worth of the household sector continues to grow.

The other factor that we look at very carefully is the debt service ratio for the household sector. The fact is that the debt service ratio, notwithstanding the increase in overall household credit, has remained very, very low, and of course that is a function of the fact that we have very low interest rates in Canada. That's one of the byproducts of a low, stable inflation environment.

Mr. Mike Wallace: I appreciate that.

We talk about exports of raw materials being under some pressure because of the U.S. economy but that manufacturing exports are up, and a few other areas. Is that in relation to each other, or is that separate from each other? Is manufacturing up compared to the decline, or is it real, actual numbers—manufacturing exports are up? I wasn't sure whether there was a combination there or not.

Mr. Paul Jenkins: No. In terms of overall growth rates, we see exports rising, but not at as rapid a rate as imports are growing.

Going back to one of the earlier discussions about the strength of domestic demand in the Canadian economy being one of the main drivers, linked to it has been a fairly strong growth of imports. When you net those out, net exports actually have been a drag on the Canadian economy through 2006. We're looking to see net exports remaining a drag this year and, as the governor noted earlier, basically becoming neutral in 2008 and 2009.

Yes, we are seeing exports growing, but not as rapidly as imports, given the strength of the domestic economy.

Mr. Mike Wallace: You also show a chart that has crude oil and natural gas pricing going up, from my perspective on a relatively straight line up.

I have two questions. One, is that due to demand or is it due to supply? And what does this do to our inflation rate?

Mr. David Dodge: Well, which blade of the scissors cuts?

It truly is that we have global demand. Certainly what markets think is that over the relevant time horizon, global demand is going to grow perhaps at the rate of supply or slightly faster, so you get a futures curve that has a bit of an uptick to it.

We're not experts in the oil industry. There is no model that we have found that does any better than using as an assumption what the market has out there for futures prices. That's not very good either, but it's the best we have, and that's why we use it.

● (1200)

The Chair: Mr. Wallace.

Mr. Mike Wallace: We spend a lot of time considering the value of the Canadian dollar vis-à-vis the United States dollar. What we don't spend a lot of time on is the value of the Canadian dollar versus that of other currencies outside of this continent.

Would you like to speak a little bit about the opportunities and the challenges that may be presented to Canada as a consequence of the downward direction of the U.S. dollar versus other currencies outside of North America?

Mr. David Dodge: That's an extraordinarily good question. We spend a lot of time working on this issue.

First of all, think of the world as one gigantic closed economy. We don't trade with Mars yet, but we trade a lot with each other. What we are experiencing is a rather prolonged period now in which the United States has been the principal absorber of savings. Their savings have not matched their domestic investment, so they've been sucking in imports. Asia and, with the rise in oil prices, the Middle East have been the big suppliers of savings to the world. So you need an adjustment to go on.

Part of that ought to be some appreciation of exchange rates for the Asian countries and the Middle East. Part of the adjustment ought to be that their domestic demand has to grow a bit faster. And part of it is that the U.S. domestic demand is going to have to grow a little bit more slowly over a period of time. That's the basic adjustment that we know has to go on, and it's the basic adjustment we've been pointing to in G-7 communiqués for quite a while now.

The question is, what policies will facilitate this in the smoothest manner to allow the world to continue to grow at something close to 5%? Therein is the great challenge. It's a challenge for everybody, but it's a challenge for us because of the structure of our economy.

What we've been working on is essentially a three-pronged strategy: first, to get more flexibility in exchange rates around the world so that all the burden doesn't fall on countries such as Canada, Australia, and the U.K., which have flexible exchange rates; second, to try to persuade the Asian economies to take the social measures and other measures to reduce the amount of their precautionary savings so that they increase their demand; and finally, of course—the other side of the coin—the United States has to do a little bit to rebalance the weight that goes on consumption.

This is a very tricky thing, and provided everybody is moving roughly in the right direction and roughly quickly enough, the chances of a relatively smooth adjustment to that situation are high. To the extent they're not—or even worse, Mr. Chairman, that they're perceived not to be—playing by these general rules of the game, there's a huge danger of protectionist sentiment building up. For us in Canada, that would be an absolute disaster, because we'd be caught in the tailwind of U.S. protectionism that, at least ostensibly, was aimed at Asia but sweeps us up in the process. That, then, can lead to a downward spiral in global growth.

That's what we as a country, whether in the ministry of finance or whether as ourselves at the Bank of Canada, have been working extraordinarily hard to try to promote. But it's not easy.

The Chair: Thank you, sir.

Mr. Thibault, you have four minutes.

Hon. Robert Thibault (West Nova, Lib.): Thank you, Governor, and thanks for being here once again.

When we talked about interest deductibility, you pointed out the risks to it and also the good points or the reason to do it. It seems to me there is a risk that announcing you will be doing it without having the plan in place could bring uncertainty to people as to their investments in Canada, and to head offices in Canada, and those things. But that's not the point I want to raise with you today.

I want to talk about the consumer price index and inflation. Being from the east, we're getting hit with a double whammy now, with the rise in the Canadian dollar—which is the negative side of our success, because we export a lot of fish and a lot of products such as tires into the U.S. market and are at a disadvantage vis-à-vis the situation with a lower Canadian dollar—and with the increasing price of energy for gasoline, diesel, and all of those products. It costs us more to harvest our fish, it costs us more to ship our products, and our energy is high.

If I speak to a household or a small business, they will tell me their inflation rate is a lot higher than 3%. When I look at your figures for domestic consumption, showing an increase in the 4% to 5% range, they would tend to point to a lot of that being on the energy side also. The energy side, in the basket of goods being bought, is disproportionate to all other items in those areas.

Can you tell me whether you've made those calculations, if you can identify them, and whether you see ongoing risks for the future?

● (1205)

Mr. David Dodge: First of all, you used the word “disproportionate”. We spend a lot of time worrying about the consumer price index, obviously. We are probably Statistics Canada's most avid critic—in the good sense of the word—of what they do. We think our consumer price index in Canada is certainly among the best in the world, probably better than consumer price indices almost everywhere else in terms of its representativeness.

When the prices of products you purchase regularly move up, it always seems that's what is really going on. The most regular purchase, and the one everybody knows, is the price of gasoline. Even if you don't purchase it, you pass the signs on your way to work every day. And everybody knows the price of basic foods, because you're buying bread, milk, eggs, and so on every week. So you are highly aware of what's happening in those movements. It is absolutely true that gasoline and fuel prices have been going up very much more rapidly, so you think the whole index is moving more rapidly. With the rise in the price of grains recently—and that feeds fairly rapidly through to dairy products, chicken and so on—you see that. So on these frequently bought items, you think Stats Can must be wrong, but—

Hon. Robert Thibault: Especially if you're at the lower end of the income scale—

The Chair: *Je suis désolé, Monsieur Thibault.*

Hon. Robert Thibault: —where it could be 90% of your purchases

The Chair: No, no. Excuse me, sir. Out of fairness to other committee members, I'm going to have to be unceremonious and cut you off at this point.

We continue now with Mr. Dykstra. You have four minutes, sir.

Mr. Rick Dykstra (St. Catharines, CPC): Thank you, Mr. Chair. I certainly appreciate your judgment in these matters.

I do have one off-topic question, Mr. Dodge, that I do want to ask you. One of the things I've noticed over the years is that when very competent and well-educated, well-positioned folks who work in the civil service move on to new careers, they come back to the areas where they served government. I wonder if that is your plan or whether you plan on heading up to the cottage.

Mr. David Dodge: I'm going to take six months off. I've worked for 40 years without a break, and my wife thinks it's time. She may regret that. Over that six months I'm going to think about what I will do next, and hopefully I'll find something useful to contribute.

● (1210)

Mr. Rick Dykstra: All right. Well, I would take bets that we may see you back here again at some point in time—presenting on behalf of someone. All the best.

One of the questions that I certainly thought Mr. McCallum was going to ask this morning—he's asked you pretty well every time we've been here—was on income trusts and the changes that have happened over the last number of days, weeks, and months.

Obviously, it had an impact, but at least from updates I've read over the last couple of days, there have been significant changes in terms of the direction they have gone—in a positive way. I wonder if that has had any impact on your outlook in terms of the Bank of Canada, but also from a monetary perspective, that in fact we have taken the right direction.

Mr. David Dodge: Obviously, we have two interests, generally. One is the efficiency of markets. On the income trusts as a corporate form of organization, what we said, and what our analysis showed, was that it's a perfectly sensible corporate form of organization in appropriate circumstances. But second, there appears to be no valid reason to have the tax system tip the corporations or entities towards choosing that form of organization vis-à-vis another form of organization.

I guess more fundamentally, and deeper, the one thing we worry about at the Bank of Canada, along with I think central banks almost everywhere, is that there seems to be a lot more global liquidity out there than one might have anticipated, given the rate of growth, of base money, whether you look at Europe, the United States, Canada, or elsewhere. That's clearly come because of changes in the structure of financial markets, changes that we think, by and large, have led to the improved distribution of risk. But they are changes that also seem to mean that there's a lot more liquidity out there, and what we call the “risky spreads” seem to have become pretty narrow. Indeed, we're off to Basel this weekend to meet with central bankers, and this issue will again come up.

This, fundamentally, is an issue we continue, with central banks, to worry about. It may mean, with the changes in financial markets, that we have to look at things a little bit differently going forward. There's a lot going on out there. This is a very real issue.

Mr. Rick Dykstra: One of the—

The Chair: Sorry, you have no time.

Mr. Pacetti, you have four minutes.

Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.): Thank you, Mr. Chairman, and thank you, Mr. Dodge, for appearing.

I think you're only going to retire in January, so I believe we'll have another chance to see you in the fall.

Mr. David Dodge: Yes.

Mr. Massimo Pacetti: So I won't say that it was nice working with you, because we only have four minutes.

Voices: Oh, oh!

Mr. Massimo Pacetti: I'm going to try to keep responses limited, because I want to try to narrow down where the Canadian economy is going to go in relation to the U.S.

If we remember, some of the cries six months ago were that if the American economy was going to falter or slow down, if Americans were going to stop spending, the Canadian economy would falter and the Canadian dollar would also go down. That doesn't seem to be happening. I think you answered that question. But if we narrow it down, what are one or two indicators, if I can limit it, we have to be on the lookout for that show that Canada could fall into the trap and follow in the same footsteps as the Americans?

Mr. David Dodge: First of all, we're looking for the American economy to grow relatively slowly in 2007, but to go back, roughly, to potential in 2008-09.

What is the weak part of the U.S. economy? We think housing—residential investment—will continue to be weak right through 2007 and 2008. That has a big impact on us, not just for lumber but for other products. And we have a little box in here. So that is probably the biggest single factor.

The one other factor that has been a worry is automobiles. The inventory correction now appears to be largely over, and while we won't see 18 million units a year being sold in the United States, we should see sort of normal demand return.

● (1215)

Mr. Paul Jenkins: If I could just quickly add something, the other point here is to keep a perspective on what's happening to the global economy overall. The fact that we have a rather robust global economy, notwithstanding the slowing in the U.S., of course, has important implications for Canada through commodity prices in particular generating a lot of income. So one of the points we've been continuing to focus on is the importance of looking at a very important issue, which is the U.S. slowing, but making sure we look at it in the context of what's going on globally.

Mr. Massimo Pacetti: I understand, and that's why I'm trying to condense this.

Again, because our economy is so attached to the U.S., we could look at it conversely. If the U.S. economy were to recover rapidly, for example, if the housing recession declined or the depression or the slowdown stopped slowing down, and if the Canadian economy were to bear the fruits of some of that, would there be an expansion? Would the Canadian economy have the capacity to expand, or are we running at full tilt?

Again, I'm using that example, but I'm sure there are others. Let's focus on the housing sector and the automobile sector.

The Chair: You have approximately one minute to answer that one, Mr. Dodge.

Mr. David Dodge: Yes. Unfortunately, I have to answer the question by saying it depends. If all of a sudden we were to indeed see firm residential construction take off in the United States, we have the capacity to meet that. We have lots of lumber mills that are not operating at full capacity in this country.

Mr. Massimo Pacetti: But what happens if it's for resources where there is no room for capacity? What happens to the Canadian economy?

Mr. David Dodge: Well, then there's more upward pressure on inflation in Canada.

Mr. Massimo Pacetti: Thank you.

Thank you, Mr. Chairman.

The Chair: *Merci beaucoup.*

We'll now continue with Mr. Del Mastro.

Mr. Dean Del Mastro: Thank you, Mr. Chair.

Mr. Jenkins, you spoke about the broader global economy. I want to go back to that for a moment, if I could.

Certainly, we see emerging economies. They're growing quite strongly. In fact, in the case of China, some would argue it's growing too strongly.

Canada hasn't cut a lot of bilateral trade agreements over the last number of years. We see that the government is investing a lot in the Asia–Pacific gateway as we try to decrease our dependence on the U. S. market for our overall economy. Could you talk a bit about the importance of furthering trade specifically with the Asia–Pacific Rim?

Mr. Paul Jenkins: Broadly, I think the importance of seeing trade continue to grow globally is a critical issue.

The governor talked about it in terms of the reverse, where the risks of protectionist pressures will take hold if the world economy doesn't move forward in terms of dealing with some of the imbalances that exist right now, the imbalances in terms of the U.S. current account deficit and the large surpluses you're seeing in countries, particularly in Asia.

For the continued strong growth of the global economy, world trade needs to continue to grow so that everyone can have a part of the growing pie. From our point of view, one of the elements that's also critical there is to have a global monetary order, as we call it, that facilitates the growth in trade.

Yes, from the point of view of what is beneficial to the global economy and what is beneficial to the Canadian economy as an open economy, I would say a continued effort to promote growth in world trade is indeed important.

Mr. Dean Del Mastro: Thanks very much.

Governor Dodge, generally speaking, there's an inverse relationship between the price of gold and the price of oil.

You mentioned the surplus of China's reserves in U.S. dollars. I think they're holding about $1 trillion in U.S. reserves right now. As they've been somewhat funding the U.S. overall deficit, they've been eating up about 75% of the world's savings.

If they were to want to take away some of their exposure to the downside risk of the U.S. dollar and invest it in precious metals, it could adversely affect the overall valuation of the U.S. currency broadly, could it not?

● (1220)

Mr. David Dodge: Yes, but let's be quite clear. Whether it's China, Europe, the United States, or Canada, it's in the interests of everybody to have the resolution of these imbalances take place in a smooth manner. It's in the interests of everybody domestically. It's in the interests of no one to do something foolish.

The question is this. Can we do enough to get a smooth adjustment so that the protectionist pressures Paul mentioned don't build up? That's the real danger.

Mr. Dean Del Mastro: Okay.

Do I still have time, Mr. Chair?

The Chair: You have one minute, sir.

Mr. Dean Del Mastro: Thank you very much.

I'd like to go back, if I could, with respect to the overall potential upside for Canadian trade.

We've heard a lot about being at a type of labour disadvantage or a cost disadvantage to some of the trading nations in Asia. I'm curious. As we look towards setting up greater trade with Asia, could you outline this? Does the bank have any opinions on where we may have competitive advantages and where there may be gains for the economy? Obviously, when you're looking to set up trade agreements, you're looking for competitive advantages to expand.

The Chair: *Le prochain, monsieur Crête.*

Mr. David Dodge: Could I just make one comment there?

The Chair: Yes, okay.

Mr. David Dodge: It's really important that we in Canada push for multilateral arrangements, because we're small enough and exposed enough that we will not be able to derive the great advantages from bilateral arrangements that larger economies can. And once the world breaks into a whole bunch of bilateral arrangements, in fact historically that's been highly impeding to trade and will really not benefit us.

[*Translation*]

The Chair: Thank you very much, sir.

Next on our list is Mr. Crête.

Mr. Paul Crête: Thank you, Mr. Chairman.

I'd like to come back to the dollar's value in relation to a single currency. You spoke about criteria. What level, whether it be 95 cents, 96 cents or $1, would be good enough for the Canadian government to seriously consider this option?

Mr. David Dodge: It's important that our unit cost remain competitive. Some variations in the Canadian dollar's nominal exchange rate do not necessarily lead to a variation in the real exchange rate. Even though the nominal exchange rate has, overall, been higher in recent years, our unit costs haven't increased much. The real exchange rate in relation to the US dollar has remained virtually unchanged.

Mr. Paul Crête: I need to have enough time for another question. I'll ask you the question right away and then you can finish your answer.

Mr. David Dodge: In any event, we have...

Mr. Paul Jenkins: It's important to control the inflation rate in Canada because, recently, Canada's inflation rate has been lower than the US's. In real terms, the dollar is relatively stable.

Mr. Paul Crête: Yes it is, but it's currently being controlled. Oil and the West are very important. In a broader North-American context, the variation may in fact not be as great as in other parts of Canada, such as Quebec and Ontario. Is this possible? If we had a single currency in North America, would there be less of an impact on the regions than we're currently seeing in Canada as a result of rising energy costs?

Mr. David Dodge: Such adjustments are always difficult to bear when relative prices change as they have over the last three years. Canada should be proud of its economy's capacity to bear these adjustments, especially in the manufacturing regions like Montreal, Winnipeg and Southern Ontario.

● (1225)

Mr. Paul Crête: What other things can Canada and international community do to get China to increase the value of the yuan more quickly? In my opinion, this is one of the keys to Canada's access to the American market. We are losing a substantial share of the US market partly as a result of that.

Mr. David Dodge: We need to work closely with the Chinese authorities. We have a good relationship with the People's Bank of China. It isn't easy for them either. We are used to leaving it up to the market to make the necessary adjustments. Since it's a matter of maintaining control, they're afraid of making adjustments to relative prices, even though it would benefit them a lot.

Mr. Paul Jenkins: The prospect of a higher inflation rate in China is very real. The scenario of a fixed exchange rate accompanied by a stockpiling of cash reserves could lead to a higher exchange rate and, consequently, to a stronger yuan owing to an increase in the inflation rate.

The Chair: Thank you, Mr. Crête.

[*English*]

Housekeeping first. For committee members who are interested in discussing the motion we have received from Mr. Pacetti, we'll be discussing that on Thursday. In advance of that we'll have a steering committee meeting at 11 for half an hour, prior to the committee in full devoting an hour and a half to the discussion of both Mr. Pacetti's motion and the pre-budget consultation process, because the two are of course linked. In terms of the time we have available for one or the other, we must discuss them at the same time, and we'll do that on Thursday.

I have five or six more questioners remaining.

Ms. Judy Wasylycia-Leis: I have a point of order in terms of my motion.

The Chair: I'll finish my comments and then I'll go to your point of order, Madam Wasylycia-Leis.

I will endeavour to include everyone in the questioning, but I'm going to continue with the normal practice I've used in every other bill, for every other witness, and each discussion. I don't want to depart from that. It's not out of a lack of a desire to deal with Mr. Pacetti's motion; it's simply because we don't have the time today available to do both this and that.

On a point of order, Madam Wasylycia-Leis.

Ms. Judy Wasylycia-Leis: You didn't give any indication of my motion, which has been before the committee for some time.

The Chair: We'll discuss it at the steering committee on Thursday. Please bring it forward at that time and we'll have a discussion about how we'd like to proceed to deal with your motion.

We won't have time to deal with either your motion or Mr. Pacetti's motion.

Ms. Judy Wasylycia-Leis: I wondered why you mentioned Mr. Pacetti's motion.

The Chair: There's been considerable lobbying and back and forth on the timing of dealing with his motion and this is why I address it now.

We'll continue with Mr. McCallum now, for four minutes.

Hon. John McCallum: Thank you.

I have a follow-up to Mr. Dykstra on the governor's future. I note that if the Bush-Harper axis fails to defend Mr. Wolfowitz, there may be a position opening up at the World Bank in the not too distant future, but that's not my question.

To the governor on the question of—

The Chair: Thank you, Mr. McCallum, for letting us know it wasn't your question.

You have a couple of minutes remaining, and I encourage you to address Mr. Dodge in your comments.

Hon. John McCallum: Thank you very much, Mr. Chairman.

On the question of babies and bathwater, I think you've twice said it's difficult, but important, not to throw the baby out—the baby in this case being the ability of Canadian companies to compete on a level playing field in their overseas expansions.

I would contend that if you have a bad policy that is delayed, it's still a bad policy. My contention would be that if the minister simply delays the implementation of his broad-brush policy so we get the baby thrown out later, rather than sooner, it's not a good outcome.

My question to you is, is it desirable that the policy be altered to protect the ability of Canadian companies to compete on a level playing field, rather than simply delay the date at which they will be unable to so compete?

● (1230)

Mr. David Dodge: In all tax legislation, as you know, transition is absolutely critical regardless of what you're going to do, but at the same time, the credibility of the whole tax system does come into question. This is the very difficult issue we struggled with in the 1980s and again in the 1990s. I'm not saying it's easy, but I think it is important that we try to deal with it, if possible. That's the technical job the department, the minister, and you as a committee will have going forward. I can't really help you very much more than that.

Hon. John McCallum: On the point of principle you made about the baby, we don't want to throw the baby out in two years or ten years, do we?

The Chair: Can I get some clarification on this baby? What exactly are we talking about here?

Mr. David Dodge: One has to be careful. The issue is that of a Canadian firm wanting to do an expansion abroad, that expansion is being financed by debt, and whether that debt ought to be deductible against the normal business operations here in Canada.

In principle, what one would say is that if it's part of their normal business operations, if it's not feeding through a tax haven to get some special deal, it shouldn't be very different from doing an expansion here, because indeed what you're trying to do is build a global enterprise that's of great benefit to all Canadians.

The problem is, to write a law that allows companies to do that and doesn't allow all sorts of fancy games to hide revenue offshore—to feed it through tax havens and so on—is an enormously difficult job. That's what you would like to do. That's what the minister, I took it, intends to do. All I would say from my own experience, is that it is a very difficult job to get right, but it's certainly something that the minister, the department, and this committee ought to try to do.

The Chair: Thank you, sir.

We'll continue now with Mr. Wallace.

Mr. Mike Wallace: Thank you, Mr. Chairman.

I have a few technical questions from the piece here. They're probably not that technical, but they are to me and I think to the general public who are watching.

I need to understand what the difference is between a chain price index and the consumer price index. I don't understand what the chain price index is, to be perfectly frank.

Mr. Paul Jenkins: Very simply, there are two ways of measuring prices. One is a consumer price, such as the consumer price index, so it represents the increase in prices for a basket that is deemed to be representative. The other way of measuring prices is in terms of producer prices, the price of goods that are being produced by manufacturers, by the service sector. This chain price index is a producer price index linked to our national account. So they're conceptually quite different, and this chain price index can be very much affected by the swings in trade that we've been talking about.

So it is a technical question. That's a technical response. It's the difference between a consumer price and a producer price.

Mr. Mike Wallace: Right. So if I understand correctly—and you've used it here today a few times—when you say core price index, that excludes some of the more volatile things. I think the list includes fruits and vegetables, gasoline, inner-city transportation—I don't know what that is, but I guess it's transit—tobacco, and mortgage interest costs.

Who made the decision to exclude those things?

Mr. David Dodge: We did a study, and we continue to study this issue. Our best estimate was that constituted or gave us an index that was the best forward-looking indicator of where consumer prices were likely to move, because our policies act only in a forward manner.

We actually calculate three or four others, which we publish on our website as well.

● (1235)

Mr. Mike Wallace: The average guy on the street I've talked to talks about the consumer price index. You've provided me in chart 1 a range within which, I'm assuming, you as a bank try to keep inflation. Is that an accurate statement? Is that what that means?

Mr. David Dodge: Our target is to keep total CPI inflation, including these volatile—

Mr. Mike Wallace: Including those?

Mr. David Dodge: Yes, that's our target.

We recognize that those elements are volatile, so we're likely to bounce around our target a little bit. The band of one to three gives you the normal range you might expect that total CPI to bounce around. It's not that we're happy if we're at three or we're happy if we're at one. We're happy only if we're at two, but we do expect the thing to bounce around.

Mr. Mike Wallace: Okay. So when I look at this chart, halfway between 2002 and 2003 all three indices, total CPI, were significantly up. And then, from a Bank of Canada perspective, that forces you to make a change in the monetary policy to try to bring that back down.

Is that what you're using?

Mr. Paul Jenkins: Yes.

As the governor indicated, we need to be forward-looking. Monetary policy works with lag, so any change of interest rates today, for example, would have an impact on the economy and on inflation, a full impact, only out 18 to 24 months. So we need to look ahead.

What we do is look at all of the trends in the Canadian economy to get a sense of what we think the underlying pressures are on inflation. That's why we look at a core measure, because you wouldn't want to respond to a volatile movement if it was temporary. The objective certainly is always to bring inflation back to our 2% target as we look out over what I would call that policy planning horizon.

The Chair: Thank you, Mr. Wallace.

Mr. Mike Wallace: That's it?

The Chair: Back to this baby. This incredible desire not to throw the baby out with the bathwater is interesting to me.

The AG's reports, and there are Stats Canada data in the last one, right back to Denis Desautels, have talked about the use of offshore tax havens, and it's growing. In the last couple of reports it has been growing exponentially, and this is in part because there's a perceived advantage, obviously, of paying less tax offshore. Clearly that's the motivation, and that's okay.

What we're talking about, apparently, with this budget proposal is addressing the issue of interest deductibility to remove one incentive to move money offshore. Correct? Okay.

If the Barbados and the Bahamas and Cyprus were such wonderful places to develop businesses on their own, that would be one thing. But to talk about flowing billions of dollars out of Canada, investing it there, and then writing off your interest here obviously creates a smack of unfairness in the minds of people who are not able to do that, who are out working and paying their taxes. I think this is really at the heart of the motivation around dealing with this issue.

Rather than let the baby soak in the dirty bathwater, I think there's a need to try to determine how we can address this issue. You've spoken rather clearly and well about the difficulty in determining what is a legitimate offshore investment and what's simply an attempt to defray your own costs here in Canada. That, we understand, is challenging.

I understand we're talking about hundreds of thousands of these types of entities that have been established offshore that are now being used by Canadian companies, and that Canada is one of the fastest growing countries in terms of making use of these types of structures. Is that true?

Secondly, in terms of the repatriation of profits earned offshore—Mr. McCallum spoke about levelling the playing field—do other countries allow you to borrow money corporately or individually, say corporately in their own jurisdictions, write off the interest, take the money, put it offshore, pay little or no tax on it, and then repatriate it tax free?

Are we in a playing field with a bunch of countries around the world who do that, or are we one of the only jurisdictions that allows that particular tax incentive to exist?

● (1240)

Mr. David Dodge: I wish I could answer that question as of 2007. I worked on this back in 1996-97. All I can say is that at that time our problem was that other countries in fact allowed all of these games to be played. So our firms would have been at a serious disadvantage if we had closed the thing up tight.

The real issue here, and it's on the tax haven side of it, is that unless collectively the European Union, the U.K., the U.S., ourselves, Australia, and the Japanese really went at this full bore, it's very hard for any one individual entity to go at it because they then make it difficult for their folks.

I can't answer your specific questions because I am now ten years out of date in terms of what goes on. You really should ask the Finance officials on that.

The Chair: Would it be—

Mr. David Dodge: It's a very difficult, highly annoying, highly frustrating issue, because the appearance here of all sorts of bad things and the actuality of some bad things going on bring the system as a whole into disrepute. That is the very important reason to try to deal with it. All I'll say is that in the two times I tried to go at it, it was extraordinarily difficult to actually find legislative means to accomplish the goal. That is now the task that the minister has given the department, and hopefully people have learned something in the last ten years and can do a lot better than I was able to do.

The Chair: Thank you for those comments.

It would seem clear that our system is based on voluntary compliance and also on a presumption of fairness, and that anything that creates the impression of unfairness is something we should be addressing. So this argument that level playing fields have to be preserved smacks to me of the argument that the race to the bottom is the one we should be entering. Surely, if corporate entities are able to escape their obligation through illegal mechanisms condoned by the government, this shifts the obligation to provide the revenue that supports government programs onto individual people. Do you have any information vis-à-vis—

Mr. David Dodge: That's absolutely correct, and therein is the difficulty. This is just a very difficult area, and it's been difficult ever since I've been engaged in this. It was difficult when we rewrote the tax law in 1972. When we rewrote it in 1972, the act was about that thick; it's about that thick now, and a lot of it has been to try to deal with these very thorny issues. It's really important to deal with them.

The Chair: Thank you. I think it's a very important issue for us to address in particular at a time when Canadians have just submitted their income tax returns, because I think Canadians want to feel that the tax system is one that is fair and that protects their best interests and not certainly just a special group on the side.

In any case, we'll continue with Madame Wasylycia-Leis now.

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

I agree this is a very interesting and important topic, but I want to come back to the manufacturing crisis, since we are talking about a loss to our economy of somewhere in the neighbourhood of $2 billion to $3 billion, in terms of lost wages and spin-off effects.

I want to ask you, Mr. Dodge, if in fact you don't have a regret as you leave your position, in terms of giving this sense of Canada's economy operating at full capacity, thereby giving consecutive Liberal and Conservative governments some reason not to act and therefore causing a problem.

Related to that, I want to ask the question that was in the paper from St. John's, Newfoundland, from Lana Payne. Would you consider taking on the manufacturing crisis before you depart for greener pastures? That's one question.

The second has to do with your involvement in and your perspective on a number of public policy issues. I just have to quote from Andrew Jackson because I think he says it well:

> ...somewhat at odds with his otherwise impeccably neo liberal/macro orthodoxy credentials, Dodge had a lively interest in broader public policy as a force for social and economic improvement.

I know you've spoken out on child care, on housing, on retirement. I'm just wondering if you have any parting thoughts on any of those issues, particularly the absence of a national child care program.

My third question has to do with hedge funds. We haven't talked about that at all. It has been a topic of discussion at the G-7. I'm wondering—

● (1245)

The Chair: Just a suggestion. If you want a response to the first couple, you may not want to pose the third. You're running out of time.

Ms. Judy Wasylycia-Leis: I would like an answer on all three, including hedge funds. I'll leave it at that for now.

Mr. David Dodge: I'll try to go very fast. First of all, when I come back in October we can talk about the social program side.

On hedge funds, what I said earlier is absolutely true. These private pools of capital—whether they be hedge funds, whether they be pools of taking corporations private—and this tremendous, apparently inexhaustible supply of liquidity to fund these guys are the real issue, and I'd be really happy at some point in the future to come back and spend some time on that.

Hedge funds is a kind of catchword that catches this really large problem. It's a very real problem and potentially a real concern.

Let me come back to manufacturing. I have no apologies for the fact that in trying to keep the inflation level, at certain points of time this means there's a relative shift from manufacturing to other sectors, and at other points of time, such as in the nineties, it meant a relative shift from other sectors to manufacturing. That is going to take place. Indeed, were that not to take place, we just would not have the total resources to deal with increasing production in the service and primary sectors without having a lot of inflation.

As long as relative prices are going to move around a lot, we are going to have sectors that are declining for a period of time and others that are rising for a period of time. The real issue is whether we have the adjustment mechanisms in place to facilitate the smooth transfer, in particular of workers from lower productivity, lower value-added occupations to those of higher value added. That is the real question.

The Chair: We have time for just two or three more questions if we go reasonably quickly.

Mr. McKay, we'll begin with you, then Mr. Dykstra, and we'll conclude with Mr. Thibault.

Hon. John McKay: Thank you, Chair.

I take the view that Canada can't dress itself up like a Boy Scout in short pants, and therefore we have to have a competitive tax regime.

I did want to ask a question with respect to the issue of the rise in the Canadian dollar. The Canadian dollar is hovering around 90¢ right now. In theory, that makes Canada's assets more expensive to outside purchasers, yet simultaneously we see a lot of Canadian industries being gobbled up by foreign interests. The steel sector is pretty well gone. The beer sectors are all gone. Income trusts are on their way. You have mining sectors, and there are a lot of articles in the business press about the “hollowing out” of corporate Canada, which will challenge our economic sovereignty.

In economic theory, this seems to be counter-intuitive.

● (1250)

Mr. David Dodge: I'm going to let Paul deal with that, but let me make two observations. One, corporate consolidation is going on worldwide. It's going on here. It's going on elsewhere. And there are some very real reasons for that.

Second, the flows actually do go in both directions. Paul is going to talk about that in a second.

Third, it comes back to the issue that was just addressed, and that is that we do seem to have an inexhaustible supply of debt finance to facilitate, whether it be hedge funds or other private pools of capital, taking companies out of the public domain. This is not just in Canada; this is a global phenomenon, and it is an issue that, as a central bank, we have to be concerned about.

Hon. John McKay: But interestingly, while you were giving testimony, Murdoch just made a $5 billion offer for the Dow Jones. Your point exactly.

Mr. Paul Jenkins: Let me address this issue of hollowing out, because it is important to get the facts around this issue.

There have been a couple of quite good studies recently. One was by the Institute for Competitiveness and Prosperity—this is the Martin institute, out of the Schulich school—looking at this issue of hollowing out. In fact, what they find is just the opposite, that in terms of the number of what they would call global leaders in the Canadian economy, the number has increased quite dramatically. They're comparing basically 1995 to 2006. So you are seeing a growing presence of Canadian companies outside Canada operating on a global scale, as well as some movement in the opposite direction.

The other study that I would draw your attention to is one by Statistics Canada, which also looked at this issue from the point of view of job creation, again looking at the growth of head offices within the Canadian economy. The growth of jobs at head offices within the Canadian economy over the last 10 years or so has come from foreign companies that now operate with head offices here in Canada.

The globalization does have this movement in both directions, and the numbers are important to look at here.

Hon. John McKay: If you took the financial services industry out of those numbers, what would it look like?

Mr. Paul Jenkins: I don't have a breakdown by sector, but certainly the Martin study looked at it across various sectors. What you're getting is this globalization showing up in the high-tech sector, health care, health services biotech. You see those sectors that have grown in importance in the Canadian economy becoming more important and indeed becoming global players.

Hon. John McKay: Canada seems to be getting bought at a quicker pace than either Australia or the United States, so I don't understand the study.

Mr. Paul Jenkins: The study, as I said, looks at the presence of Canadian companies globally today compared to 10 or 15 years ago, and what you're seeing is that the number of Canadian companies operating globally has increased across a broad sector of areas.

The Chair: Thank you very much.

Mr. Dykstra, for just three minutes, sir.

Mr. Rick Dykstra: You are being tough, I tell you.

The Chair: Two and a half.

Mr. Rick Dykstra: I'm going to simply ask my questions first and let you respond, and roll out the clock, as they say.

One of the things that no one has asked about that I really want to know is, have you recovered the items that were stolen from the Bank of Canada?

Second, I didn't see a lot in here, but obviously the environmental measures we'll be taking over the next number of years are going to have an impact, as we've talked about, to try to balance the environment and the economy at the same time. I'd like to hear your comments on that.

Third, I come from a riding that is very close to the border. I noted in your report the expected increase in our dollar as compared to the U.S. We're actually above what you're predicting for the end of April, beginning of May. There is a big impact on the greenhouse industry, the wine industry, the automotive industry in Niagara, and obviously across the country.

Could you briefly touch base on all three?

Mr. David Dodge: Let me take them very quickly in reverse order.

As I said, there is substantial day-to-day and week-to-week volatility in the dollar. You are right, we are above the range that we did our projections on, and we'll just have to see as we come to the next time what sort of trading range we have. We are above what we had assumed, and we will take that into account next time, if we stay there.

On the environmental side, we have no expertise in this. Let's be quite clear. The only expertise we have is in the financial mechanisms that might be used to facilitate whatever measures the government decides to take, and we are in the process of beginning to do some serious work on the issues of how emissions trading systems could actually work. The great importance there is the future price, because that's what really drives it. The great problem with the emissions system so far actually has been that there hasn't been a long enough futures market to actually make them work.

On the final issue, the money that was stolen from the museum, Paul, do you want to say a word on that?

● (1255)

Mr. Paul Jenkins: Very quickly, once that came to light, we took measures to investigate it thoroughly through our internal audit department. There were some internal controls that were not pursued leading to this theft, and I'm certainly satisfied that corrective measures have been taken to avoid that in the future.

The Chair: Thank you, Mr. Dykstra. Thank you, gentlemen.

We'll conclude with Mr. Thibault now.

Hon. Robert Thibault: Mr. Chair, I want to speak to the establishment of interest rates, the interest rate policy.

I understand your principle that you want to keep inflation between 1% and 3%, and nobody would argue with that. What I would ask is, on the system and the considerations you make in establishing the interest rate, if you look at the current time, our rate is acceptable at 2.2% and you're looking at 2.7% over the short to medium term. That's our rate of inflation. But if we break it down across the country, your report shows that in Alberta there's a surge and it's at about 5%, and that's acceptable because we're coming in under 3% nationally. But if that same surge at 5% or 6% was in the Ontario market, our national rate would be heading above the 3% and would probably trigger an interest rate increase. So that action you're taking to cool down one region of the country can stifle or crush the other regions.

What do you take into consideration when making that type of decision?

Mr. David Dodge: We operate nationally. The weight of Alberta is roughly 12% nationally. The weight of Ontario is I guess about 43% or 44% nationally. So obviously, if indeed in Ontario or Quebec we had inflation going through the roof, it would necessitate much stronger action.

A good example would be 1988-89, when in fact there was actually a huge problem in central Canada and we had to take very vigorous action, you'll recall, back then.

This is a problem, and maybe on this we'll conclude, because there is no optimal currency area. Whether you're in Europe—because the Europeans have the same problem—whether you're in the United States, or whether you're in Canada, as long as you have, in essence, a continental entity that is very large and quite diverse, you are always going to have this. The real issue is to get movement in the relative prices and wages in the various areas. That's what's working.

Right now, we have inflation running at between 0.5% and 1% in the east and at around 5% in Alberta. That is encouraging movement of resources into those areas that need the resources, whether they be human or capital, and indeed we're getting the adjustment across the whole economy.

It's not easy. It's not easy at all. And it doesn't mean that everybody adjusts smoothly. There are always hiccups along the way. But the one thing that I think we collectively have learned over the last 30 or 40 years is that not to adjust is not an option. Failure to adjust means we all go down the tubes together, rather than rise together. So that's what's going on. It's not easy, but it is very beneficial to all of us over the longer haul.

The Chair: Thank you very much, committee members, for a fruitful discussion of the monetary policy review of the Bank of Canada.

Thank you to our guests, Mr. Jenkins and Governor Dodge. We appreciate your being here again.

The meeting is adjourned.

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