Remarks by David Dodge
Governor of the Bank of Canada
to the 2006 Ontario Economic
Leadership Summit
Niagara-on-the-Lake, Ontario
25 October, 2006

The Global Economic Landscape and the Implications for Ontario

The Ontario Economic Summit is an important event, and I do wish I could have attended, not only so that I could deliver my remarks in person, but so that I could listen to the various discussions that will take place over the course of the next two days. You will be discussing topics that are central to Ontario's future economic prospects. How can we develop human capital to its fullest potential, and retain that capital? How can we foster research, innovation, and commercialization in this province? How can we improve Ontario's competitiveness in the global marketplace? As policy-makers, labour, and business leaders, how we answer these questions will go a long way in determining the economic well-being of our citizens in the years ahead.

My purpose this morning is to set the scene for your discussions of these questions. I will start by reviewing the outlook for the global economy as set out in the Bank's *Monetary Policy Report*, which we published last week. I will then look at how global developments can be expected to affect the Canadian economy in general and the Ontario economy in particular. Following that, I'll say a few words about the themes of the conference and about a couple of the policies that I see as important to securing Ontario's economic future. Finally, I will be happy to take your questions and hear your comments for the remainder of my time with you this morning.

The Global Economic Landscape

Let me begin with the outlook for the global economy as a whole, before turning to the implications for Canada and for Ontario, in particular. Certainly, the headline numbers for the global economy are encouraging. The strong growth of recent years appears set to continue. The Bank's base-case projection is for real growth in the global economy of 5.1 per cent this year, moderating slightly to 4.5 per cent by 2008.

However, these numbers mask some important differences in the growth prospects of different regions. Growth in Asia continues to be very strong, led by the economies of China and India. Indeed, the Chinese authorities have their hands full trying to hold growth at a more sustainable pace. Growth in other emerging markets is coming from areas such as South America and Africa, which bodes well for the future of these regions. At the same time, it is very encouraging that stronger domestic demand growth is finally taking hold in Europe and Japan.

But after several years of strong expansion, the U.S. economy is cooling down, restrained by a pullback in the housing sector and slowing demand for automobiles. After growing at a 5.6 per cent annual rate in the first quarter, U.S. economic growth slowed to just 2.9 per cent in the second quarter, and may well have slowed to less than 2 per cent in the third quarter of 2006. Earlier this year, the Bank had projected that the U.S. economy would begin to slow, but the pullback we are seeing now is larger, and coming sooner, than we had expected. In our *Report* last week, we updated our projection to say that U.S. growth should average 2 to 2.5 per cent in the second half of this year and the first half of 2007. Activity should then recover to above three per cent growth in the second half of next year and throughout 2008.

I don't want to minimize what we see happening in the United States. But I think it is important to recognize this slowdown for what it is—a necessary cyclical correction in the U.S. economy. In our view, this is likely to be a temporary slowing of growth, not a contraction. When our forecast is expressed on an average annual basis, it perhaps does a better job of illustrating the mild and temporary nature of this slowdown. We are expecting 3.3 per cent growth for 2006 overall in the U.S. economy, 2.6 per cent growth in 2007, and 3.2 per cent in 2008.

In our base-case projection, we do not see the pullback in the housing and auto sectors spreading in a major way to U.S. consumption more broadly, or to business investment. Nor should the slowdown be very prolonged. Currently, this is a reasonable assumption. There are no signs of any systemic stress in financial markets or among financial institutions in the United States. Nor is there anything in the economic data to suggest that the pullback in these two sectors is spreading. Indeed, the Beige Book published by the U.S. Federal Reserve made this same point two weeks ago, although I recognize that this fact is cold comfort to those Ontarians whose livelihood is closely linked to the fortunes of the U.S. housing and auto sectors. Of course, there is a risk that this projection could turn out to be wrong, and I'll return to this risk in a few minutes.

Let me make one more point about the global economy before turning to the domestic outlook. For some time now, policy-makers have been worried about global imbalances; that is, the very large current account deficit in the United States, which is mirrored by current account surpluses in Asia and major oil-exporting countries. The increase in demand we are now seeing outside North America, and the slowing in the U.S. economy, is certainly helpful in terms of bringing about a gradual resolution of imbalances, and reducing the risk of an abrupt, disorderly resolution. The Bank's base-case projection assumes that this gradual, orderly resolution will take place. That said, it is important for policy-makers to continue to take appropriate measures that allow market-based adjustments to take place both within and across their domestic economies. If markets can be confident that these measures will be taken, it will reduce the risk of a sudden swing in market sentiment and a disorderly resolution of imbalances.

The outlook for Canada

Now let me turn to the outlook for the Canadian economy as a whole, before looking specifically at Ontario. With the U.S. economy slowing more abruptly than had been expected, Canadian GDP growth fell short of expectations in the second and third quarters. After expanding at a 3.6 per cent annual rate in the first quarter of this year, the economy grew by only 2 per cent in the second quarter. When Statistics Canada publishes the third-quarter figure at the end of November, we expect roughly the same 2 per cent number.

As we look ahead, consumer spending should remain solid for the rest of this year and right through the end of 2008, thanks to continued gains in disposable income and increases in household net worth. However, housing investment should decline slightly in 2007 and 2008, following many years of extraordinarily strong growth. The Bank expects business investment to remain solid as firms react to capacity constraints, and to the expected high prices for energy and metals, continued favourable financing conditions, and high levels of cash flow. In terms of governments, the Bank continues to assume that this sector will operate in rough balance over time. This implies that the large surpluses seen recently will not persist and that governments will bring their books into balance.

Once again, it is important to think of this as a mild, and likely short-lived, cyclical slowdown. The Bank projects final domestic demand to grow by 4.2 per cent in 2006, by 3.2 per cent next year, and by 2.8 per cent in 2008. However, slowing U.S. growth will have a clear impact on growth in the Canadian economy in the near term. The Bank is projecting that net exports will subtract 1.3 percentage points from growth this year and 0.7 percentage points next year, and that net exports will not contribute to growth in 2008. Overall, the Bank projects 2.8 per cent growth of real GDP in 2006, slowing to 2.5 per cent in 2007, but coming back up to 2.8 per cent in 2008.

In our *Report* last week, we said that the Bank currently judges that the economy is operating with a slight amount of excess demand. Our projection for growth implies that this excess demand would be eliminated by mid-2007, and that the economy should then remain near its production potential through to the end of 2008.

Overall, the Canadian economy has performed remarkably well when you consider that it is continuing to adjust to a number of powerful global forces. These include the rise to prominence of China and India, which has led to both stronger global demand for many Canadian goods and services, as well as increased competition for some Canadian firms. In turn, strong global demand has led to increases in most, but not all, commodity prices, and to an associated rise in the Canadian-dollar exchange rate. All of this has occurred at a time when central banks around the world have been withdrawing liquidity from the global economy.

Of course, economic adjustment is easier said than done. And it is important to acknowledge that adjustment is often very difficult on an individual level. Still, taken as a whole, the Canadian economy continues to adjust quite well. However, recent sluggish growth in labour productivity has led us to reduce our estimate of potential growth from 3 per cent to 2.8 per cent over the period to the end of 2008.

The Bank's projection is that core inflation should remain slightly above 2 per cent over the next few months, before returning to 2 per cent in the second half of 2007, and remaining there through 2008. As for total inflation, it will continue to be affected by the cut in the Goods and Services Tax and trends in energy markets. We expect total inflation to remain below our 2 per cent target, averaging around 1.5 per cent, from the fourth quarter of this year to the end of the second quarter of next year. Following that, total inflation should remain near 2 per cent until the end of 2008.

Now let me say a few words about the risks to our projection. The risks, both on the upside and the downside, appear to be a little bit greater than they were earlier this year. The main risk on the upside continues to relate to the momentum in household spending and housing prices. Household income continues to grow, consumer credit growth is currently quite high, and house prices have been rising sharply. These three factors could lead to higher consumption than we expect, which would put upward pressure on inflation. In addition, the strong growth in prices and wages now seen in Western Canada could also spread to other regions. On the downside, the main risk is that the U.S. slowdown could be deeper and last longer than we expect. This would imply lower demand for Canadian exports and broader weakness across our economy. The Bank judges that these risks to its inflation forecast are roughly balanced. And the current level of the target for the overnight rate is judged, at this time, to be consistent with achieving the inflation target over the medium term.

Implications for Ontario

Having laid out the Bank's projections, I will now look at the implications for Ontario's economy. There are really two sets of issues here. The first relates to the implications of the short-term cyclical downturn. The second relates to the longer-term structural challenges facing Ontario. Let me address these in turn.

It is clear that the cyclical pullback in the U.S. housing and auto sectors is causing particular difficulties for Ontario. Given the degree of integration of the Ontario and U.S. economies, this province will feel a significant impact from the U.S. downturn throughout the second half of this year and the first half of 2007. When you consider that automotive products made up 44 per cent of Ontario's merchandise exports last year, it is clear that the U.S. downturn will likely affect Ontario more severely than other provinces. Related manufacturing industries could also continue to face serious challenges. But I remind you that roughly 70 per cent of Ontario's economic activity comes from the service sector, and that sector remains in good shape. Overall, Ontario may well underperform the Canadian average for the balance of this year and in 2007. Nevertheless, modest growth in Ontario's economy should persist.

Those are some of the short-term issues facing Ontario. Now I want to say a bit more about the longer-term structural issues facing some of Ontario's industries. The forest industry, including pulp and paper, is facing a number of structural challenges. These include increasing competition from places such as Brazil and Indonesia, as well as a flat or declining global demand for newsprint. In addition, wood costs in eastern Canada have risen faster than elsewhere, adding to the challenges.

In terms of automobiles, there is an ongoing shift in the structural demand for motor vehicles within North America. Although Ontario has been making adjustments in response to these changes, more are needed. And the prospects for other industries, where value added has traditionally been rather low, will also continue to be limited in the face of intense competition from Asia and elsewhere. Here, I am thinking of industries such as furniture, clothing, and textiles.

However, while acknowledging these structural challenges, we should remember the importance of Ontario's healthy service sector. The prospects for many service industries, including those with high value added such as financial and business services, remain very positive, and these should continue to support the Ontario economy for some time to come.

But no matter which sector we are talking about, we should also remember that the importance of improving efficiency is paramount. And so it is encouraging that firms in the province have been investing in machinery and equipment, most often with a goal of improving efficiency and productivity. We all need to improve efficiency, and this means that policy-makers need to pay particular attention to improving the efficiency of our financial markets. And, as I've said in many other speeches, policy-makers have a particular need to keep efficiency in mind, both in terms of fostering competition and improving our regulatory framework, throughout the economy.

Policy Priorities for Ontario

I'd be happy to say more about the need to improve efficiency in our question and answer session. But before I turn the floor back over to you, let me close with some comments about two of the issues you will be discussing over the next few days—developing human capital and improving infrastructure.

Ultimately, the strength of our economy depends on the skills of its workforce. To maximize these skills, we need to take a truly lifelong approach to learning and to skills development. There is no single approach or policy that will do the trick. Skills development must be a priority for everyone—for parents, for students, for workers, for governments, and for employers.

Having a highly skilled workforce begins with parents. They need to do their best to get their children ready to learn by the time they enter school. There is clear evidence that early childhood development is vitally important in preparing children for their years at school. But parents need support in this role, and governments need to do their part in providing this support. Public investment in early childhood education has a high payoff.

This role for governments continues during the school years. The public sector must invest in improving the effectiveness of education. To be clear, the point is not to keep children in school longer. Rather, the point is to make sure that children actually are acquiring necessary skills while they are in the classroom.

Of course, post-secondary education is critical to the development of our workforce. At the college level, we need to see more close co-operation between colleges and employers in order to integrate learning with the work environment. In this way, we can maximize the relevance of education, and students can receive valuable experience in genuine workplaces that employ the most modern and advanced technology. I have seen good examples of this kind of co-operation between Humber College and firms in sectors such as design, merchandising, and high-end manufacturing. These are positive steps, but we need to see many more of them.

The need to focus on skills development continues through to the post graduate level. We have seen how research centres can grow to become the centre of gravity for economic development in a certain sector. The obvious example in Ontario is the close connection between Waterloo, Research In Motion, and quantum computing. This type of partnership helps to build comparative advantages for Ontario, and the province needs to develop more of them, quickly.

Outside of the academic world, it is crucial that, as employers, we take seriously our responsibilities to invest in the skills of our workers. I spoke about this issue at length last year in a speech at Humber College, so I won't spend a lot of time repeating those points. Instead, I'd invite you to read those remarks, which can be found on the Bank of Canada's website.

The last point I would make about skills development is that we need to keep demographic pressures in mind. The population is aging, and we will soon face the challenge of how to make more effective use of the skills of workers in their sixties, and even beyond. We will need to examine employment incentives, work environments, and other issues to ensure that older workers who wish to contribute to the labour force can still do so.

Aside from developing the skills of our workforce, we also need to remove as many barriers to mobility as possible. As I've noted, economic restructuring is happening in Ontario, as it is across the country and around the world. To take full advantage of this restructuring, people need to be able to move. To this end, I was encouraged to see Ontario signal its desire to join the Investment and Labour Mobility Agreement between Alberta and British Columbia—this would be a very helpful step by all three governments.

It is also important to recognize that skills gained in one industry may well be easily transferred to another industry, with only a small amount of additional training. It is important for businesses and policy-makers to focus on this and not allow occupational licensing requirements to act as an unnecessary barrier to the transfer of labour.

And of course, it is extremely important that we take steps to maximize the contributions of skilled immigrants to Canada. We need to find ways to smooth the process of recognizing foreign training and credentials, and supplement them to meet the needs of the Canadian economy, so these highly skilled people can take their place in the workforce.

I have focused on the development of human resources in this section because it is a necessary—though not sufficient—condition for Ontario's future prosperity. In this vein, I'm glad to see there will be discussion of the Irish experience, as that country's remarkable success was predicated on developing a skilled and adaptable workforce.

While policies to get the most out of our "human" infrastructure are important, we also need to develop our physical infrastructure in order to reach our full potential. This critical infrastructure includes public assets, such as highways, public transit and transportation facilities, power, waterworks and waste water, schools, hospitals, and other facilities. It also includes private infrastructure, such as pipelines, rail, and telecommunications networks. Having modern, reliable infrastructure in place allows businesses to invest with greater certainty, thus furthering the ability to adjust and compete in a changing global economy. Ontario needs public policies that can support both public and private investment in infrastructure so that firms can become more productive.

The key questions here are how to improve the efficiency of infrastructure investment, and how to finance that investment. There is evidence from other countries that public-private partnerships can both increase the efficiency of investments and support their financing. Now is the right time to encourage partnerships between the Government of Ontario and private providers, given the climate of low nominal interest rates and the presence of large pension funds that are searching for these kinds of investment opportunities. Of course, the most efficient and timely allocation of resources for infrastructure occurs when the incentives are right. And it is true that the hardest incentive to get right is proper pricing. A lack of pricing that appropriately reflects demand and supply conditions may be one reason why there have been relatively few PPP infrastructure projects in Canada. But new technologies provide new opportunities to gauge demand for public services, and to price them accordingly. Clearly, though, if public-private partnerships are to deliver on their promise, it is essential that the risks be appropriately shared between governments and the private provider. And I do recognize that constructing appropriate risk-sharing arrangements is not easy.

Conclusion

Let me conclude. I have set out the Bank's projections for a strong global economy, although near-term weakness in the U.S. economy will lead to some slowing in Ontario. But this slowing should not be prolonged. The real challenge for policy-makers is to address the long-term structural issues facing Ontario's economy.

Today, I've stressed the importance of human resources development and infrastructure. But I know there are other crucial issues to discuss. So let me now turn it back over to you, so I can take your questions and hear your comments.