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Mr. Massimo Pacetti

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• (1135)

[English]

The Chair (Mr. Massimo Pacetti (Saint-Léonard—Saint-Michel, Lib.)): Good morning, everybody. Good morning, Mr. Dodge, Mr. Jenkins. It's a pleasure having you here before the committee—a routine every six months, I think it is.

So I think you know the routine. I will allow you a few minutes for your opening statement or remarks.

[Translation]

Committee members will then have an opportunity to put their questions.

Go ahead.

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

Good afternoon, distinguished members of the committee.

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

Last Thursday, we released our April Monetary Policy Report. In the report, we said that the global economy has been unfolding largely as expected, and the outlook for the Canadian economy is essentially unchanged from that in January's Update.

The Canadian economy continues to adjust to global economic developments. This was also an important theme last October when Paul and I appeared before this committee.

These developments include the realignment of currencies in response to global imbalances, the higher prices of both energy and non-energy commodities, and growing competition from emerging-market economies.

[English]

In Canada we're seeing more evidence of sectoral adjustments to these global developments. Many Canadian commodity-producing sectors are expanding. However, firms in some other sectors that are exposed to international trade are facing pressure from the appreciation of the Canadian dollar and from foreign competition. On balance, net exports have been a drag on the economy, but with robust domestic demand, some sectors such as retail, wholesale, and housing have been growing very strongly.

In total, the bank expects the economy to grow by about 2.5% in 2005 and about 3.25% in 2006, with growth this year and next coming primarily from strengthened domestic demand. To continue to support aggregate demand, we decided to leave the target for the overnight rate unchanged at 2.5% on April 12.

Members, the bank continues to judge that the economy is operating slightly below its production capacity, but we expect it will move back to full capacity by the second half of 2006. Core inflation is projected to return to 2% around the end of 2006. Based on the scenario employed by oil price futures, total CPI inflation is expected to remain slightly above 2% this year and slightly below in the second half of next year.

In line with this outlook for growth in inflation, a reduction in monetary stimulus will be required over time. This outlook is subject to both upside and downside risks and to uncertainties. The risks include the pace of expansion in Asia and the prices of oil and non-energy commodities. A further risk relates to the resolution of global current account imbalances. Should these imbalances persist, a risk of a disorderly correction will grow over time. Most of the uncertainties with respect to the Canadian outlook relate to how the economy is adjusting to relative price changes associated with major global developments.

Monetary policy continues to facilitate this adjustment process by aiming to keep inflation at the 2% target and the economy operating near its production capacity.

Mr. Chairman, Paul and I would now be very happy to take the committee's questions.

• (1140)

The Chair: Thank you, Mr. Dodge.

We'll go directly to questions, with seven minutes for the first round. We'll go to Mr. Penson and then to Monsieur Loubier.

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

I'd like to welcome Mr. Dodge and Mr. Jenkins to the committee today. It's always a pleasure to have you here to give us an update on where the bank sees the Canadian economy going.

I'm interested, Mr. Dodge, in two other aspects. The first is the Asian one you mentioned and whether your analysis shows that China is going to continue that strong growth of 8% to 10% GDP growth a year that's consuming so many resources, that is driving up the prices, and driving up prices that are hurting some sectors, even the resource sectors such as agriculture, because of higher fuel prices, higher prices for fertilizer; all of that is impacting the agriculture sector as well.

I'd be interested to hear a little about whether you see any softening in the growth scenario in China, and also where you see housing. One of the areas that's really carrying the Canadian economy is the housing sector. Where is the point where demand is pretty much satisfied, or what can we expect in that sector in terms of demand versus availability in the next couple of years?

Mr. David Dodge: Let me start with the issue of China. Indeed, one might more loosely phrase it "non-Japan Asia", because these economies are all strong, and they are linked together.

What has been driving China has been very high rates of investment in China—roughly 40% of their GDP is going to investment. There is the question, always, whether it is all productive investment. That's question number one, and number two is how long it is going to go on. Number three is, at what point are we going to see monetary policy a little tighter in China and some of this growth slowdown? I think the best outlook is for high growth rates to continue, at least for the foreseeable future in 2005 and 2006—perhaps slightly weaker than what we have seen, but that would still be extraordinarily strong by historic standards. That certainly is the view of the IMF. That is the view of the Chinese authorities, as we talked to them over the weekend. Nevertheless, it's fair to say that the Chinese authorities are worried both that this investment be productive and, secondly, that it is continuing to go at a very high and probably unsustainable level. What they will need to do is to make.... Over time it will come down, but the domestic household consumption will rise.

I think the best outlook through to the end of 2006 for China is high growth rates, probably with a 7% handle—maybe an 8% one—but a little bit down from where they were.

India is another major economy growing very rapidly—not quite as rapidly as China, but nevertheless rapidly. Again, the outlook for India I think is pretty good. There may be marginally slower growth in 2005 and 2006 than in 2004, but in fact that would be helpful.

For the rest of non-Japan Asia, the outlook is for reasonably strong growth. There are perhaps some questions in Korea as to how exactly they're going to adjust, because as you probably know, the won has appreciated quite significantly in recent months.

That's basically it: strong Asian demand over the short run, big adjustment problems that they're going to have to make over the longer haul, and some danger of inflation pressures mounting.

• (1145)

Mr. Charlie Penson: Mr. Dodge, I'm just wondering whether you can help us out. I know China is trying to convert a lot of their government businesses over to the private sector. It's a commitment they have given to the World Trade Organization. Have you looked

at that, and do you see it presenting any problems for them as they privatize many of those big corporations?

Mr. David Dodge: We're not experts on that, so let me talk about the one piece we do follow very closely, and that's their financial sector. It is extraordinarily important and will be key to the ongoing developments. Here they are making progress. The progress is clear. It's never as fast as one would like, but that doesn't differentiate China from many other countries.

Nevertheless, they are making progress. They're in the process of privatizing two of their four large banks. They have made some considerable progress in cleaning up some of the non-performing loan problems they have on their books. It is extraordinarily important for China going forward that they make progress in this sector.

We wish they would liberalize a little faster and allow foreign institutions, such as our insurance companies, to carry out more business. That would help things move more quickly, but they are making progress.

Paul, you've been following this more closely than I have. Maybe you'd like to add something.

Mr. Charlie Penson: Just before you do that, can I just ask a question? How important is that progress to being able to stop the pegging of their currency to the U.S. dollar? Is that part of the progress that's being made?

Mr. David Dodge: Let me be very careful, because there are really two questions here. It is certainly a very important part of what is needed before they can run a clean float like we and many other countries do. It's extraordinarily important that it proceed, and as I said, it has been proceeding well.

Paul, maybe you could just make a couple more comments on the progress.

Mr. Paul Jenkins (Senior Deputy Governor, Bank of Canada): First of all, on the financial sector itself, they have been taking a number of initiatives to move that reform forward. Indeed, this year two of the large banks, the Bank of China and the China commercial bank, are to be listed. There's actually going to be an IOP associated with those. Other banks are going to be listed in Hong Kong. As you look further out into 2006, which is an important date because of the WTO, foreign banks will have complete access to domestic currency retail markets in China. So you can see that things are moving forward from that perspective, and that's really the area we pay particular attention to.

If I may just quickly come back to your first question on prices, as the governor indicated, we are looking for some slowing in the rate of growth of the world economy, but still holding up at fairly high levels. So in terms of commodity prices, our base-case scenario that we present in our report suggests that those commodity prices will remain at fairly high levels, but we're certainly not looking for continued rates of increase of the sort we've seen in recent years. That general scenario is supported by the information we gather from our regional offices and publish in what we call our business outlook survey, where we actually ask individual firms about their input prices, which I think was the origin of your question.

The Chair: Thank you, Mr. Penson.

Monsieur Côté is next, and then I have Ms. Minna.

[*Translation*]

Mr. Guy Côté (Portneuf—Jacques-Cartier, BQ): Thank you very much, Mr. Chairman. Mr. Jenkins, Mr. Dodge, thank you for coming here today.

Recently, we witnessed a major oversight with respect to our projections. These are, of course, based in part on Canadian exports to the US and on the value of the Canadian dollar. Given the recent range errors that have occurred at Statistics Canada, should we automatically assume that these projections are relatively accurate?

To your knowledge, have steps been taken to prevent a repeat of similar errors? As we know, when this error came to light, it had somewhat of an effect on the Canadian dollar.

• (1150)

Mr. David Dodge: I'll begin.

Regardless of the country involved, trade figures are the hardest to project. These are subject to corrections that in many cases are significant. Consequently, it is important for us not to place too much emphasis on monthly fluctuations in these figures.

Having said that, we feel that exports will not be very strong this year, that the situation will turn around in 2006, that imports will be strong this year and that the trend will continue because of strong domestic demand. As you can see from the table on page 30, as a result of net exports, growth in 2005 will be down by over one per cent, and in 2006, by .2%. As I already said, these projections are generally fairly accurate, even though actual figures can fluctuate quite significantly from one month to the next.

Paul.

Mr. Paul Jenkins: If I could just add to that, as the Governor mentioned, there are always many monthly revisions. When it comes to applying monetary policy, the trend series is the most important consideration for us. Among other things, we take into account the international trade trend, even in such areas as the labour market as well as the inflation trend. It's always important not to place too much emphasis on monthly adjustments and to analyse trends on a quarterly and yearly basis.

As the Governor mentioned, since relative prices fluctuate considerably—for instance, the inflation rate or the exchange rate—it is difficult for Statistics Canada to accurately determine the difference between the price trend and the volume. It's a matter of the

prevailing trend at any given time, but that isn't what determines the trend as far as the figures go.

Mr. Guy Côté: Several months ago, the bank put a new \$20 bill into circulation. I realize it may be somewhat premature to ask you this question, but have you noticed if the new currency note has reduced the incidence of counterfeiting?

Mr. David Dodge: Yes, and that's true not only of \$20 dollar bills, but of \$50 and \$100 notes as well. Clearly, the incidence of counterfeiting has declined rather sharply. For that reason, in mid May, we will be incorporating the same security features into the \$10 bill. We must, however, continue to be vigilant, because professional counterfeiters never give up. To date, we're happy to see that the counterfeit bills that have surfaced are of very poor quality.

• (1155)

Mr. Guy Côté: Fine. I'll have more questions later.

The Chair: Thank you.

Ms. Minna.

[*English*]

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

Welcome again, Mr. Dodge. It's good to see you, and it's good to keep hearing you talk about the wonderful impact early childhood education would have on our future economy. I've read your latest speech.

I want to touch base with you on a couple of things. You have rounded our production down from 2.9% to 2.6%, and that's a bit of a downturn. Meanwhile we're showing a growth of 2.6% for the next year and 3.3% for 2006-07. I just wonder if you can explain the downturn in the short term and what you think is causing that, from the point of view of productivity, and then the optimistic increase to 3.3%, which is fairly strong, for 2006-07.

Mr. David Dodge: Yes. First of all, let me preface this by saying our outlook is essentially the same as it was. While there are some tiny wiggles, one ought not to read all that much into them.

Those wiggles occur in 2005. The reduction in 2005 is kind of an arithmetic issue, because we ended 2004 at a marginally higher level of output than we thought it would be. There were revisions in the growth rate, so we ended 2004 as a whole with a growth rate of 2.8%, as opposed to our previous forecast of 2.7%. So that's point one.

On point two, the structure of output through the year was a little different than we thought it would be. It was much stronger in the second and third quarters and weaker in the fourth. So just the arithmetics of the way we calculate growth rates year over year led to the downgrade from 2.8% to 2.6%.

In fact, if we look at the year, we continue to expect roughly 2.5% in the first half of the year and 3% in the second half of 2005, rising to about 3.5% in 2006 through the course of the year. When you do year over year averages you get some differences in the numbers, but the main point is don't read very much into the numbers; our basic outlook is unchanged.

Hon. Maria Minna: And it seems to be positive.

One of the things affecting this, in addition to the price of the dollar, is that the oil prices have gone up considerably. I just wonder about the impact of the short- and medium-term forecasts you have for oil. Are you expecting them to continue to stay high, or are you expecting some difference?

Coupled with that—if you could piggyback—what do you see in terms of production in the oil sands in Canada? Would any production coming on line, or that reserve, have any impact on the overall prices?

Mr. David Dodge: This is a really important issue. Maybe we can take just a little bit of time on this, because it is absolutely critical.

The Chair: Fine. We have plenty of time.

Mr. David Dodge: First, I think one needs to start at the level of the world and ask what's going on. We had world growth last year of a little over 5%. We're looking for world growth probably to be a little over 4% in 2005 and 2006. As we heard from the previous question, a lot of that growth is coming from countries highly dependent on oil as their marginal source of energy.

Thus, what we've seen is the world demand for oil—and this is starting back in 2003—grow considerably more rapidly than anyone had thought. It is certainly faster than the IEA, the International Energy Agency, had thought. That has meant demand at the moment has moved up to the point where there is essentially no spare capacity currently available in the world, broadly speaking, and that, obviously, would move up short-term oil prices.

It is very interesting this time around, and quite different from what we've seen in the past. Normally, the futures curve for oil comes down by the time you get at six or seven years; it remains reasonably well anchored, and that's chart 19 in our publication. This time, in fact, what's happened is that the long futures—the six- and seven-year futures—have moved up quite substantially. That is kind of unusual, so you have to ask why the medium-term outlook is for relatively high prices. Whether it ends being \$50 or \$45, it's certainly high by historic standards. Why is that? It's largely because the outlook for world demand is that over certainly the next six or seven years, it's going to grow as fast as supply can be brought on; it does take time to bring supply onto the market.

Following the outlook of a lot of analysts who know more than we do—but certainly consistent with our medium-term outlook for world demand—we are looking for relatively high oil prices, certainly over the medium term. That bodes well for production in Canada, but as you know, the lead times are relatively long. What we have been seeing is investment starting to proceed faster than we had originally anticipated, in terms of some tar sands developments, and the plans for additional pipeline, and so on, seem to be brought forward a bit.

The real constraint we face here in Canada is with both the skilled labour and the capacity to produce the inputs—whether those be refining inputs, coking inputs, steel pipe, whatever—to bring those developments on line quickly. Thus they will be spread out over time. While this is true in Canada, it is also true around the world that refining capacity is limited, and the ability around the rest of the world to bring new supply on quickly is also limited.

So the outlook is for a reasonably high level for a considerable period of time, with strong activity in Canada as a result of that, but there will be short-run volatility. Those prices are going to move around, because at the moment, supply and demand are balanced on a knife edge.

Paul, maybe you would like to add something. This is a really important issue.

• (1200)

Mr. Paul Jenkins: Indeed, it is a very important issue.

Just to add, if I may, to the governor's comments, on page 13 of our full report—again directed to your question about the investment side as a result of the increase in oil prices—we have a table that shows recent trends in investment. You can see very quickly, if you look at the second line, which is oil and gas extraction, that the rates of growth of investment in 2003, 2004, and 2005 are really very high and are expected to continue to stay quite high.

That's just one quantitative answer to your question in terms of investment. It's not the oil sands per se, but it's included in there, and you can see the growth rates are really quite significant in response to the economic factors the governor has already mentioned.

• (1205)

The Chair: Thank you.

Perhaps we can go to Ms. Wasylycia-Leis, and then to Mr. Solberg.

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

Thank you, Mr. Dodge and Mr. Jenkins, for your presentation today.

I want to focus first on the issue of productivity, since you've spoken a lot about that recently. I think you've suggested that we might have to tighten our policies to deal with this, even if it means job losses, if our potential is not growing as fast as we had hoped. I'm wondering if in fact we shouldn't be looking at this whole issue in a different way, and whether or not the assumptions of the Bank of Canada are correct, and whether or not we're operating with much more slack in the job market than you're suggesting. That's one question.

The other has to do with workers. We always look at workers, and we are always trying to suggest we have to do something to make workers more productive. I appreciate your focus on child care; however, I don't hear much from the Bank of Canada about improving the record of business and the corporate sector. I'd like to know why we aren't hearing more about the slow rate of investment, despite the fact that profits are way up, despite the fact that there have been tax cuts, despite the low interest rates.

I'm looking, for example, at some of the recent charts out of Stats Canada, showing a significant increase in pre-tax profits and a drop in investment as a percentage of GDP. I'm looking at stats from KPMG, showing the corporate tax rate advantage in Canada versus the United States. And I'm looking at the net flow of foreign direct investment, showing we're at negative 49%. I'd like to know, in your view, why business investment has been so slow to respond to what I would consider a very favourable and profitable situation.

Mr. David Dodge: Those are both excellent questions. Let me deal with the productivity issue first.

Productivity, which is simply output per worker hour, is really hard to determine, certainly over the short run. Clearly, we were disappointed over the last two years that output per worker hour has not increased. On the other hand, we think there are some technical reasons for this, and there will probably be some revisions to the numbers. Hence, you'll note that we have not changed our estimate of capacity. We still think that over the next two years output per worker hour will grow at its trend rate of one and three-quarters. We've not revised down our estimates of capacity, even though the last two years were disappointing.

What is true is that during a period of significant adjustment, it takes time for transformation from one sector to another. There are reasons to think that in the very short run there might be some downward bias.

I can assure you that we are still working on the basis of output potential growing at 3% a year for the next couple of years, being divided roughly 1.75% productivity and 1.25% labour inputs.

We think there is a small degree of slack in the economy, but it's very difficult at times of significant structural shifts to get an absolutely firm handle. I would just caution on this.

Turning to the investment issue, it is extraordinarily important, whether you are talking about investment in machinery and equipment or investment in people.

I gave a speech at Humber College on investment in people. I won't repeat what I went into there, but it is extraordinarily important for both the education system as well as the employer and employee to have the opportunities for ongoing upgrading of skills. It's also important to be able to use fully the older workers as we look forward to a time when the labour force will be somewhat more aged than it is now. So that's the human side.

On the physical side, we have been looking for what we call a hand-off from the consumer sector, which we think could be the real engine of domestic growth. In a number of countries, this has been a little slower than we would have anticipated *ex ante*. Despite the fact that we have very high rates of capacity utilization, we have not seen this move as fast as we had hoped in 2003.

Nevertheless, towards the end of last year it did a little better than we had thought. Business fixed investment made a little bit bigger contribution to growth, and we are expecting it to make a very significant contribution to growth this year and next. We anticipate that it is coming.

• (1210)

Paul, maybe you'd like to say a little bit about the surveys, and so on, and why we think there is indeed evidence that it's coming.

Mr. Paul Jenkins: We have a number of sources of information on investment plans as you look throughout 2006 and into 2007. I made reference to some of that information in response to the previous question.

Statistics Canada puts out a survey that they call the private and public investment intention survey. That is clearly showing investment picking up in those areas where you would expect it, given the profitability numbers you made reference to.

We also look at other sources of information. An important one for us in that regard is again on the surveys that we conduct through our regional offices from coast to coast and the business outlook survey that we recently published prior to the release of our monetary policy report. There too it supports evidence of investment picking up, again in sectors that one would anticipate.

This hand-off the governor was talking about, where the household sector has been one of the dominant forces in terms of contribution to growth...as we go through this year and into next year, we are seeing that the investment side is beginning to pick up.

That's one reason why we continue to feel comfortable with this productivity forecast or assumption of 1.75%, I might add, together with a labour input assumption of 1.25%—in other words, employment growth associated with that in the order of 1.25% per year. We still feel comfortable with that 3% growth potential.

Ms. Judy Wasylycia-Leis: I appreciate those answers.

The Chair: We'll come back.

Mr. Solberg.

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

Welcome to the governor and the deputy governor. It's a pleasure to have you before us again.

I want to follow up on a line of questioning that my colleague, Mr. Penson, started, which has to do with growth in the U.S. economy. In some of the notes we have, I note that projections for growth are actually fairly good. But I also note that in your initial comments you talk about some of the risks we may face. One of them, I gather, would be an increase in interest rates.

Given the fact that so much of the strength in the U.S. economy seems to have come from housing, at what point does the U.S. economy start to get into trouble if there is an increase in interest rates and it affects the housing market? What will that do to the economy? How much of a risk is there of that really happening?

• (1215)

Mr. David Dodge: That's an extraordinarily good question.

Our view is that housing will cease to make a major contribution to growth in the United States as we go forward. Investment, which has been even more sluggish than one might have expected in the United States, is indeed likely to make a more significant contribution. That would in fact be a very welcome development.

The real issue, though, as you have noted, is that the world has in essence relied on the U.S. consumer as a residual source of consumption. Consumption in Europe has been very weak. Consumption in Japan has been very weak. Indeed, if we look at the emerging market economies, it's not domestic consumption that has been driving them. It has largely been exports to fill that U.S. demand.

When we talk about imbalances, the real worry is that we know the U.S. consumer sector is going to have to save some more in the end. We know that the government sector is going to have to "dis-save" less, and that will not be fully filled by the growth in investment. We need consumption in the rest of the world to increase over time.

The real worry is that the rebalancing will not take place smoothly, in part because of domestic policies in Europe, Japan, and non-Japan Asia, but also in part because exchange rates are not being allowed to play the full part they could in terms of that rebalancing.

There are definitely risks. That's what we flagged at the bottom of that list, the risk that global imbalances will not be resolved in an orderly fashion, but rather that we would have a decline in U.S. domestic demand before we would have a comparable offset elsewhere in the world.

Mr. Monte Solberg: I'm going to switch gears here with a completely different question.

I'm interested in the potential impact on the U.S. economy of a hedge fund failing. There's been some talk lately about the possibility that maybe one of these hedge funds, which are pretty shadowy entities, might be in big trouble, and we might have another situation similar to the one we had previously, which had a big impact on the stock market, shaking investor confidence.

Can you reflect on that and just offer what you see as the degree of risk both our economy and the U.S. economy run from these hedge funds?

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

When we go to the meetings at the Bank for International Settlements, the governors' meetings, the financial markets meetings, and the regulators' meetings, this is something we do spend a fair bit of time on and have been trying to monitor quite carefully. It is certainly true that the Federal Reserve in the United States spent some time on it, as did the securities commissions.

I think there are two issues here, and one has to keep them somewhat separate. The first is, to what extent are these funds very highly leveraged because of lending from the banks? If they ran into trouble, as did LCTM, what you'd have is a lot of banks in trouble in the end. Now, our best analysis of this is that this is not nearly the problem, as we sit here in the spring of 2005, it was early on. The banks themselves, while they are lenders to these operations to provide leverage, are not providing as much of the leverage as they were earlier on.

But the structure of these investments is very complicated. In fact, leverage may be being provided by people who own the funds who don't realize the extent to which they are providing leverage. That is the work that is going on.

The general conclusion is that this is something that has to be watched very closely but that at the moment does not present a serious risk.

But Paul, you're closer to this than I am. Do you want to say a little bit more on this?

• (1220)

Mr. Paul Jenkins: I think the one additional comment I would make is to compare today to the experience you're referring to, the long-term capital experience. That was an era when we saw a lot of emerging market countries operating on fixed exchange rates, an era where a lot of these leveraged operations were being put into the market on the basis of these fixed exchange rates being in place. One of the major developments that has occurred post the Asian crisis and post the Russian crisis, which led up to long-term capital, is that we now have flexible exchange rates in most of these countries. That really is a fundamentally different environment.

The importance, in the context of the governor's comments, is that flexible exchange rates force participants in markets to look at two-way risks. It no longer is a one-way bet in terms of having to remove that fixed exchange rate.

So the environment is quite different. Risks remain, as the governor has mentioned, but that overlay of the macroeconomic environment is fundamentally quite different. Those flexible exchange rates, we feel, are important in terms of countries managing their macroeconomy, but equally important in terms of the financial system supporting that growth on an ongoing basis.

Mr. Monte Solberg: Thank you.

Mr. David Dodge: Mr. Chairman, if I could, I'll add one more point, and I think this is important because more and more we're seeing smaller investors buy into so-called hedge funds. It is that one has to be very careful in looking at the ratings that go on some of the investments these things hold, in particular collateralized debt obligations and so on. Those are highly structured financial products. They get rated, but a triple-A rating on those products is not the same as a triple-A rating on the Government of Canada or the Royal Bank or whatever. It has a totally different meaning. I think it's very important for investors who are investing in funds that hold these sorts of assets, these highly structured assets, to recognize there are more risks than they would think from just looking at a straight triple-A rating.

The Chair: Thank you, Mr. Dodge.

I'm going to try to finish the five-minute round.

Mr. Bell.

Mr. Don Bell (North Vancouver, Lib.): Mr. Dodge, let's just go back to the U.S. economy for a moment. There are three aspects I'm wondering about. What is the effect of the U.S. claim that they'll cut their deficit in half by I think 2015? I'm also wondering about more current issues, the effect on growth and inflation of the softwood lumber dispute and the U.S. ban on Canadian beef.

Mr. David Dodge: I think those are two quite different questions.

Let me just say that over the weekend Secretary Snow reiterated that their objective is to cut the U.S. deficit in half by the end of this presidential term, and that is clearly a feasible objective. The big worry, as my counterpart Mr. Greenspan has pointed out, is not really the short term but the longer term. The unified budget balance, which is what the federal government goes by, is at very serious risk in the United States over the longer term. That's over the longer term because they have not made the adjustments they need to make over time to the social security system. It's not that it can't be fixed, but it needs to be done, perhaps more immediately, as we get into the middle part of the next decade, because of the commitments they have for medicare and medicaid in the United States. So the medium term is actually a bigger worry than the shorter term.

The second issue was trade. I'll tell you, it's not a very wonderful atmosphere on Capitol Hill at the moment, and it's not just with respect to the couple of issues we are most concerned about. Generally, there is a strong reaction that all of the current account problems or trade problems in the United States really reside... because people elsewhere in the world are doing nasty things, rather than that the United States is making some of the adjustments it needs to make. That was clearest last week in respect of China and the big increase in textile imports from China with the change in the MFA.

I think this is a very worrisome situation for us here in Canada, and it's something we have to be cognizant of. That is why we at the bank have been arguing in international circles that we really have to make sure that at least we have an international monetary order that is working appropriately so it doesn't put pressure on the trade order, which would be a real disaster for us here in Canada.

• (1225)

Mr. Don Bell: Thank you.

I'll just follow up on that. The demographics you're talking about in terms of, in the U.S., the effect on their social security plan.... In Canada our plan is projected out for 75 years, I think. I'm just curious about any aspect you see of that, the labour force question, and immigration changes or rules that could affect our market.

Mr. David Dodge: First of all, in respect of the CPP/QPP, as you know, those were restructured quite significantly in 1996-97, and indeed are in very much better shape than most public pension plans around the world. I would almost say *all*, but I want to be careful about that.

In a very innovative way we set up the Canada Pension Plan Investment Board to ensure that the rate of return on those funds is as

high as possible, consistent with the prudent taking of risk, so that future pensioners can be assured that the CPP will be there for them over time

Finally, I would note that there's a big difference between Canada and the United States. In Canada, the CPP operates totally separately from government—federal or provincial—so there is not the temptation to reach in and spend the surpluses that are there for workers when they retire. That I think is a very important difference between our plan and the American plan or the European plans.

Then if we look at demographics, we're clearly on the record here on several important issues. First of all, we have to recognize that the rate of growth of the labour force population, even with high levels of immigration, will slow dramatically over the next 10 years, and we will have years, as we get to the end of the next decade and into the 2020s, when it will actually turn negative.

What that means is that it's very important that we give our young people the opportunity to get into the labour force and be productive as quickly as possible, and secondly, of course, that we give our older workers the opportunity, should they wish to do so, to continue to participate, and, very importantly, as I said in response to Judy's question, that we continue to provide training for workers throughout their working lifetimes so that they're not left high and dry at the age of 60.

What we don't have very well worked out—it's not as bad as elsewhere, so I'm not saying it's a disaster by any means—is the best means of workers being able to phase out of working and how that links to their defined benefit pensions. In the CPP it works reasonably well up to the age of 65; it doesn't work very well after the age of 65. In most defined benefit pension plans there are some real difficulties in working this out.

So we do face some very real challenges, which we should be working on, with respect to older workers.

Finally, with respect to immigration, immigration will be important. But even very high levels of immigration won't mean that we will have a growing labour force as we get out there. High levels will help stabilize the labour force but won't contribute to growth. Again that goes back to the issue of productivity. If our real incomes are going to continue to grow, then output per labour hour has to rise. So we don't just ask people to work longer and longer and harder and harder; we get the output per hour up.

• (1230)

The Chair: Thank you, Mr. Dodge.

Ms. Ambrose, and then I have Mr. Hubbard.

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

Thank you, Mr. Dodge and Mr. Jenkins, for being here today.

I wanted to pick up on something that's been raised a few times so far, and that's the U.S. economy.

I heard Mr. Greenspan speak this weekend about the U.S. current account deficit, that it's sitting at about \$800 billion annually and costing to the tune of \$1 billion a day to sustain. But one of the larger issues that could have an impact on the Canadian economy is that a majority of U.S. dollars are being held by central banks around the world and not necessarily by individual investors.

It wasn't Mr. Greenspan who said this, but another economist with the IMF suggested that this could precipitate a major correction in the U.S. economy, and this might occur if these countries decided to dump the U.S. dollar. If so, obviously this would have repercussions for the Canadian economy and the Canadian dollar, and I wonder what you're doing to prepare for this potential situation, or if you could comment on this.

Mr. David Dodge: That's an extraordinarily good question.

First of all, this is one of the reasons we have pushed very hard at the IMF and in other international fora to get people to think very hard about coordinated or cooperative action on domestic policies that would get world consumption to grow a little bit faster as the U.S. inevitably must in fact shrink that current account deficit. It would be a disaster if they were to take action to shrink that very quickly, reducing world demand, and if then in fact world demand were not to grow elsewhere commensurately. Then we would all suffer, and indeed in that circumstance the danger of real protectionism raising its ugly head would be very severe. So that's one set of issues.

The second set of issues, of course, is that building up of reserves beyond what one might call precautionary balances is in fact preventing an adjustment in nominal exchange rates, in particular between Asian countries and the United States, which would serve to bring about over time—and I stress the words “over time”—a correction in that imbalance. As you know, we, as Canadians, have argued very strongly that some movement in those nominal exchange rates is important.

Absent that, of course, in the end there would have to be either rip-roaring inflation in Asia—because the real exchange rate must adjust in the end—which is destabilizing, or deflation in the rest of the world, which is destabilizing.

So we have been working very hard to bring about two things: (a) appropriate adjustment in exchange rates; and (b) more cooperative action on policy. That means that some work needs to be done on bringing and dragging the IMF as an institution into the 21st century. This was an item that was slated for discussion but did not get enough discussion this weekend in Washington, which we will be pressing very hard for in the future.

Finally, what are we doing here in Canada to be prepared? Well, the best thing we can do here to be prepared in terms of macroeconomic policy is to maintain across all levels of government fiscal balance, number one, and certainly that's really important for the next decade or so, because of the demographic issues Mr. Bell raised. And of course we at the bank must continue to try to keep the economy operating very close to capacity.

On the microeconomic side, though, we do need to make continued progress in facilitating adjustment, and that doesn't just mean beating up on people. It does mean progressing both on the

training side to facilitate that adjustment and in freeing up markets to allow them to operate more efficiently.

● (1235)

The Chair: Thank you, Don.

I have Mr. Hubbard and then I'm back to Monsieur Côté. I'm going to go to Mr. McKay, then Mr. Penson, and then I'll go to Ms. Wasylycia-Leis.

Mr. Charles Hubbard (Miramichi, Lib.): A lot of the information we have heard is very consoling to a lot of people, not only to parliamentarians but maybe to people across the country, for example, the idea of very stable growth and of good forecasting. Some people around the table here have concerns about some forecasts. They think that some don't forecast as well as others.

There are factors. I'm looking at, for example, table three on page 30, where you talk about the growth of consumption and the growth of government and so forth. It seems to be very stable. Even though we have an increase in our budget this time, probably about 12% or 13%, I guess what the bank is saying is that it all looks very well.

We also have within the budget certain factors that are going to change some of our investment in where money may flow. One of those I'd like to ask about is the RRSP change. We're allowing more money to flow out of Canada to enable participants to invest in other countries. I would like to know if this is going to be a factor in terms of money being available in Canada for investment.

We're also dealing big time with Kyoto and what effect it might have in terms of our government's obligations and, more significantly, in terms of how industry might react. Maybe we could get some comments on two of the big engines of our economy, dealing with the auto industry and with our hopes for the continued progress in the aviation industry.

Maybe Mr. Dodge or Mr. Jenkins could comment on those two or three points to see what their outlook would be in terms of the RRSP, the auto and aviation industries, and Kyoto, which is drawing a lot of attention today in our press.

Mr. David Dodge: Since you've raised four issues, we'll split them two and two. I'll take whether we should be sanguine and the RRSP issue, and I'll leave Kyoto and the industrial structuring to Paul.

Look, we're not sanguine. What we're saying is that the outlook for 2005 and 2006 is about as good as it gets. Credit conditions are about as good as they have ever been. Household balance sheets are actually very strong, corporate balance sheets are very strong, and in this country, government balance sheets are pretty good. So that is true, but there are big risks out there. We talked earlier about the international risks, which I think really are there, and we talked also about the risks that come from the restructuring that has to go on domestically, which is always difficult. Let's not minimize the difficulty in making those transformations.

So I don't think we should be sanguine. Indeed, the time to do things that are difficult is when times are reasonably good, and we really do need to get on with the job on that domestically, but internationally as well.

On the RRSP issue, let me say right off that we think this will make for a more efficient capital market, and since we think it's extraordinarily important that our capital markets be as efficient as possible, we think this, in the end, is a very, very sensible thing to do. Will it have much impact? In the short run, of course, probably not, because Canadian assets at the moment are relatively attractive, and indeed the experience, if we look at Britain, which had similar restrictions on its plans and then took them off, is that in fact it doesn't affect things very much.

Where the real effect is going to be is on large pension plans covering lots of workers who were indeed using derivative instruments, in essence, to get around the rules, but those instruments were very costly. So they can actually achieve the same distribution of their assets now in the open market without going through that cost, which was up to about 50 basis points. That means that pensioners in fact are going to be better off in the future.

Finally, I think it is important to note that what is available, the sorts of assets that are available here in Canada, are of a relatively narrow range, so prudent risk management says you ought to be spreading over those, just as prudent risk management in the United States or in the U.K. says you better have some of these Canadian assets on your books.

Finally, as one more point, I think this will be very good in provoking the mutual fund industry, which has relied a bit on a captive market because of these rules here in Canada. There's now going to be more competition, and that's going to be better for savers, in particular the small saver in his or her RRSP.

Paul, let me turn to you on Kyoto and the auto industry and industrial restructuring.

• (1240)

Mr. Paul Jenkins: Let me start with the second of those two, the auto industry and the aviation industry, which you mentioned. What I'd like to do is cast the net a little bit broader in terms of the adjustment we are seeing in Canada and the adjustment we feel will have to continue to move forward in response to global change.

This is very much a theme of our report. There's a section beginning on page 12 called "Adjusting to global change". The point we make there is that with these global developments, exchange rate adjustments link to a number of global economic forces at play, together with the emergence of countries like China and India and the competition associated with that. This will entail an adjustment for the Canadian economy as we go forward.

What type of adjustment? It will entail an adjustment of labour from one sector to another sector. It will entail investments in some areas, such as the commodity areas we've talked about, the tar sands, for example, and the energy sector more generally, which will benefit from this global trend we're seeing in terms of the emergence of countries like China.

Clearly, investments are needed there to expand capacity, but there are other sectors of the Canadian economy—the automotive sector, the aviation sector—that are experiencing increased competition due to the emergence of these countries. What we're seeing there is, yes, some investment, but not so much to expand capacity as investment designed to increase productivity and reduce costs, to try to find

ways to compete in that global economy and against those global forces that we're going to continue to face.

We are going to see the sectoral pressures continue. We've seen clear evidence of it to date, and in part this comes back to some of the policies the governor was talking about, micro policies to enable countries and companies to adapt, to have a workforce that's flexible and can move from one sector to another as these forces play out.

I think you've touched on a very important issue. There's quite a bit in our report that deals with this from a macro perspective, including the manufacturing sector, which is very much concentrated in those two that you touched on.

With regard to Kyoto, we're not experts in that, by any stretch. These are medium- to longer-term issues, clearly. Moreover, they are global issues that many countries—the emerging market countries in particular—need to face. The sorts of industry and industrial production you see in many of these countries uses antiquated technology, so it is important to think about these issues from that global perspective, using new technology worldwide to grow and prosper but in ways that can move away from that heavy industry structure that so many of these countries have relied on in the past.

• (1245)

The Chair: Thank you, Mr. Jenkins.

Monsieur Côté.

[*Translation*]

Mr. Guy Côté: Thank you, Mr. Chairman.

In your report, you talk about inflationary pressure and about the appreciation of the Canadian dollar in relation to the US dollar which impacts our exports considerably. Investment spending has also declined, although an increase was noted during the current year. Fortunately, these effects were offset somewhat by growth in the domestic economy.

In your report, you focus at length on the global economy and on the emergence of certain economic powerhouses such as China. Canada is feeling the effects of this robust growth in some sectors, notably textiles. Mention is made of a possible adjustment in the US trade balance.

Shouldn't your report be sounding a few alarm bells? Shouldn't it be having that effect? How would you assess the current situation and what would your prognosis be for the short term? Should we in fact be sounding the alarm? To what extent can the Bank of Canada make adjustments to mitigate some of the adverse effects of all of the developments that I've noted?

Mr. David Dodge: As you pointed out, microeconomic adjustments are always difficult to make. You mentioned the textiles and clothing manufacturing sectors. Winnipeg is especially affected by the latter sector. The Beauce industry is impacted by the cycling industry, while the auto sector affects virtually all of southern Ontario. There is no question that some difficult, but nonetheless important, adjustments will be required. Microeconomic policies are needed to facilitate these adjustments.

What can the Bank of Canada do? Not much, from a microeconomic standpoint. The best we can do is keep the economy operating at near capacity by maintaining the inflation rate at around 2%. That's important, because a stable monetary situation boosts confidence in terms of investment spending for the future.

I do not, however, wish to minimize the importance of short-term adjustments. The difficulty lies in making these adjustments, either in the case of the industries that I just mentioned, or in the case of others that are in serious need of skilled labour, specialists and inputs to boost production.

It's a difficult process but as I see it, Canada is in a much better position than it was in the 1980s, for example, to make these kinds of adjustments.

● (1250)

Mr. Paul Jenkins: Just to add to that briefly, the challenge you mentioned, namely making adjustments to the Canadian economy, is a central theme of the Monetary Policy Report. Obviously reallocating capital and labour entails costs for certain sectors and businesses.

Having said that, as the Governor pointed out, a number of global forces are present. The role of monetary policy is to continue to facilitate the adjustment process. How? First of all, by aiming for an inflation rate of about 2%, but also by helping the economy operate at full potential. Current major economic forces are a very important theme in this Report, but the role of monetary policy in facilitating this adjustment is also a key consideration.

Mr. Guy Côté: At the moment, the inflation rate is within your target range. You also mention in your report that the economy is operating at near full capacity. I don't recall the exact words you used, but that's more or less what you said. Based on these two criteria, do you feel that the Bank of Canada is doing a good job at this time and that conditions are conducive to as smooth a transition as possible in light of global changes?

Mr. Paul Jenkins: As I said, the role of monetary policy is to facilitate economic adjustment. It's important to aim for keeping the inflation rate at around 2% and also to help keep the economy operating at full potential. From a macroeconomic standpoint, that is the role of monetary policy.

Mr. Guy Côté: I'm not interested in microeconomics. However, from a macroeconomic perspective, as you state in your Report, the rate of inflation is within your target range and the economic is operating at near full capacity.

From a macroeconomic perspective, the Bank of Canada is doing what it needs to do at this time to ensure as smooth a transition as possible in light of changes that can arise. It's not my role to conduct policy. That's your job.

Mr. David Dodge: As noted in our April 12 Report, we haven't tweaked interest rates in order to continue facilitating this adjustment. However, we need to recognize that interest rates will eventually have to rise.

[English]

The Chair: Thank you, Mr. Dodge.

I have Mr. McKay, then Mr. Penson and Ms. Wasylycia-Leis.

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

And thank you, governor and senior deputy governor. I always enjoy these visits by you because they're like your own personalized seminar on the state of the nation. Unfortunately, due to the number of questions already asked, many of the areas I was interested in have been reviewed.

I wanted to look at your chart 19 here. The chart shows that since basically the middle part of 2001 to 2002 the price of oil has gone from in the area of about \$20 per barrel over about a three-and-a-half-year period up to, at the high point, I guess, about \$57, and there have been some reports that we're talking about the cost of oil going to \$100 a barrel.

Your argument seems to be that it's going to be fairly stable over the next two or three years, in the range of \$50 to \$60 per barrel, in part because futures seem to be trading at that level. That seems to be the basis for your argument, although when you answered another questioner, you said that really there's no spare capacity to respond to increased demand.

I'm having trouble squaring those two thoughts, because if the demand continues even at a moderated pace, it would seem reasonable to assume that the cost of oil is going to keep on moving on an upward trajectory. So that's the first question.

The second question is, if that happens, what would be the impact on the triple deficit of the U.S.—you know, on its demographic challenges, budget deficit, and exchange deficiencies?

The third question has to do with the Chinese linking their yuan to the U.S. dollar. It's not clear to me—this is a separate question, I suppose—what interest the Chinese government has in delinking. What would the Chinese government achieve by delinking from the U.S. dollar?

● (1255)

Mr. David Dodge: I'll take the oil questions and Paul will take the question on China, because I think that's a very good question. It is indeed in the Chinese interests to do so, but Paul will go into that.

In terms of the oil issue, I think one has to clearly separate the very short term, when it is absolutely impossible to add to capacity and where it is very difficult to make adjustments to reduce consumption, from the medium term, where indeed capacity can be added to and where consumption adjustment or utilization adjustments can be made.

Over time it's clear that additional capacity can come on. It can come on in Canada through pretty heavy investment. It can come on in a place like Mexico, if they were to open up their industry to allow the full bore of technology to be brought to bear. It could come on a bit faster in the Middle East, if the same thing were to be allowed. But it does take time.

On the other side, on the utilization or consumption side, a higher price will drive consumers to find ways to economize. Eventually, we'll buy more sensibly sized cars, and we will eventually find ways to use a little bit less electricity. But very importantly, industrial users will economize as well.

So over time you would expect the price mechanism to be working to resolve some of these imbalances, which is why I don't think you'd find anybody—whether it be Central Bank, the IEA, the OECD, or the IMF—that would project over the long haul very, very sharp rises.

On the other hand, good world growth means that the demand, even attenuated by economizing measures, is going to grow, and the output side can grow at only a limited pace. So that's why looking out we are looking for relatively high prices over a relatively prolonged period, but I think analysts like ourselves—or like the IEA or people who really delve into it—really would say that if there's going to be a price spike, it's likely to be a very short one.

When you read Goldman Sachs' analysis of \$100, if you read the whole analysis, you'll see that wasn't really what they were saying at all. They were talking about a very tiny spike. So I don't think one ought to be spooked by that. On the other hand, one had better get used to prices that are higher than what we got used to in the 1990s.

In terms of the impact on the United States, the United States, as you pointed out, is a huge importer of petroleum products—of crude and indeed of products—because of their lack of investment in refining capacity. Indeed, investment in refining capacity is unlikely to come on all that quickly, in part because of environmental concerns and in part because there is a lack of certainty as to whether this demand is going to continue.

This is really important for us, because without that capacity to refine the heavier grades of crude—the grades that we produce out of the tar sands—it doesn't open up as much opportunity for us.

But yes, higher prices for oil are a clear negative for the United States in the short run and are somewhat negative in the medium term overall. But I wouldn't put too much emphasis on that, because over the medium term in fact the economy can adjust. In the short term, clearly price spikes do cut other consumption.

Let's then turn to this other very interesting question on China.

Paul.

• (1300)

Mr. Paul Jenkins: Let me respond to your question, Mr. McKay, by posing a couple of questions.

Most of China's growth in recent years has been export led. Going forward, they need to continue to generate growth in the order of 8% or 9% to absorb this transfer of labour from a rural to an urban setting.

My first question is, can growth of that order of magnitude continue on an export-led strategy? My answer to that would be no.

The second question is related to the vast accumulation of reserves that China has incurred. My question is, is that really a good investment of the wealth that this country has been accumulating,

with 3% or 4% in U.S. treasuries, as opposed to investing it in their domestic economy? Again, my answer is no.

To generate the sort of growth rates required to accomplish their policy objectives, China will need to rely increasingly on domestic demand. That's where dealing from a fixed exchange rate is important. Moving to a floating exchange rate enables you to do both. You can run your policies to generate more domestic demand. At the same time, it is an important mechanism to ensure that the wealth they are accumulating gets disbursed among their citizens within the country.

The points we have been making internationally with regard to this issue have been focused on our belief that moving from a fixed to a floating exchange rate is in China's best interests. It's what they will need to be able to manage their economy so that it will generate the sort of growth they need year in and year out. I do not believe they can continue to do that with an export-led growth profile.

The Chair: Why can't they live off an export economy?

Mr. Paul Jenkins: Look at the size of the Chinese economy. At the moment, in contrast to most other countries, whether industrialized or industrializing, consumption in China accounts for something like 30% to 40% of their economic growth. In North America you're looking at growth coming from domestic demand that is more like 60% to 70%. A country the size of China, with its growing importance in the world economy, has to be able to generate growth from within its own economy. That really is the basic point.

• (1305)

The Chair: I was relating it to Canada. Canada would be an export economy, would it not?

Mr. David Dodge: The answer is that our growth strategy is a very balanced one, as opposed to an export-led growth strategy. At some point, the export-led growth strategy has to transform itself into growth in domestic demand.

It is very peculiar when you think about the distributional consequences of what's happening. The very badly paid Chinese worker is now subsidizing me when I go to buy my blue suit. That's a very peculiar transfer of income, if you think about it. The way the real incomes of the ordinary working person in China are brought up is by increasing what they can purchase with their dollars, rather than by subsidizing me to buy my blue suit. You'd like them to be able to buy things for themselves and their families. That is what an appreciation of the exchange rate will do. And that is exactly what the Chinese need, for domestic reasons. Forget the international reasons; it's what they need for domestic reasons.

The Chair: Thank you, Mr. Dodge.

Hon. John McKay: I don't know whether the Chinese worker will be interested in this, but I just got an e-mail saying that Cardinal Ratzinger has been elected as Pope.

The Chair: Yes, Cardinal Ratzinger.

Mr. Penson.

Mr. Charlie Penson: Thank you, Mr. Chair.

This is a very interesting discussion, especially as it relates to China and their fixed exchange rate. On the current account deficit in the United States, I'd just like to follow up on what Ms. Ambrose was discussing earlier.

I think, Mr. Dodge, you said something to the effect that the U.S. may get fairly aggressive on dealing with this current account deficit. I'm interested in the tools they might use to deal with it, and I'm concerned with some of the tools they might use. In the past they've lowered interest rates, which makes their dollar lower, and that hasn't seemed to work all that well, but what if they were to expand on this protectionist idea that's been developed in much of the United States? It was tried back in the 1920s, as you know, and largely led to the prohibitive tariffs that led to the huge depression in the 1930s. That's a real concern, and I think it should be a concern to all of us.

What tools could they use, short of massively cutting their expenditures and their government spending, to deal with this current account deficit, other than things like huge tariffs or lowering the U.S. dollar?

Mr. David Dodge: That's a really good question. First of all, let's be very clear that while there are certainly huge pressures in Congress to do something, the administration—at least so far—has taken a very balanced view on this, for precisely the reasons you say: there is an enormous danger that we get into a protectionist mode around the world, and that protectionism in one place leads to protectionism in another, and that is a real disaster.

That, of course, is part of the reason we think it's very important that all countries not only play by the WTO rules, but also play by the monetary system rules, which essentially means one of two things when you start to run these big surpluses; either you inflate like hell domestically, which in effect changes the real exchange rate to bring about an adjustment, or you allow your currency to move.

Central bankers, of course, would never counsel inflating like hell, so we say let the currencies move to make the adjustment. But that will take time, and initially when the currencies move, the adjustment is often in the wrong direction, because it takes time for consumption patterns or investment patterns to change.

That is not a problem. It is not an issue that the U.S. couldn't finance a current account deficit of 5% or 6% in the short run. There is plenty of finance out there in the short run that in fact has allowed the situation to go on without corrections being made.

Where the real danger comes is over the medium term. If corrections aren't made and there's an indication those imbalances are going to grow over time, rather than be on a course that will correct them, that is the danger. But I don't think anybody ought to think that an imbalance of 5% or 6% at a point in time is a disaster.

The problem is that steps are not being taken to allow the market to correct that imbalance over time. That is where the problem is; we're not using this rather good period to take the steps to correct those imbalances. I mean "we" collectively, the world.

● (1310)

Mr. Charlie Penson: What levels would that U.S. current account deficit have to get to before it was—

Mr. David Dodge: As I said, there is no reason to be in balance in any given year, both for capital market reasons and for trade reasons. We've gone through periods when we've had big deficits. It's very important if you're trying to finance massive capital investment that you can't sustain in your own market, so there is absolutely nothing that's bad, qualitatively, about a big deficit or a big surplus at a point in time.

What is bad is the absence of mechanisms to allow that rebalancing over time, because then what happens is great fear—we build up great fears—about what will happen in the future, and that leads to very abrupt and calamitous situations when the adjustment has to take place.

So it's not that—

Mr. Charlie Penson: But isn't it true, Mr. Dodge, that the U.S. current account deficits have largely been offset by investment, people wanting to invest in the United States? Is there any trend you're seeing that would lead us to be concerned that those investments might be starting to drop off and therefore make the current account deficit more of a problem than it has been in the past?

Mr. David Dodge: Yes, and I'm just searching for it.

What is really interesting is that if you look at the sources of finance for the United States and divide those between direct investment, portfolio investment, and official, if you go back to the late 1990s, what you had was huge direct investment in the United States. That balance began to change at the end of the 1990s to include a little bit of official and a bit more portfolio.

If you look at it today, you have a much higher percentage of that being official, which is the buildup of these exchange reserves, and on the private side you're getting more of it being portfolio as well. We're getting to the point now where the appetite of a typical Canadian pension fund to stuff more U.S. assets into its portfolio is not all that great. So over time there are limits to how great the appetite is to hold these assets. It's particularly worrying when the official sector is coming in and taking so much of this.

The Chair: Ms. Wasylycia-Leis, and then Mr. McKay.

Ms. Judy Wasylycia-Leis: Thank you very much. I have four questions that I'll put to you all at once. Otherwise, the chair will cut me off.

The first goes back to the point I raised about record-level corporate profits. You responded in part to my concerns, but I still sense from you a fairly imbalanced approach to this whole area, with a great deal of focus on workers, productivity, and less of a prescription for how the corporate sector ought to be reinvesting in Canada.

So my question on that has to do with this. Why wouldn't you say something against further corporate tax cuts at this juncture, which doesn't seem to be doing much to increasing investment and is certainly taking money away from the very programs you say are necessary, like lifelong training and education for a more educated labour force?

Secondly, why do you keep emphasizing workers having to work longer and harder, even to the point where you oppose mandatory retirement and dismiss it as a silly policy, when in fact it seems to me we should be putting our efforts into helping workers deal with this tremendous lack of security about old age? Isn't that a drain on the system, and doesn't it have an impact on fiscal policies in Canada?

Thirdly, we have banks with record high profits. You've said we should resolve the merger question, but I don't hear you saying anything about banks reinvesting some of their profits in communities they've abandoned and helping with community economic development, as well as providing access to local financial services.

You've spent a great deal of time talking about training and opportunities to raise skills for workers and also the importance of the success of the CPP and having a plan in place where resources aren't raided for use by government, yet we have an EI fund where that happened. Government raided the EI fund to the tune of \$46 billion. That's money that could have been used for workers' skills. Yet when you were with the Minister of Finance, you actually oversaw the reduction in access to benefits that still plagues our system today, and your 1996 reforms didn't deal with this problem and ensure that we had a separate EI fund that didn't get rolled into tax revenue, which you say is a problem when it comes to CPP.

My last question has to do with another time in your past, when you were with the Minister of Health, when Paul Cochrane was the assistant deputy minister to you and he was bilking the system out of millions of dollars. He was recently charged. He was recently convicted on a couple of those charges. He received only a year in jail, a slap on the wrist, as many, many people in the community have said. Do you think that was an adequate sentence, and how does that kind of development actually contribute to confidence in the Canadian economy and productivity as a whole?

• (1315)

The Chair: You ran out of time. There's no time to answer the questions.

Mr. David Dodge: Let me start off on the corporate profit side. It is absolutely true that in North America—the United States as well as Canada—corporate profits are at very high levels as a share of GDP. I think 2004 was not a record historically, but it certainly, within recent times, is at an extraordinarily high level, and certainly for the first time in about 25 years, we found that corporate investment actually fell short of corporate profits in 2004.

We certainly expect that to reverse, and indeed the evidence in financial markets in the first quarter of this year is that it is reversing. The corporate sector as a whole is once again becoming a net borrower rather than being in this very strange position that they were in, as you pointed out, in 2004, of actually being a net lender. As I said, we at the Bank of Canada and at the Federal Reserve have been—and indeed this applies equally in Europe and in Japan—surprised that we haven't had more investment a little bit earlier from

the corporate sector than we've had, but we certainly do see that turning around in 2005 in terms of investment.

Secondly, we see some of these corporate profits being competed away. They are going to come down a bit, and there will be some rebalancing in 2005 and in 2006 between corporate profits and labour income because—I don't have to tell anybody here—the share of labour income in the national economy is well below trend and will have to come up.

In terms of workers working longer and harder, that's not what I was trying to say. I was really trying to say productivity is important, which is basically working smarter. On the other hand, we have some extraordinarily well-trained, skilled people in their late fifties and sixties—and that is the leading edge of the baby boom—and it would be very unfortunate if we had structures in our market that prevented them, should they wish, from making a full contribution to the economy. It wasn't asking people to work harder. It's just that we have an enormous opportunity, especially since 80% of our employment is in the service sector or is in a sector where physical constraints aren't what they were. No one is going to ask a miner or a nurse who has to do heavy lifting...and we cannot expect those people to do that sort of job on and on. There are, on the other hand, lots of jobs in the economy where they can make a real contribution and would like to, provided we have the flexibility training and so on to allow them to do it.

Bank profits should be competed away, and that is why we have argued really quite strongly that as Canadians we ought to have a real concern for the efficiency of our financial sector both to secure that ordinary citizens get the best service at the lowest price, get the best ability to borrow at the lowest price, and get the best returns they can on their savings, so that corporations and small businesses indeed have access, at an appropriate price, to the funds they need to make the investments we've been talking about.

• (1320)

What we have argued is that whether it's in the bank sector, the insurance sector, or the securities area, what we need to do is promote efficiency as a real goal, because that will make us all better off.

Finally, with respect to the situation at Virginia Fontaine, I don't want to say anything more particularly about it, because as you know, it's still before the courts in Winnipeg. I would make a general comment, that I think breach of trust, whether it be on the part of a public servant, an official, or in the corporate sector is a very serious problem. We as a society function on the basis of trust. When trust is abused, those who are convicted of abusing that trust ought to be subject to the full force and full penalties of the law.

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

Mr. McKay.

Hon. John McKay: I want to go back to the line of questioning about China, and on the oil price as well. I found, as you were unpacking the answer, that other thoughts came.

I understand your argument that essentially it's in China's interest to delink, because they could do better things with the money. Also, the U.S. dollar is a lousy investment. Maybe I'm putting it a little bit strongly, but there has been depreciation in the U.S. dollar, and it seems to me the Chinese people as individuals have recognized that and have started selling off U.S. dollars. But the central bank has not. I wonder whether you've observed that trend. If so, what are the larger implications for this argument that the U.S. dollar and the Chinese yuan should be delinked? That's my first question.

My second question is directed to the governor. I understood your arguments with respect to the price of oil in the medium long term; I think you're right. But your chart 19 is essentially a short-term chart, which is three years. I'm not sure whether you count three years as medium long term, but I would call that short term. It seems to me your medium long-term arguments almost force you to conclude that there's going to be an oil spike in the next three years.

• (1325)

Mr. David Dodge: Let me deal first with that. When supply and demand are so finely balanced, the risks of a short-term spike are fairly high. If some production goes off line for some reason, or if something happens that disrupts ocean shipping or something like that, the risks are obviously high when there's very little excess capacity. Up until now there's been very little incentive for excess capacity. I don't want to go into all of that argument.

We only showed out to three years in chart 19, but in fact those futures curves go out about seven years. They're flat all the way out. This is very different—I would stress this—from the picture 18 months or so ago, when it tended to pivot on a point somewhere between \$20 and \$30; the short one would go up, but it would pivot. What's happening now is that it's all come up. It is a different picture.

Hon. John McKay: Then your entire positioning is based upon that futures market?

Mr. David Dodge: It is, because we are not in any way experts. The market may be equally as bad a forecaster as forecasters A, B, and C who do independent forecasts. But that's the market. There is a real logic behind it, if you think that world growth is likely to continue at reasonably sustained levels. The fact that oil prices are high going out into the future seven or eight years is actually based.... The way the market comes to it is that it's going to take a while for capacity to come on line, and the outlook for world growth, in particular in those economies where oil is the marginal source of energy, is totally consistent with a very sensible view of the world.

Now, if everything collapses and we run into a big trade imbroglio and world growth slows to zero, it would have the opposite effect.

• (1330)

Hon. John McKay: All bets are off.

Mr. David Dodge: In terms of the Chinese, I think your major premise is a little bit not quite right, because the individual Chinese citizen at the moment doesn't have a mechanism to invest his or her savings offshore. That's because the domestic financial markets in China are very underdeveloped. In fact, about the only option the

individual Chinese citizen has had is to stick money in one of the big state-owned banks that pays a very low real rate of interest. But because there is not, by any means, an adequate state pension or medical system, the individual household really has to save to protect itself.

Ask yourself what would happen if more opportunities were indeed opened up. What we are seeing happen is that there is quite a large curb market developing—i.e., a sort of grey market for investments that are not flowing through the banks—as ordinary Chinese citizens try to invest in something that will give them a positive real return on their assets. But think what would happen if ABC mutual fund could open up so that the ordinary Chinese citizen could actually buy some sort of mutual fund assets in the rest of the world. There actually would be quite strong demand, we think, for those assets.

So it's not at all clear that opening the market, were there vehicles for the ordinary Chinese citizen to invest, would mean everything would flow into China. There would be money flowing out, just as in our pension plans we want to flow money out to balance our portfolios. It's not absolutely clear that there's a one-way street and that the only way the Chinese currency could go is up. That's probably true for a while, but over time, these capital flows balance out.

It's very important for the ordinary Chinese worker to have access to this. That's why, when we talk to the Chinese officials—and quite frankly, I think the people at the People's Bank of China understand this—we say that it really is in the domestic interest of the Chinese, forget about the world, to move to allow their currency to appreciate, to contain domestic inflation, and to give their workers the benefit of the gains they're making.

The Chair: Thank you, Mr. McKay.

Just quickly again, can we go over your position on the bank mergers, and if necessary the cross-pillar issue and another issue I have at heart, the national securities regulator?

The problem we're facing with the bank mergers is what will happen in the smaller communities. I think Judy alluded to that. I understand they have to compete internationally, but we have a problem here in Canada.

Mr. David Dodge: As I said, our arguments that we made at the bank—and I tried to lay them out in my speech to the Canadian Club in Toronto in December—were that we need a very efficient financial sector in Canada, for two reasons: first of all, and very importantly, so that Canadian savers and investors can have access on the best possible terms to the highest return on the part of the savers and the cheapest and most efficient form of financing on the part of the firms that need to access those markets for investment. That is extraordinarily important; secondly, the financial services sector as a whole is a very important sector. It's a sector that pays high wages and generates a lot of opportunities. That is, quite frankly, the basis for a lot of the development in the greater Toronto area, in the Montreal area, and a little in Vancouver and Calgary. It's also very important from the point of view of being a sector that can grow and gain its share of the world market. That is true of the banks. That is true of the insurance companies. That is true of the investment side.

The worry about small communities is a very real one. What is very interesting, and I think extraordinarily important, is that we have out there other institutions, in particular the credit unions, that in fact serve small communities very well. What we have seen as the banks do close some of their branches is that there's been an appetite on the part of the credit unions to move into these communities. They are perhaps better structured to meet the needs of those communities, especially because they can balance out their assets through the centrals.

While there will be a period undoubtedly where there will be branch closures, and there certainly have been branch closures, there are also opportunities here for other institutions to move in. Certainly what we have seen is a willingness—not just a willingness, but let me put it more strongly—a desire of these institutions to come in and capitalize on what they perceive as being the inefficiency of the large banks dealing in these communities.

• (1335)

The Chair: Just quickly, the banks or the financial sector is important to the Canadian economy, but aren't we going to move some of those jobs off shore or outside of Canada?

Mr. David Dodge: What I want to do is move jobs that are off shore, on shore into Canada by having a really efficient sector, and we can do that.

For example, we are still probably as good as...well, we are better than other nations in most other markets in financing junior mines.

We can be even better, so that's an argument to try to have a better, more unified market sector to try to build that.

Our banks, in fact, are really quite good at certain things. They're not as good perhaps in major investment banking as the big institutions in New York, but they're very good at other things. To give them an opportunity...not only an opportunity, but to force them through the market pressures in the markets for their shares to do their very best to deliver the very best service is I think really good in the end in allowing headquarters jobs to stay in Canada, rather than have these institutions becoming increasingly irrelevant on the world scene.

I think there is a real opportunity for the financial sector. We do have a good reputation both on the banking side and the insurance side and, as I said, in some niches of the investment markets. We ought to play to that, because that's a great industry to have on shore.

The Chair: With regard to the national securities regulator, we're seeing that there's pressure on a Canada-wide basis. Is there also pressure on North America versus Europe versus Asia?

Mr. Charlie Penson: Mr. Chair, these are very big-topic areas. They deserve to have a more in-depth discussion. It might be appropriate to invite the governor and staff back, so that all of us can participate in this debate. There are two important debates here, and I don't think you're going to have enough time to discuss them both this afternoon.

Mr. David Dodge: Certainly, Mr. Chair, we'd be happy to come back and talk about the financial sector efficiency issues. We are doing a lot of work on this, and we think it's really important that all Canadians understand the importance of having an efficient financial sector.

Our life insurance sector is recognized worldwide. What we are seeing is a sector where consolidation has taken place, where institutions are making considerable strides offshore to gain market. What this means is really good jobs at the head offices here in Canada and real contribution to Canadian GDP.

So we think it is a sector with lots of opportunities. We start from a solid base, but we need to ensure that we continue to work hard to provide the structure that encourages the greatest efficiency.

• (1340)

The Chair: Thank you Mr. Dodge, Mr. Jenkins. I appreciate the visit.

Since the members must go, the meeting is adjourned. Thank you.

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