David Dodge: Update on economic and monetary developments in Canada

Opening statement by Mr David Dodge, Governor of the Bank of Canada, before the Standing Senate Committee on Banking, Trade and Commerce, Ottawa, 28 March 2001.

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I appreciate the opportunity to appear before your Committee for the first time since my appointment as Governor of the Bank.

On this occasion, I would like to touch on the Bank's contribution to good economic performance, our emphasis on openness and transparency, and our role in promoting domestic and global financial stability. I will then comment on the Bank's view of current economic conditions and discuss any issues you may wish to raise.

The Bank of Canada has a commitment to contribute to the economic well-being of Canadians. This means conducting monetary policy so that it fosters sustained economic growth, by creating conditions favourable to rising investment, employment, and incomes and by bringing about a more stable macroeconomic environment.

The unique contribution that the Bank can make to good economic performance is to preserve confidence in the future value of money. This means that Canadians should be able to go about their business secure in the knowledge that their central bank will do whatever it takes to keep future inflation low, stable, and predictable.

The cornerstone of our monetary policy approach is an explicit inflation-control target. The current target range of 1 to 3 per cent, with emphasis on the 2 per cent midpoint, was established jointly by the Bank and the government under an agreement that runs until the end of 2001. An announcement regarding a new agreement to extend beyond 2001 will be made well before the end of the year.

In a world that is subject to all kinds of shocks and with financial markets increasingly more open and globalized, monetary policy actions stand a better chance of being effective if they are more predictable and better understood by the public. That is why the Bank emphasizes transparency and effective two-way communication. In this context, I would like to highlight our latest initiative to improve public understanding of the Bank's actions. We have adopted a system of eight fixed dates each year when we announce decisions to change or maintain the Bank Rate and explain the reasons for our action in a press release.

For a market economy like ours to function well, there must be widespread confidence not only that money will retain its value, but also that Canada's financial institutions, markets, and infrastructure are sound and efficient. Individuals and businesses must be confident that financial claims can be reliably and efficiently created, held, and transferred. This is why the Bank of Canada works closely with other federal and provincial entities to promote financial stability.

The Bank focuses its attention mainly on macro financial stability issues. Our contribution includes the provision of liquidity to the financial system, the oversight of major clearing and settlement systems, policy advice to the government on the overall framework for the financial system, and collaboration with other domestic and international bodies that work on financial stability issues.

In an increasingly interconnected world, we also must — and do — work with other members of the international community to promote the development of robust national financial systems and to prevent or minimize the impact of global financial crises of the sort experienced in the 1990s.

Canada has a financial system that is recognized worldwide as being sound and efficient. To keep it that way, we must ensure that as financial markets evolve we evolve with them. The Bank will, therefore, continue to work closely with its domestic and foreign partners to strengthen financial stability at home and around the world.

Let me now give you a quick overview of the economy.

Since last fall, most forecasters have marked down their projections of world economic growth for 2001, from just over 4 per cent to just over 3 per cent. While 3 per cent may not be a stellar performance, it would still be quite respectable.

In the United States, positive developments in such areas as employment and housing provide some hope that the end of the slowdown may not be far off. The Bank continues to believe that the pace of economic expansion in that country will strengthen during the second half of 2001, supported by the substantial decline in interest rates, the moderation in energy prices, and the drawing to an end of the current inventory adjustment. The exact timing of the recovery is uncertain, however, and will depend importantly on how U.S. consumer confidence and business investment evolve.

In Canada, somewhat slower growth had been foreseen for 2001 as the economy was beginning to press against capacity. In fact, growth eased in the fourth quarter of last year. And with data for the first three quarters revised, the level of economic activity at the end of 2000 was not quite as high as we had estimated. Based on recent indicators, growth in the first quarter of 2001 will be less than in the closing months of last year.

The slowing is clear in the automotive sector, where there have been production cutbacks in response to weaker U.S. demand and excess inventories. Activity has also eased—from very high levels—in electronics and telecommunications, where world production has been running ahead of demand.

These three high-profile sectors naturally attract a lot of attention, especially in parts of Canada with a heavy concentration in such industries. Weakness also continues in sectors that produce non-energy commodities. But we must keep a sense of perspective. There is still considerable strength in other important areas of our economy. The latest data show that investments in the energy sector are very strong. And, except for autos, retail sales are solid. In addition, activity in housing, non-residential construction, and most other service industries remains firm.

When we weighed all of the evidence in early March, we concluded that there was, in the near term, room for more monetary stimulus without risking pressures on capacity and inflation. On 6 March, we cut the Bank Rate by another 50 basis points, bringing the total reduction since January to 75 basis points. These lower domestic interest rates and rising disposable incomes, aided by recent tax cuts, should help to support the growth of domestic demand in Canada in the second half of 2001.

This additional stimulus to economic activity is consistent with keeping the core rate of inflation in Canada close to the 2 per cent midpoint of the inflation-control target range. We see total CPI inflation moving down to about 2 per cent in the second half of 2001, if world oil prices remain around current levels.

All in all, as we look ahead through this year and into 2002, the Bank remains positive about Canada's economic prospects.

The recent volatility in exchange rates, both here in Canada and in many other countries, has generated considerable public commentary, and I would like to say a word about that. What we have been seeing is a strengthening of the U.S. dollar against all major currencies despite the marked slowdown in U.S. economic growth. Since the exchange rate is a key price in the Canadian economy, the Bank recognizes that movements in its value can be a source of concern for Canadians. I want to reassure you that the Bank watches market developments closely and carefully assesses the effects of currency movements on aggregate demand and inflation in Canada.

In closing, Mr. Chairman, let me emphasize two points. First, although we expect reasonable growth to resume in the second half of the year, there are risks and uncertainties attached to this projection. These risks stem from global and, especially, U.S. developments. Although a moderation of U.S. demand was needed to sustain non-inflationary growth over the medium term, the slowing has been more abrupt than anticipated. As we look ahead, the question is how quickly will the necessary adjustments in production and inventories be completed in North America.

My second point is that Canada's economic fundamentals are sound—in fact, they are the best they have been in nearly 30 years. Canada continues to benefit from a climate of low, stable, and predictable inflation. Canadian governments are running budgetary surpluses. Canada is running a record trade surplus. Federal and provincial governments are reducing their public debts. Canada is reducing its net foreign indebtedness. And there has been a surge in investment in equipment and technology that is essential for rising productivity and improved standards of living. Canada's strong fundamentals should operate in favour of the Canadian dollar over time. Moreover, corporate balance sheets are strong, financial institutions are sound, and credit markets are functioning well. Although consumer debt loads have increased, with rising incomes and lower interest rates households are in a better position to service those debts.

In sum, Mr. Chairman, I believe that Canada is well placed to weather this period of economic adjustment. Given the uncertainties, however, the Bank will continue to monitor developments closely with a view to maintaining the low inflation that helps our economy to achieve its full potential.