David Dodge: The Bank of Canada's contribution to the economic well-being of Canadians

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Vancouver Board of Trade, Vancouver, British Columbia, 20 April 2001.

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I am glad to have this opportunity to talk to the Vancouver Board of Trade.

I know that you are anxious to hear the Bank's views on the current economic situation, and I will have some comments on that later. But first I would like to talk about how the Bank contributes to good economic performance and how we promote financial stability here in Canada and abroad.

The Bank's contribution to the economic well-being of Canadians

The Bank of Canada has a commitment to contribute to the economic well-being of Canadians. In other words, we must conduct monetary policy so that it fosters sustained economic growth. Fundamentally, this means creating conditions that favour rising employment and incomes, strong investment, and a more stable macroeconomic environment.

Low, stable, and predictable inflation

The best contribution the Bank can make to good economic performance is to preserve confidence in the future value of money. This means that Canadians should not have to worry about the effects of inflation when they make everyday decisions as consumers, business people, savers, and investors. It means that they should be able to go about their affairs confidently, knowing that they can count on their central bank to do whatever is necessary to keep future inflation low, stable, and predictable. In this way, they will be able to make sounder economic decisions, which will lead to better performance for the economy as a whole and to rising incomes.

Since the early 1990s, inflation in Canada has been low and stable. And economic activity has been expanding solidly over the past several years despite some major global disturbances.

Of course, a low-inflation policy by itself is not sufficient. It must be complemented by other policies: policies that seek to improve the structure of our economy; policies that seek to enhance the skills and flexibility of our workforce; policies that seek to make Canadian product and labour markets more efficient. In addition, all levels of government must continue to reduce their net indebtedness. This is extraordinarily important if we as a nation are to become less vulnerable to external shocks and to prepare for the pressures of a shrinking working-age population.

Inflation-control targets and a flexible exchange rate

Let me now talk briefly about the role of the inflation-control targets and the floating exchange rate in Canadian monetary policy.

Explicit inflation-control targets were jointly introduced by the Bank and the Government of Canada in 1991. Since 1995, the goal has been to hold the trend of inflation inside a target range of 1 to 3 per cent, with emphasis on the midpoint of 2 per cent.

Inflation targets provide an anchor for policy and an anchor for people's inflation expectations. They supply the Bank with an effective mechanism for assessing and dealing with demand pressures in the economy in a way that reduces fluctuations in output. Here's how this 'stabilizer' feature of the targets works. If total demand was pressing on the economy's capacity to produce, so that the future trend of inflation looked likely to move towards the top of the target range, the Bank would tighten in order to reduce demand and inflation pressures. Equally importantly, in a symmetric fashion, if demand was weak and future inflation looked likely to move towards the bottom of the range, the Bank would ease, providing more room for the economy to expand.

The basic point here is that the focus on inflation control allows the Bank to support growth when the economy is weak and to prevent overheating when the economy is strong and is pushing against capacity constraints.

The other important element of our monetary policy approach is a flexible exchange rate. A floating exchange rate allows our economy to adjust to economic disturbances such as a sharp change in foreign demand for our products or a sharp movement in the relative price of our exports compared with our imports. In cases like these, movements in the relative value of the Canadian dollar help our economy to adjust with less fluctuation in output and employment than if the exchange rate did not move. And when our currency moves in response to those shocks, the inflation target helps to anchor expectations regarding its value in world markets. So the inflation target and a flexible exchange rate work well together—indeed they reinforce each other—under our current monetary policy framework.

Effective two-way communication

In an increasingly interconnected world subject to all kinds of shocks and uncertainties, delivering a monetary policy that is credible and effective has become quite a challenge. The Bank believes that greater openness and clear, two-way communication are important ways in which it can influence the economy, particularly at times of increased uncertainty. Put another way, our actions will likely be more successful if those we seek to affect—the financial markets and the general public—understand what we are up to and why.

The Bank has made considerable progress in this area, and efforts will continue. Today, we provide large amounts of data and commentary on monetary policy in our regular publications and in speeches such as this one. Very importantly, we have also developed an excellent Web site that contains more than 5,000 documents touching on every aspect of our operations. It includes economic and financial data, research and analysis, speeches, and even an inflation calculator. I strongly urge you to visit our Web site, at www.bankofcanada.ca. I also encourage you to stay in touch with our regional offices across Canada.

Our latest initiative to improve public understanding of the Bank's actions is a system of eight fixed dates each year for the announcement of decisions on the Bank Rate. This system has been in place since last December. I believe that it is working well because it allows all of us here in Canada to focus on our own unique economic circumstances.

The Bank's contribution to domestic and global financial stability

As I said before, widespread confidence that money will retain its value is crucial to sound economic performance. But a market economy like ours cannot function properly unless it is also supported by a strong financial system—that is, sound financial institutions, efficient financial markets, and a robust financial infrastructure. Canadians should be able to count on financial claims being reliably and efficiently created, held, and transferred.

If the financial system is not robust, it can turn into a channel through which the effects of shocks—financial or economic—are magnified as they are transmitted from one part of the system to the next, within a country or between countries. The experience of the 1990s with the Mexican and the Asian financial crises showed us how this can happen. The echo of those events reverberated around the world. And, in both instances, Canada was sideswiped by the disturbance.

So there are compelling reasons why all countries have to ensure that their financial systems function well.

Here in Canada, the Bank works closely with other federal and provincial entities to promote financial stability. Bodies such as the B.C. Securities Commission focus on individual markets. But the Bank of Canada focuses mainly on stability issues from a broad, system-wide perspective. We contribute to financial stability in a number of ways. The Bank provides liquidity to the Canadian financial system. It oversees major clearing and settlement systems. It gives policy advice to the government on the overall framework for the financial system. The Bank also collaborates with other domestic and international bodies that seek to improve national financial systems and to prevent or minimize the impact of global financial crises.

Canada's financial system is recognized worldwide as being sound and efficient. To keep it that way, those of us charged with promoting financial stability will have to stay one step ahead of today's rapidly evolving financial markets. The Bank of Canada will continue to work closely with its domestic and foreign partners to strengthen financial stability here in Canada and around the world.

This completes my brief overview of the Bank's role in promoting monetary and financial stability. I now propose to turn to the current economic situation.

Recent economic developments

Let me start with the external environment in which Canada operates. The sharp easing in the pace of economic expansion in the United States has caused most forecasters to scale back their projections of world economic growth for 2001. Compared with an average projection of just over 4 per cent last fall, we are now looking at something a little over 3 per cent—not spectacular, but still quite respectable. This forecast assumes that, after a weak first half, economic activity in the United States will strengthen in the second half.

Some of the recent U.S. data (such as housing, motor vehicle sales, and industrial production) indicate that the economic situation there may be stabilizing. The Bank expects that, with stable or lower energy prices and with the inventory adjustment process well advanced, U.S. economic growth should strengthen during the second half of the year. The reductions in interest rates by the U.S. Federal Reserve should underpin this recovery. But of course, its exact timing and precise strength are difficult to predict.

Here in Canada, our economy was, by last summer, beginning to press against capacity limits. Thus, somewhat lower growth was anticipated for 2001. But, with the abrupt slowing of the U.S. economy, growth in Canada began to slow significantly in the final quarter of 2000. And by mid-2001, the Canadian economy will probably be operating somewhat below potential—that is to say, below what it is capable of producing over the long run without adding to inflation pressures.

This slowing in economic activity has not been uniform. Some high-profile sectors such as the automotive, electronics, and telecommunications equipment industries have been affected the most. And the prices for many non-energy commodities have been weak. It is this weakness that has had an important effect here in British Columbia.

But to keep a sense of perspective, let us not forget that there is still considerable underlying strength in other areas of our economy. This is certainly true of the energy sector, where production and especially investments to increase capacity are in high gear. And retail sales have held up well. In addition, activity in housing, non-residential construction, and most other service industries remains firm in most parts of Canada.

On balance, looking at the economy as a whole, the Bank concluded that there was room to provide additional support to total demand consistent with our objective of keeping inflation close to 2 per cent over the medium term. To return to my earlier point, this is exactly how the inflation target is working today to guide us in our actions to support growth at a time when total demand is weak.

So last Tuesday (17 April), we cut the Bank Rate by a further 25 basis points to 5 per cent, bringing the total reduction in interest rates since January to 100 basis points. This means that the overnight rate here in Canada is now at 4 3/4 per cent. It is this rate that corresponds to the federal funds rate in the United States, which is now 4 1/2 per cent.

Easier domestic monetary conditions, rising disposable incomes (boosted by recent tax cuts), continued business investment in new technology, and a pickup in U.S. growth should support a stronger economic expansion in Canada in the second half of 2001 and in 2002. Consistent with this profile for output growth, core CPI inflation will likely average somewhat less than 2 per cent over the remainder of this year, but move back up to 2 per cent towards the end of 2002. (Core CPI focuses on the CPI without its volatile food and energy components, and without the effect of changes in indirect taxes.) Total CPI inflation is still expected to move down to about 2 per cent towards the end of 2001, if world oil prices remain around current levels. The Bank's spring ***Monetary Policy Report,*** which will be coming out on 1 May, will provide more detail on the economic outlook.

The increased uncertainty surrounding global economic prospects has been reflected in recent developments in financial markets. Despite the marked slowing in economic growth in the United States, the U.S. dollar has strengthened against all major currencies, at least partly because global investors have sought the safety and liquidity of U.S. financial assets at a time of market uncertainty. Although the Canadian dollar has remained firm against other major currencies, the decline in its value against the U.S. dollar has once again generated considerable public commentary in this country.

Since the exchange rate is a key price in our economy, the Bank recognizes that movements in the external value of our currency can be a source of concern for Canadians. I want to reassure you that we watch market developments closely. And we carefully assess financial market sentiment towards the Canadian dollar and the implications of movements in its value for aggregate demand and inflation in Canada.

In closing, let me leave you with two key messages regarding our economic prospects. First, the Bank continues to expect a pickup in growth in the second half of this year and further strengthening in 2002. However, there are uncertainties attached to this scenario, mainly stemming from external—especially U.S.—developments. For example, there is a risk that the slowdown in the United States could be more protracted than anticipated. The Bank will have to monitor developments in this area closely.

My second message is that there are good reasons to be positive about Canada's economic prospects over the medium term. We have established a climate of low inflation. Most Canadian governments are running budgetary surpluses. As a nation, we have a large trade surplus with the rest of the world, and we are reducing our net foreign indebtedness. Moreover, there are no serious speculative excesses in the economy. Corporate and financial sector balance sheets are generally healthy. Credit markets are functioning well. And although consumer debt loads have increased, with rising incomes and lower interest rates households generally are in a good position to service those debts.

All this gives us a more solid basis to stand on as we go through this period of economic adjustment. And it provides a platform for future growth. The Bank's role is to target low inflation and to work with others to promote financial stability. As I explained before, by targeting inflation the Bank is providing appropriate support for growth in output and employment at this time of increased economic uncertainty.