David Dodge: Update on economic and monetary developments in Canada

Opening statement by David Dodge, Governor of the Bank of Canada, before the House of Commons Standing Committee on Finance, Ottawa, 1 May 2001.

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I am pleased to appear before this Committee for the first time since my appointment as Governor of the Bank, on the occasion of the release today of our spring *Monetary Policy Report*. Mr. Knight and I hope to be able to return on the day of, or shortly after, the publication of our *Report* every May and November.

The *Report* provides our latest assessment of the outlook for economic growth and inflation in Canada. Before I give you a flavour of that assessment, I would like to say a word about the objective of Canadian monetary policy and how we go about achieving it.

The Bank of Canada has a commitment to contribute to the economic well-being of Canadians. Thus, we must conduct monetary policy so that it fosters sustained economic growth by creating conditions that favour rising output, employment, and incomes, and a more stable macroeconomic environment.

The unique contribution that the Bank can make to sound economic performance is to preserve confidence in the future value of money. Canadians should be able to go about their business fully expecting that their central bank will keep future inflation low, stable, and predictable. In this way, they will be able to make sounder economic decisions. And this will lead to better overall economic performance.

The Bank pursues low inflation within a monetary policy framework based on an inflation-control target and supported by a flexible exchange rate. The current target is to hold the trend of inflation inside a range of 1 to 3 per cent, with emphasis on the midpoint of 2 per cent.

Inflation-control targets help to anchor policy and to anchor people's inflation expectations. And they provide the Bank with an effective mechanism for assessing demand pressures. In this way, we can take action to prevent overheating when the economy is strong and is pushing against capacity limits, and to support growth when the economy is weak.

At the same time, a flexible exchange rate allows our economy to adjust to disturbances, such as changes in foreign demand for our products or changes in the relative prices of our exports compared with our imports. And it helps us to adjust with less overall fluctuation in output and employment than if the exchange rate did not move.

With this brief overview of Canada's inflation-control strategy, let me now turn to the economic situation. When my predecessor appeared before you in May 2000, our economy was growing vigorously, bolstered by strong domestic and U.S. demand. Indeed, with signs of emerging capacity pressures, and with the need to sustain non-inflationary economic growth in Canada, the Bank raised interest rates the day after our appearance before this Committee.

These higher interest rates led to some cooling off in domestic demand in Canada. What we, and most other analysts, did not anticipate was the abrupt slowing in U.S. economic growth. This is the factor that has contributed to a greater-than-expected moderation in economic activity in Canada.

Since February, the Bank has been saying that we expect growth in the first half of this year to be very modest. And we have indicated that, by the middle of 2001, the Canadian economy will probably be operating somewhat below potential. Overall, the information received to date is broadly in line with the Bank's expectations. The monthly numbers have been volatile: some have been weaker and some have been stronger than anticipated. But they are generally consistent with our view that the weakness in the first half will be mainly associated with inventory adjustments in markets facing soft demand—in particular, motor vehicles—and with adjustments in other industries—notably electronics and telecommunications equipment.

The Bank continues to believe that, after very modest growth in the first half of 2001, economic activity in Canada will pick up in the second half and strengthen further in 2002. Let me explain what we are basing this on. Despite lower production in the three high-profile sectors I just mentioned, aggregate economic activity continues to grow, buttressed by underlying strength in other areas, including the energy sector, retail sales, housing, non-residential construction, and most service industries.

Supported by recent tax cuts that boost disposable income, final domestic demand should continue to expand. And we expect a recovery in foreign demand in the latter part of the year, encouraged by the substantial reductions in U.S. interest rates. Nonetheless, there are uncertainties about the exact timing and strength of the pickup in U.S. growth.

Here in Canada, we have lowered interest rates significantly to support growth in total demand in line with our objective of keeping inflation close to 2 per cent over the medium term. Since January, the Bank of Canada has cut rates by a total of 100 basis points, bringing the overnight rate—the rate that corresponds to the U.S. federal funds rate—down to 4¾ per cent.

With this monetary easing and with the strengthening in the pace of economic activity in the second half of the year, we now project annual average growth of between 2 and 3 per cent in 2001. For next year, we see output expanding at a rate slightly above the Bank's estimate of potential output growth of 3 per cent.

Consistent with the Bank's expected path of output growth, core CPI inflation will likely average somewhat below 2 per cent over the remainder of 2001, then move back up to 2 per cent by the end of 2002. Total CPI inflation is expected to be volatile over the next few months, before moving down to about 2 per cent by the end of the year if world energy prices remain close to current levels.

I would now like to say a word about recent developments in financial markets. These developments have essentially reflected the increased concerns and uncertainty surrounding world economic prospects. In the circumstances, global investors have, once again, sought the safety and liquidity of U.S. financial assets. And this has led to an appreciation of the U.S. dollar against all major currencies despite the marked economic slowdown in that country. Although the Canadian dollar has remained firm against other major currencies, the decline in its value against the U.S. dollar until just recently has been the subject of much public commentary in Canada. Since the exchange rate is a key price in our economy, the Bank recognizes that movements in its value can be a source of concern for Canadians. I want to assure you that the Bank monitors market developments very closely. And we carefully assess the implications of currency movements for aggregate demand and inflation in Canada.

In closing, let me reiterate that the Bank remains generally positive about Canada's economic prospects in the period ahead. We continue to expect a pickup in growth in the second half of this year and further strengthening in 2002. The main risk to this outlook is the timing and strength of the projected pickup in U.S. growth. Given this uncertainty, we will continue to monitor developments closely and we will respond appropriately.