David Dodge: Monetary policy and inflation targets 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, 29 November 2001.

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Malcolm and I are pleased to appear before this Committee. We hope that we will be able to do so, on a regular basis, in the future.

Today, I would like to start our discussion by spending a few minutes explaining how we at the Bank of Canada go about setting monetary policy.

The Bank has a commitment to contribute to the economic well-being of Canadians. This means that we must conduct monetary policy so that it fosters sustained solid economic growth.

As I said to you last March, the unique contribution that monetary policy can make to good economic performance is to preserve confidence in the future value of money. When people can count on their central bank to keep inflation low, stable, and predictable, they can make sounder economic decisions.

The Bank pursues low inflation within a framework based on an explicit inflation target, supported by a flexible exchange rate. The current target is to aim at the 2 per cent midpoint of a range of 1 to 3 per cent over the medium term. I say “over the medium term” because monetary policy actions take time to have their effects on the economy and on inflation. Some effects are felt fairly quickly. But the full impact on inflation can take up to 18 to 24 months. So, in setting monetary policy, we have to look ahead and make judgment calls about future economic developments and about the timing and final outcome of any actions we take today.

Since their adoption in 1991, inflation targets have proven very effective in keeping inflation low and in anchoring people’s inflation expectations. They have also provided the Bank with a useful mechanism for assessing and dealing with demand pressures on future inflation in a way that helps to keep the economy on a more even keel.

Let me explain how the inflation targets work to guide monetary policy and to allow the Bank to help stabilize the economy.

At any point in time, there is a certain level of output that an economy can produce without putting either upward or downward pressure on inflation. Economists refer to that level of output as “potential output” or “production capacity.” The level of potential rises over time as more workers join the labour force; businesses increase their investments in new technology, machinery and equipment; policy measures are taken to make product and labour markets more flexible; and all of us become more efficient and productive in what we do. Because potential output depends on many factors and their interaction, it is not something we can measure precisely—either in level or growth terms. But we can roughly estimate it, by analyzing the trends in those factors. At the Bank, we estimate that potential output in Canada is likely to rise by about 3 per cent per year over the medium term (as shown in Chart 1).

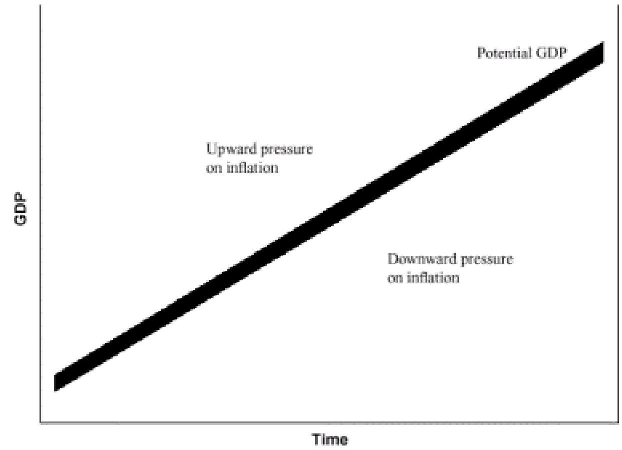
In estimating potential output, we find the emphasis on inflation control to be particularly helpful. It helps us to avoid systematic errors in assessing potential. For example, if inflation was coming in persistently below our expectations, it would be a strong signal that production capacity was higher than our estimate, and vice versa.

Now, in terms of setting monetary policy, the key question is where the economy is likely to be relative to potential several quarters down the road, and how that will affect future inflation.

If the economy is likely to be operating close to, or above, its capacity to produce, it is reasonable to expect that this will put upward pressure on inflation in the future (Chart 1). If this seemed likely to take inflation above target, the Bank would tighten monetary policy (that is, raise its key policy interest rate) to moderate demand and head off those pressures. On the other hand, if the economy is likely to be operating below potential, then there will be downward pressure on future inflation. If it looked that this would take inflation below target, the Bank would ease monetary policy to provide more room for the economy to expand.

Chart 1

Canada - GDP, Potential GDP and Monetary Policy



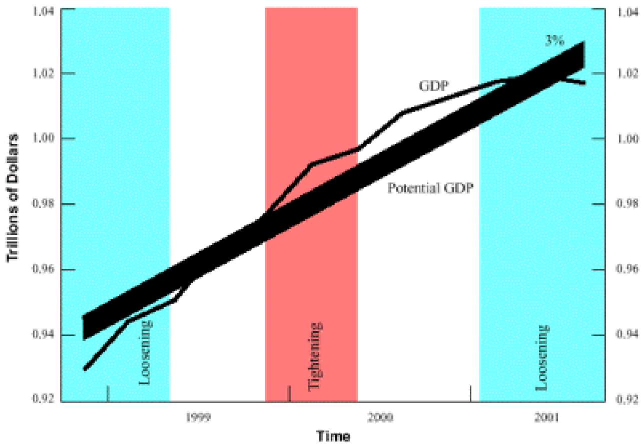
Thus, the emphasis on inflation control works symmetrically. It allows the Bank to take policy actions to prevent overheating, when the economy is strong and is pushing against its capacity limits, and to support growth when the economy is weak.

Let me now try to relate this to our recent experience in Canada.

If we go back to the fall of 1998, when the worldwide reverberations of the Asian and Russian financial crises were still very much with us, we can see from Chart 2 that our economy was operating below potential. Since this implied that there was a good chance future inflation would be below target, we eased monetary policy through the latter part of 1998 and the first part of 1999. Our economy rebounded strongly during 1999, and expectations were that it would continue to grow robustly—above potential—for some time, bolstered by strong domestic and U.S. demand. With signs of emerging capacity pressures, we then moved to gradually tighten policy in late 1999 and through the first part of 2000, to cool off demand and prolong sustained non-inflationary growth.

Chart 2

Canada - GDP, Potential GDP and Monetary Policy



The slowing of the U.S. economy that began in the second half of 2000 was welcome because that economy had been growing very rapidly for some time and it was in danger of overheating. But what we, and most other analysts, did not anticipate was the collapse in U.S. business investment, particularly in the information and telecommunications sectors. This led to a sharper slowdown than expected. When this became apparent early in 2001, the Bank's assessment was that it would lead to a moderation in growth in Canada, which would leave our economy operating somewhat below potential by mid-year. But we also expected that the pace of expansion would pick up in the second half of 2001 and strengthen further in 2002, returning us to potential output levels. So, although we proceeded to loosen monetary policy, we did so at a measured pace.

In the first half of the year, available economic information was broadly in line with the Bank's expectations. By midsummer, however, evidence began to accumulate that the recovery in U.S. investment—a key factor in the expected pickup in growth in the second half of 2001—would be delayed and that the slowdown in that country would be deeper and last longer than anticipated. Economic activity outside North America had also begun to show more clearly the effects of weaker U.S. growth and of the ongoing global retrenchment in the information and telecommunications sectors. In Canada too, there were signs that domestic demand, which had held up through the first part of 2001, was softening and that the inventory adjustment was not as well advanced as expected.

So we revised down our growth projections. The implication of this, as we looked out several months down the road, was that the economy would be operating substantially below potential and that inflation would be below target. That is why, at the end of August, we again lowered interest rates to support domestic demand growth.

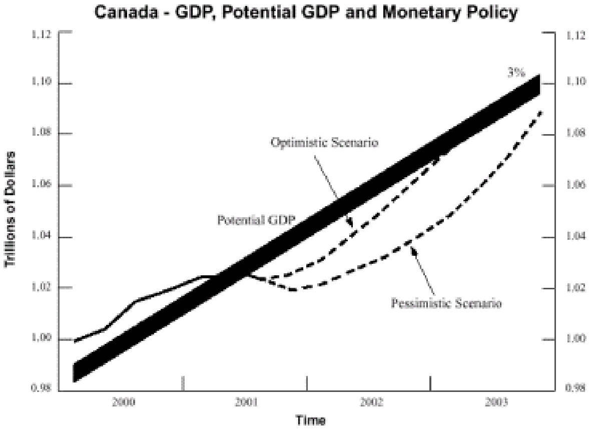
The terrorist acts in the United States, and their worldwide fallout, introduced a whole new layer of uncertainty into the global economic picture, further dampening near-term growth prospects.

I do not have to tell you how difficult it is to assess the ongoing economic effects of those disturbances, which may have had a significant effect on the psychology of North American households and businesses. But, as I said before, because monetary policy is forward-looking, we have to make a best possible evaluation of likely developments several quarters ahead.

As we look to 2002, the timing and extent of a recovery in economic activity will depend crucially on geopolitics and on how quickly confidence returns to normal. As we discussed in our November Monetary Policy Report, one can envisage two scenarios (Chart 3). In the first, confidence could be restored quickly, and robust growth could resume in early 2002, supported by the substantial monetary and fiscal stimulus already in place. In the second, confidence could stay fragile for some time, and growth would be anemic through most of 2002.

Chart 3

Canada - GDP, Potential GDP and Monetary Policy



Note that, under either scenario, the Canadian economy would still be operating at levels that are below capacity by the end of 2002. This means that inflation would continue to be below target through next year.

How has the Bank responded to all this? To underpin confidence in the wake of the extraordinary uncertainty generated by the terrorist acts, we took the exceptional step of lowering our key policy interest rate by 1/2 of a percentage point on 17 September, outside our regular fixed announcement schedule. And we moved again to ease rapidly—by 3/4 of a percentage point, on 23 October, and by 1/2 of a percentage point, on 27 November.

The cumulative reduction in policy interest rates since the beginning of the year amounts to 3 1/2 percentage points, of which more than half—2 full percentage points—occurring since late August. This substantial amount of monetary stimulus will work to support a resumption of healthy growth in output, investment, and employment, given Canada's solid economic foundations.

In view of the ongoing uncertainties, it is still too early to characterize the economic outlook with great assurance. Nonetheless, signs that the geopolitical situation may be stabilizing and that households and firms are beginning to adjust to the new environment, suggest a somewhat greater likelihood that the Bank's more optimistic scenario may come to pass than was the case a month ago.

In closing, let me stress that I have oversimplified how the Bank judges the performance of the economy relative to its potential. In addition, I have not mentioned all the factors that can influence the growth of potential or the future path of inflation. But I have provided the basic elements of the inflation-targeting approach that the Bank uses to help promote good economic performance.

Mr. Chairman, in my remarks today I focused, appropriately, on the contribution monetary policy can make to sustained economic growth. But I want to emphasize that, while low inflation is essential in this context, it is not sufficient by itself. Other policies, both macro- and micro-economic, must continue to focus on enhancing productivity and raising our production potential over the medium term.

This focus is extraordinarily important if we want to achieve sustained, solid economic growth and rising standards of living over time. We should not lose sight of it as we go through the current short-term difficulties.