David Dodge: Inflation Targeting During a Difficult Year

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Saskatoon and District Chamber of Commerce Saskatoon, Saskatchewan, 29 January 2002.

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Thank you for the opportunity to speak to you this morning.

As you may know, the end of this week will mark the first anniversary of my appointment as Governor of the Bank of Canada. It was an honour to be appointed, and it has been a privilege to serve Canadians in this role. I have had the opportunity to work with an extraordinarily talented group of professionals at the Bank, as well as a supportive Board of Directors. Together, with input from Canadians across the country, we have worked hard to conduct monetary policy as well as we could during rapidly changing, and increasingly difficult, economic times.

As I come to the end of my first year as Governor, it seems natural to look back and review some of the challenges and changes that have marked the past 12 months. The main economic concern of the past year was the slowdown that occurred not just here in Canada, but in most major economies. Compounding the economic concerns were the 11 September terrorist attacks in the United States.

Inside the Bank of Canada, there were some major developments as well. Two things in particular stand out for me. We went through our first year with our new system of fixed announcement dates for interest rate decisions, and we renewed our inflation-control agreement with the federal government. Yesterday in Winnipeg, I spoke about our fixed announcement dates. Today, I'd like to talk to you about our inflation-control target system. Then I'd like to take a few minutes to review the current state of the economy and touch on Canada's economic outlook.

Renewing the Inflation-Control Targets

Last May, the Bank and the federal government jointly announced the renewal of our inflation-control agreement. This was an important decision. It strengthened a policy framework that has given our economy low, stable, and predictable inflation for the past decade.

One of the main benefits of the targets is that they help the economy to run more smoothly when there are surprises in the level of demand for Canadian goods and services. Let me elaborate. Under the agreement, the Bank of Canada aims to guide total consumer price inflation towards the 2 per cent midpoint of our 1 to 3 per cent target range over the medium term. So when demand for goods and services leads the Canadian economy to push the limits of its capacity, and there is a risk of future inflationary pressures, the Bank will raise interest rates to cool off the economy.

But importantly, inflation targeting also works the other way. When the economy is operating well below its production capacity and inflationary pressures are likely to ease, the Bank will lower interest rates to stimulate growth. This was the situation we found ourselves in during the past year, as signs of the slowdown emerged.

By working in a symmetrical way, inflation targeting helps to level out the peaks and valleys of the business cycle. It promotes sound growth while tempering economic ups and downs. And this benefits everybody.

But the benefits of this framework go beyond its usefulness in setting monetary policy. It also helps reduce uncertainty about future inflation, by giving Canada a credible anchor for its monetary policy. Let me explain what that means.

Once the original agreement between the Bank and the Government came into effect in 1991, inflation quickly came down into the target range. But more importantly, measures of inflation expectations began to fall in line with the target range as well. At first, this applied to expectations of inflation over a 2-year period. But the time frame lengthened gradually, and since 1997, inflation expectations have been essentially anchored on 2 per cent for 30 years into the future.

This is important, because when inflation expectations are well anchored, the real economy works better. Wage bargaining can become less contentious. And we have seen a trend towards fewer labour disruptions and a lengthening of collective bargaining agreements. With stable inflation expectations, investors can better assess the future value of their investments. At the same time, savers know the future purchasing power of their money will not be eroded by inflation.

Supporting our inflation-control framework is our flexible exchange rate system. Although from time to time there may be excessive volatility in exchange markets, having a flexible exchange rate is important. This is particularly true for Canada because we are a small, open, and relatively specialized economy. The structure of our economy is different from that of the United States.

Now, when we renewed the inflation-control agreement with the federal government last year, we strengthened the framework in four ways. We lengthened the term of the agreement to five years, which should reinforce its credibility. We clarified that we are aiming inflation explicitly at the 2 per cent midpoint of the target range. This emphasizes that we pay equal attention to the top and the bottom of the target range. We committed to providing an explanation in our key publications – the *Monetary Policy Report* and *Monetary Policy Report Update* – if inflation persistently misses the target. This increases our accountability to Canadians. Finally, we refined the way we measure core inflation.

Refinements to Core Inflation

I want to take a minute to explain what core inflation is, and why it is important.

The Bank's inflation-control target applies to the annual increase in the total consumer price index. But we use core inflation as a guide to help us predict where overall inflation is likely to be in the future.

In calculating core inflation, we exclude the prices of those goods and services that tend to be the most volatile; that is, subject to temporarily wide movements both up and down. Previously, we would strip out all food and energy items from the CPI basket of goods and services when we calculated core inflation. But not all components of food and energy are volatile. Similarly, there are other prices in the economy that are highly volatile. So we found it helpful to focus just on the volatile components in order to do a better job in predicting the future path of inflation.[1]

Let me give you an example that explains why core inflation is important. In late 2000 and early 2001, energy prices were shooting higher. Anybody who drives can remember paying a lot more at the gasoline pumps a year ago than now. Natural gas and heating oil prices were also rising sharply. These prices were being reflected in the overall inflation rate, which moved above 3 per cent for the first time in almost 10 years. This prompted some commentators to call on the Bank to raise interest rates.

But the core rate of inflation was telling us that these higher energy prices were not significantly feeding into other prices. The core rate suggested that inflation would fall back around the midpoint of the target range, once the surge in energy prices either levelled off or reversed itself. In fact, this is exactly what happened. It would not have made sense for us to raise interest rates in the face of these temporarily very high prices for oil and gas. So even though total CPI inflation was high in the first half of 2001, the weakening economy indicated that downward pressure on inflation was coming. We expected core inflation to fall by the end of the year, as indeed it did, and to fall further in 2002. That led to our decision to lower, not raise, interest rates.

In the last few months, we've seen rapid declines in volatile components, such as gasoline, fuel oil, and air fares. This means total consumer price inflation is now well below the core rate of inflation. And in such circumstances, it is equally inappropriate to base our policy actions on swings in total CPI inflation.

The Slowing Economy in the Past Year

Let me now look back at a rather difficult year for the economy. During 2001, we lowered interest rates at every fixed announcement date, in order to adjust to the changing economic circumstances.

At the beginning of the year, our main concern was the impact that a slowing U.S. economy would have on Canada. Although domestic demand in Canada was holding up, against a backdrop of weaker foreign demand, we lowered our target for the overnight rate through the first half of the year.

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1 Both the old and new measures of core inflation also remove the effect of changes in indirect taxes.

But by mid-summer, evidence began to accumulate that the U.S. slowdown would be more protracted than anticipated, and that economic activity outside North America would be much weaker. At the same time, there were indications that domestic demand in Canada, which had held up well through the first part of the year, was softening. So at our 28 August fixed announcement date, we said that we had revised down our expectations for growth.

Then came the terrorist attacks of 11 September. Their immediate impact and subsequent fallout compounded the problems of the economic slowdown. And the attacks presented a pressing challenge to the Bank of Canada and other central banks: to keep the world's financial systems operating smoothly.

One of the Bank's key functions is to promote financial stability in Canada. That means keeping markets functioning well, even in times of extreme stress, such as the days immediately following 11 September. The Bank of Canada, as did other central banks around the world, stepped in to provide financial markets with ample access to domestic liquidity. And we reached an agreement with the U.S. Federal Reserve that would have permitted us to provide extra U.S.-dollar liquidity to Canadian banks had it been necessary. In short, we made sure that the disruption did not turn into gridlock. If there was one positive thing to emerge from this terrible event, it was that the global financial system kept running as well as it did.

But in the aftermath of these events, we were left with another challenge. That was to try to minimize the economic impact of the attacks. It was obvious that consumer and business confidence would suffer. We needed to do our part to help keep the loss of confidence as small as possible, which would help the economy recover as quickly as possible.

That is why in the days following the attacks, we took the extraordinary step of lowering interest rates outside our fixed announcement dates. It then became clear that the economy would continue to operate below its capacity throughout 2002, with resulting downward pressure on inflation. So we sped up the pace of interest rate reduction at the next two fixed announcement dates. We wanted to support economic growth, which would help keep inflation within our target range of 1 to 3 per cent.

The terrorist attacks created all sorts of uncertainties—economic, political, and military. So it was extraordinarily difficult last fall to be very certain about the future track of the economy. Now however, a clearer picture is beginning to emerge.

The Current Economic Situation and Outlook

One way for us to get that clearer picture is to actually get out across the country to see what is going on in Canada's regions. These opportunities to get away from the frenetic world of financial markets, and to see what is happening in the real economy, are extremely important to me, and to the Bank.

Let me focus on this province for a moment. Here in Saskatchewan, the impact of a slowing world economy was felt mainly through a weakening in commodity prices. This hurt not just the agricultural sector, but the important mining sector as well. After posting very modest growth in 2001, Saskatchewan's economy is expected to show an improvement this year. A pickup in the global economy should boost commodity prices, which would be a big help to the province.

Saskatchewan's agricultural sector would also be helped by a return to more normal weather patterns. There is an old farming saying that you can't lose a crop in January. But there is a clear critical need for more moisture in the soil and we all hope it comes soon.

Of course my predecessor, Gordon Thiessen, has strong roots in this province and he understood well the difficulties faced by farmers year in and year out. But I want you to know that I too can relate to the trials of farming. I have a small cow-calf operation outside Ottawa, and I know how difficult this business can be. We can try to do something about the economy at the Bank of Canada, but sadly, we can't do anything about the weather.

One clear positive for Saskatchewan has been the fiscal record of the provincial government, which is currently projected to post an eighth consecutive surplus. This strong fiscal record can only help the province deal with the sort of negative shock we experienced in the past year.

In looking at the country as a whole, some sectors of the economy have recovered smartly from 11 September, but in other areas the adverse effects have persisted. Certainly air travel, both for business and tourism, continues to be weak.

Last week, we published our *Monetary Policy Report Update*. In it, we said that the economy looked increasingly likely to find itself between the two extreme possibilities we had sketched out in last November's full *Monetary Policy Report*. On the plus side, geopolitical developments have been positive. Indeed, consumer confidence seems to be recovering in the absence of new terrorist attacks.

But it is difficult to pinpoint the exact moment that the economy will begin to recover or precisely how strong that recovery will be. What I can say is that the conditions for strengthening world economic growth are in place. Excess capital stock is being worked out of the system, leading to expectations of greater investment ahead. And low commodity prices should rebound as global demand picks up.

All told, we see Canadian growth in the first half of 2002 averaging between 1 and 2 per cent on an annualized basis. But growth should accelerate in the second half, with an average in the range of 3 to 4 per cent on an annualized basis.

What does this mean for inflation? We saw total consumer price inflation dip sharply in November, then stabilize in December. At the same time, core inflation also fell during those two months. This is consistent with an economy operating below its capacity.

With the economy growing more slowly than potential output through the first half of the year, excess supply will continue to build. So both total and core inflation are expected to remain near current levels for the next few months. But by lowering the target for the overnight rate, the Bank of Canada has taken vigorous action to stimulate domestic demand. We expect that as this excess supply begins to be taken up, both core and total CPI inflation should move back up close to our target of 2 per cent in about two years.

Businesses of all kinds are still adjusting to the security risks that the events of 11 September have shown to us. In our view, this should be a one-time adjustment. But it probably means that there will be a small reduction in the level of our economy's potential output.

I would now like to say a few words to reinforce our views about recent exchange rate developments that are a source of concern.

Over time, exchange rates should reflect underlying economic and financial developments and prospects. But in the short run, there can be volatility as markets gauge those prospects.

As I have already noted, it is becoming clearer that our economy will strengthen as we go through this year and into 2003. Recent data increasingly support the view that a recovery is taking hold. Household spending in Canada, particularly on interest-sensitive purchases, has been stronger than expected. The latest data on exports and manufacturing activity show signs of recovery. The inventory adjustment is progressing. And with early evidence of a revival in the U.S. economy, the world prices of non-energy commodities appear to have bottomed out.

These signs of a pickup in economic activity in Canada are encouraging. But the recent movements in the Canada–U.S. exchange rate do not appear to have reflected those developments and the depreciation we saw over the last couple of weeks is not helpful for the economy. Economic recovery in Canada does not hinge on the current low levels of the Canadian dollar against its U.S. counterpart.

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So to conclude, this past year has certainly been full of challenges. I know, however, that we have done the right things to get the economy growing strongly again, and that we are in good shape to take advantage of better times when they arrive. I feel confident in predicting that one year from now, when I'm looking back over my second year as Governor, I'll be looking back over a recovering economy, one that is much stronger than it is today.