David Dodge: Bank of Canada's outlook for the Canadian economy

Remarks by Mr David Dodge, Governor of the Bank of Canada, for a meeting with Canadian banks and the investment community, New York, 31 January 2002.

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I am pleased to be here today and to have this opportunity to talk about the Bank of Canada's outlook for the Canadian economy and to update you on our monetary policy actions.

This has been a very difficult year for all of us in North America, but especially for you here in New York City. The tremendous loss of human lives as a result of the 11 September terrorist attacks has been tragic. Among those who died there were family members, friends, and colleagues. And there were other innocent citizens of many nationalities caught in this tragedy, including Canadians. All of us at the Bank of Canada share a deep sorrow and extend our heartfelt sympathy.

The immediate impact and the fallout from last September's events introduced new layers of uncertainty into the economic picture, compounding the effects of a deepening global economic slowdown that had become more evident during the summer.

The Bank of Canada quickly responded to this extreme uncertainty by aggressively lowering interest rates in order to minimize the economic impact of the attacks and limit the loss of confidence. Since September, we have lowered our key policy interest rate by 200 basis points, bringing the total reduction since the beginning of 2001 to 375 basis points.

This substantial monetary easing, together with measures taken by Canadian governments to reduce taxes and to strengthen national security, should support growth in domestic spending.

On this basis, and with the improvement we have seen since the fall in the geopolitical climate and in consumer confidence, it is now clearer that the Canadian economy will gather momentum as the year unfolds. The timing and strength of the recovery will partly depend on how quickly business confidence and business investment, which remain weak in many countries, bounce back. Here, it is important to note that in Canada we did not have the same degree of overinvestment in fixed capital in the manufacturing sector during 1998-2000 as in the United States. So, the need for retrenchment and for adjustment of excess capacity in Canada would be less.

The Bank of Canada's current view is that economic growth in Canada will be relatively modest in the first half of 2002—between 1 and 2 per cent, on an annualized basis—but that it will accelerate in the second half—to a range of 3 to 4 per cent—and strengthen further in 2003.

This output profile means that there will be an appreciable amount of excess supply in the economy through 2002. Because of this, we see core inflation averaging just under 1 ½ per cent in the second half of 2002—below our 2 per cent target. Total CPI inflation should remain below the core rate until late 2002. With slack in the economy starting to be taken up in the second half of 2002, and expected to disappear by late 2003, inflation should move back up close to 2 per cent in about two years.

I would now like to reiterate some of the comments I made on current developments last week, when we released our *Update* to the November *Monetary Policy Report*, and in two speeches I gave in western Canada earlier this week.

It is now becoming clearer that the Canadian 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, and elsewhere, are encouraging.

Over time, exchange rates should reflect economic and financial developments and prospects. But movements in the Canada–U.S. exchange rate do not yet appear to have reflected the recent developments in our economy. And to the extent that the recent depreciation of the Canadian dollar risks affecting consumer and business confidence in Canada, it is clearly not helpful for our economy. Furthermore, at this juncture, it is certainly the case that the economic recovery in Canada does not hinge on the current low levels of the Canadian dollar against its U.S. counterpart.

Let me sum up. There is a good chance that when the final national accounts data for Canada come out, we will see positive, albeit modest, economic growth in both the last quarter of 2001 and the first quarter of this year. At this point, all available data suggest that final demand in the fourth quarter was stronger than we had anticipated. With production coming in at a much lower rate than final demand, the implication is that there has been a sharp rundown of inventories during the fourth quarter. This bodes well for the future, since it underpins the significant momentum we expect to see in economic activity as the year progresses.

This is not to say that there are not uncertainties or risks in the economic outlook, or that the Bank of Canada will not remain alert to unfolding developments. But, overall, the prospects for the Canadian economy are looking up.