David Dodge: Update on economic and monetary developments 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, 30 April 2002.

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When Malcolm and I appeared before you at the end of last November, a heavy cloud of uncertainty hung over the outlook for the world economy and for Canada. Much of that uncertainty stemmed from the September terrorist acts in the United States, which came at a time when the global economy had slowed more than expected.

To counter that uncertainty and bolster consumer and business confidence, the Bank of Canada moved aggressively to provide monetary stimulus. Between last September and January 2002, we lowered interest rates by 200 basis points, bringing the total reduction since January 2001 to 375 basis points.

As it turned out, consumer confidence was not as badly shaken in the aftermath of those tragic events as had been widely feared. Indeed, confidence bounced back as perceived geopolitical and economic uncertainties diminished. The world economy has begun to strengthen. Here in Canada, a robust recovery appears to be underway. Growth in the fourth quarter of last year and the first quarter of 2002 was appreciably stronger than expected, so that the **level** of economic activity is now higher than we thought it would be six months ago. This momentum is reflected in the extraordinary number of new jobs created since the beginning of 2002. In terms of the two scenarios we had painted last November, clearly, we are into the more optimistic one, in which a recovery in consumer confidence leads to an early resumption of economic growth.

What do we see now as we look ahead?

The Bank projects that, in the first half of 2002, the Canadian economy will grow by between 3 1/2 and 4 1/2 per cent, at annual rates. And we expect that it will continue to expand in the second half of the year and in 2003 at a rate somewhat above that of its production capacity (or potential), which we estimate to be around 3 per cent a year.

You may recall, Senators, that at our last visit I spoke about the concept of potential output. We set monetary policy so as to keep inflation low and stable, thus contributing to sustaining economic growth at its full potential.

Six months ago, we assumed that our economy would be growing at a pace well below the rate of capacity growth in the fourth quarter of last year and the first quarter of this year. We thought that the gap between the actual level of economic activity and the level of potential would be widening throughout this period. Instead, growth has turned out to be much stronger than expected. This means that our economy is operating at a much higher level than we thought. So the output gap is smaller than we had predicted and is currently narrowing. Indeed, we expect that it will close in the second half of 2003.

The output path that we are now projecting is consistent with core CPI inflation being at 2 per cent by about the end of next year. Total CPI inflation will probably continue to fluctuate in coming months as oil and natural gas prices move around. But, like core inflation, we expect it to be at the 2 per cent target midpoint by about the end of 2003.

Although we no longer face the same degree of uncertainty as we did last fall, there are still important risks and uncertainties in the outlook—some of which are working on the upside and others on the downside.

Given the amount of monetary and fiscal stimulus in the economy, output growth could be even stronger than projected. But it is also possible that some of the recent strength in spending on consumer durables was borrowed from the future, so that the growth of household expenditures will be weaker than expected. At the same time, there is still considerable uncertainty about the timing and strength of the pickup in business investment in North America, mainly because of the continued weakness in profits. Moreover, recent tensions in the Middle East could have implications for crude oil prices and the global economy.

While we face many of the same risks as the United States, there are a couple of differences in our situations that are worth noting. First, as we pointed out in the *Monetary Policy Report*, we expect that in Canada final demand will make up a larger share of the growth in the first quarter, while inventory rebuilding will constitute a smaller share than in the United States.

Second, while weaker-than-expected confidence among large businesses remains a risk for both countries, the sectors that face the biggest challenges, such as computer equipment and telecommunications, make up a larger share of the U.S. economy than of the Canadian economy.

So what do recent economic developments in Canada mean from a policy perspective?

As I mentioned, our economy is now operating at a significantly higher level than we had expected. So the amount of spare capacity is smaller, and is expected to be absorbed sooner, than we assumed last November. In these circumstances, our job will be to gauge the strength of the economy as it approaches its capacity to produce and reduce the amount of monetary stimulus in place in a timely and measured manner. We want to ensure that inflation stays close to the target so that, over the medium term, our economy can continue to grow at full capacity.

What do we mean by "timely and measured"?

"Timely" relates to the fact that there is always a lag between our policy actions and their effect on the economy. We must be timely and forward-looking because our actions take a year to 18 months to have their full effect on output, and 18 months to 2 years to have their full effect on inflation.

"Measured" relates to the judgments that we will make as we approach full capacity. If the economic data going forward tell us that we are taking up excess capacity more quickly than expected, we would have to reduce monetary stimulus more quickly. But if the data suggest that the return to full capacity is going more slowly than we thought, we would then need to move more slowly.

Allow me to close by using the familiar car analogy. Over the past year we put our foot on the gas to help us get up the hill of economic difficulties. The prudent thing now, as we return to more normal driving conditions, is to ease off on the gas—ease off, **not** slam on the brakes—to make sure that we continue our journey along the highway at a safe cruising speed.

It is in line with this that we moved, on 16 April, to raise the target for the overnight interest rate by 25 basis points.