David Dodge: Monetary policy - meeting the challenges of an uncertain world

Remarks by Mr David Dodge, Governor of the Bank of Canada, at the Speakers Forum, Toronto, Ontario, 29 January 2003.

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I want to talk today about some of the uncertainties surrounding Canada's economic prospects and how the Bank of Canada is dealing with them through its conduct of monetary policy. In particular, I'll discuss what's happening to prices in the economy and how Canada's macroeconomic policy framework protects it from the risks of persistent inflation or deflation. Finally, I will update our outlook for the Canadian economy.

Two weeks ago, I was in Basel, Switzerland, for one of our regular meetings at the Bank for International Settlements. This meeting, as well as others during the past year, have been particularly interesting for Canadians. Other participants always ask us, "How come you Canadians are doing so well, when the rest of us seem to be struggling?"

We have been telling them that one of the reasons why Canada has been less affected by the recent worldwide economic slowdown is that we made extraordinary efforts during the 1990s to get our macroeconomic framework—that is, our monetary and fiscal policies—right. We all know it was painful to adjust to free trade and to conquer inflation in the early 1990s, and to eliminate public sector deficits over that decade. Canada paid an economic price for those efforts during the 1990s. But they are now yielding clear economic dividends.

Of course, we've also had some good luck. We are less exposed to sectors that are struggling the most. But Canada's economic strength during the past two or three difficult years for the world economy reflects, for the most part, the fact that Canada stuck to its basic policy framework. As we move forward, this underscores the importance of maintaining that framework—especially now, when the near-term world economic outlook is not strong, and the geopolitical climate is uncertain.

With all this economic uncertainty, it is not surprising that we hear concerns these days about both the risks of accelerating inflation and the risks of deflation.

I think it is important to place these concerns into some context, so that Canadians can better understand the risks and implications of price shifts in the economy. That is why I'm going to concentrate most of my comments today on this subject. After all, the goal of the Bank of Canada's monetary policy is to maintain low, stable, and predictable inflation.

For over a decade, following a joint agreement with the federal government, the Bank has operated with a system of inflation targets. We aim to keep the trend of consumer price inflation at the 2 per cent midpoint of a 1 to 3 per cent range. Because we have managed to keep inflation inside the target range through most of the past decade, Canadians' expectations for inflation have become firmly anchored around the 2 per cent target.

Right off the top, let me assure you that the Bank of Canada will continue to pursue a monetary policy focused on returning inflation to that 2 per cent target, should it deviate in either direction. Canada's inflation-targeting framework operates symmetrically; that is, we minimize the chances of both a sustained upward drift in inflation and the threat of deflation.

Recently, rates of inflation in Canada have come in higher than expected. At the same time, a weak global economic environment, the huge drop in equity prices, and declines in the prices of some manufactured goods are raising fears of deflation in other countries. Let's look at both these risks.

The upside risk: inflation

First, let's consider the upside risk of accelerating inflation. It has been more than a decade since Canada has experienced prolonged high inflation. Since the targeting system was put in place, both the trend of inflation and inflation expectations have come down to near 2 per cent and stayed there.

In recent months, CPI inflation has risen substantially, for several reasons. We've seen higher oil and gas prices, higher home and auto insurance premiums, higher tobacco taxes, and, in Ontario, higher electricity prices. There has also been the "echo effect" of temporary price discounting in late 2001, following the 11 September terrorist attacks.

At the same time, stronger demand in Canada has been pushing up prices in some sectors, such as housing and some services. These pressures are starting to show up somewhat more broadly in the CPI data; and, without offsetting declines in other components of the CPI, these pressures are having an impact on all our measures of trend inflation. This suggests to us that demand conditions may be strong enough now to make it easier to raise prices and widen profit margins.

The Bank's policy aims to maintain total CPI inflation at 2 per cent, or to return it to that point within 18 to 24 months. With that horizon in mind, we need to look through any short-term volatility—and there's been a lot of short-term volatility in recent months. Mostly, we do that by focusing on our measure of core inflation, which excludes the eight most volatile components of the CPI, as well as the effect of changes in indirect taxes on the remaining components.

Of course, any measure of core or underlying inflation won't perfectly predict future inflation. We also look carefully at what is happening to individual CPI components, to gauge the size and persistence of any price changes. So, for example, recently we have spent a lot of time examining the factors driving the prices of electricity, insurance, and some foods.

Many of the relative price movements churning the current inflation numbers will likely prove to be temporary. But the recent pattern of persistently higher-than-expected rates of inflation, together with other signs of capacity pressures, may be indicating that our economy is operating closer to capacity than the Bank had previously thought.

The downside risk: deflation

Let me now turn to the potential downside risks on the price front—deflation, which is a persistent decline over time in the average prices of goods and services.

We have all heard a lot about the toll that deflation has taken on Japan. In some other countries, including the United States, concerns about deflation have also arisen because prices for goods have been falling. Their economies have been operating below capacity, and the resulting output gap is putting downward pressure on prices.

Why is the possibility of falling prices so worrisome? Well, when North Americans think of "deflation," they usually think of the 1930s and the terrible economic and social consequences of the Depression. Back then, deflation was the result of a spectacular drop in demand.

That kind of deflation can lead to a vicious circle of declining profits and share values, increased debt burdens, business bankruptcies, lower investment, and a further weakening of demand. The goal of macroeconomic policy should be to avoid this type of situation. It is precisely for this reason that Canada's inflation-targeting framework operates symmetrically.

But weak demand isn't the only thing that may pull down prices. A drop in prices that is triggered by increased productivity would not harm an economy, because the higher productivity would boost profits, stimulate business spending, and improve real incomes.

With that in mind, let's look at what has been happening to prices around the world. In many of the world's biggest economies—Japan being the exception—inflation has been averaging around 2 per cent. That's low by historical standards, but still well above zero. In some of these economies, as I've mentioned, the prices of *goods* are actually falling. But much of that drop has come about as a result of higher productivity.

Productivity growth has been more concentrated in goods-producing industries. That is why we see sharp divergences in goods and services prices. In the United States, for example, over the past year, goods prices—based on the core measure of inflation—fell 1½ per cent, while services prices rose by about 3½ per cent, resulting in an overall core inflation rate of about 2 per cent. A similar scenario is playing out in the United Kingdom.

If technological advances and productivity growth cause lower goods prices, profitability in the goods-producing industries will be preserved, wages and salaries can increase, and there will be no adverse effects on total employment and spending.

In Canada, goods prices are rising more slowly than services prices. However, we're not seeing actual *declines* in the overall price of goods. Although this may have something to do with structural differences in our economy, fundamentally it reflects the fact that domestic demand in Canada is stronger than in the United States, and our economy is operating closer to capacity.

Here is some of the evidence we have to date to support this view. Capacity utilization among Canadian goods producers is getting close to the point where production constraints start to emerge. In some sectors, businesses are reporting shortages of skilled labour. And profit margins for consumer-related industries trended up through the first three quarters of 2002. All of this suggests that most goods prices in Canada are not being discounted because of weak demand, as appears to be the case in the United States. Moreover, Canadian corporate balance sheets are improving and are, indeed, in relatively good shape compared with those in other countries.

Symmetrical monetary policy minimizes the risk

So, those are both sides of the price picture. I've laid out for you some of the factors that are moving prices at home and abroad. Now, I'd like to spend some time explaining how Canada's monetary policy framework reduces the risk of both persistent inflation and persistent deflation.

As I said before, Canadian monetary policy acts in a symmetrical manner—that is to say, we pay equal attention to any significant movement in inflation, whether above or below the 2 per cent target. We respond to shocks that would push inflation trends away from that target. For example, following the 11 September 2001 terrorist attacks, we quickly and aggressively cut our policy interest rate to shore up confidence. Then, in the spring of 2002, evidence started to build that demand was growing faster than the economy's potential. So, even though this was not yet showing up in prices, we raised our key policy rate three times between April and July, by a total of three-quarters of a percentage point.

Last fall, when inflation was rising, we refrained from raising rates because we expected that global economic weakness would restrain total demand for Canadian goods.

As we go forward, the Bank will be acting to prevent the current high headline inflation rates from feeding into expectations and to return inflation to the 2 per cent target. We will also be assessing all measures of capacity pressures in the economy.

The outlook for the Canadian economy

And this brings me to the Bank's economic outlook for the next 18 months or so. While Canada's economy has outperformed those of our major trading partners, our prospects are still very much influenced by developments abroad. After all, we sell to the world. So let me start with the external outlook.

Since last summer, we have been worried about financial headwinds and geopolitical uncertainty and their effect on global demand.

In our *Monetary Policy Report Update* that we just published, we said that global economic prospects may have weakened further in the first half of the year. However, we continue to expect global economic growth to pick up in the second half of the year and into 2004.

We also expect that risk premiums in financial markets will continue to decline, which should further improve the environment for business investment later this year.

But on the geopolitical front, the possible outbreak of war in the Middle East remains the great uncertainty. Let me outline the implications of some of the scenarios we face. A negotiated early resolution of the standoff in Iraq, or even a short, decisive conflict, could reduce geopolitical tensions fairly quickly. But a prolonged war would make the world economic outlook even more uncertain and would hurt business and consumer confidence. In the case of a war, oil supplies might be disrupted, which would lead to higher oil prices, further restrain global economic activity, and raise total CPI inflation around the world.

I would note, however, that higher oil prices would raise the value of Canada's oil and gas exports. Finally, a prolonged war could boost US government spending and, hence, US demand.

Of course, we don't know how the situation in the Middle East will be resolved. So, we have made an assumption that the related uncertainties will dissipate in the second half of 2003. Our projections for the global and Canadian economies are based on this assumption.

So, let me now turn to the Canadian outlook. After growing significantly faster than potential during the first half of 2002, Canada's economy slowed to a growth rate close to potential in the second half of the year. Even with this slowdown, the *level* of demand has remained near capacity since the middle of last year.

As we look forward, we foresee below-potential growth in the first half of the year. But we anticipate increased demand pressures in the second half of 2003 and into 2004, as global uncertainties diminish. However, with an appropriate reduction in the amount of monetary stimulus, we see the level of output remaining close to capacity during 2003 and into 2004.

As I said earlier, recent inflation rates have come in somewhat higher than expected. This reflects certain one-off price increases, such as higher insurance premiums, but also some broadening of price pressures as a result of stronger demand.

The one-off factors will hold the core rate of inflation well above the 2 per cent target in the first half of this year.[1] In the second half and into 2004, we expect the *core* rate to ease, as the effect of the one-off factors diminishes and the removal of monetary stimulus keeps demand pressures in check.

The outlook for total CPI inflation this year will continue to be importantly affected by developments in crude oil prices. With oil and gas prices where they are now, we could see CPI inflation rates between 4 and 4.5 per cent in the first quarter. If oil and gas prices decline in the second half, as futures prices suggest they will, then total CPI inflation would move back down in line with core inflation.

Let's remember that the stance of monetary policy remains stimulative. To return inflation to the 2 per cent target over the medium term, we will need to remove some of the stimulus. In other words, we will need to raise interest rates.

A number of elements will come into play in determining the pace at which we will reduce monetary stimulus. Let me reiterate them. First, although much of the recent run-up in inflation was the result of special factors, we can't rule out the possibility that demand pressures are becoming more prominent. So, we will watch these pressures carefully. Second, the Bank must guard against the risk that inflation above the 2 per cent target might lead to an increase in inflation expectations. These, too, we will monitor closely. Third, the confidence of investors and financial markets has improved but remains fragile because of geopolitical and world economic uncertainty. We will be watching credit and financial market developments to gauge the climate for business investment. Fourth, the way in which events in the Middle East unfold could affect demand and inflation, globally and in Canada.

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To conclude, let me repeat that this is not an easy time to predict the course of the global economy. But Canada's economy, while feeling the impact of world uncertainties, is showing sustained strength. That strength reflects the extraordinary work Canadians have done in creating and maintaining a sound macroeconomic framework. I can assure you that monetary policy, as a key part of that framework, will continue to serve Canadians well in meeting the challenges of an uncertain world.

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1 In December, core inflation moved down to 2.7 per cent, largely reflecting rebates for electricity in Ontario. But this is expected to be reversed in January. Indeed, what we take from the December numbers is a continuation of recent price trends. So, inflation is projected to be above the 2 per cent target for the rest of this year.