David Dodge: The Bank of Canada's views on the Canadian economy and inflation

Opening statement by Mr David Dodge, Governor of the Bank of Canada, to the House of Commons Finance Committee, Ottawa, 29 April 2003.

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Good afternoon, Madame Chair and members of the committee. I would like to start by saying how much we at the Bank of Canada appreciate the opportunity to come here twice a year, following the release of our semi-annual *Monetary Policy Report*. We are very aware of the need to keep Members of Parliament and, indeed, all Canadians informed about what we're doing and why. It's important that we explain our views on the economy and on inflation. So, thank you for the opportunity.

I'm going to spend a few minutes summarizing for you our most recent *Monetary Policy Report*. But, before I do that, I'd like to say a few words about my colleagues here with me today.

I am delighted to introduce to you our newly appointed Senior Deputy Governor, Paul Jenkins. Paul has been with the Bank of Canada since 1972 and, for the past 11 years, he has served as a Deputy Governor. In that role, Paul has been responsible for the Bank's analysis of international economic and financial issues and for our liaison with related international bodies, such as the International Monetary Fund. He's also been in charge of the strategic direction and oversight of the Bank's public communications.

Paul has a deep understanding not only of economic and monetary policy issues, but also of the Bank and its staff. I know he will provide energetic leadership in helping the Bank continue its tradition of excellence in promoting the economic and financial welfare of Canada.

Also with me today is Deputy Governor Chuck Freedman. Chuck will retire in September, after almost 30 years at the Bank. He's been a Deputy Governor since 1988, and his leadership in the areas of monetary policy, financial institutions, and Canada's clearing and settlement systems has been invaluable. One of Chuck's most important contributions has been his tireless promotion of bilingualism at the Bank. I can't begin to say how much we will all miss him—especially those of us on the Bank's Governing Council—not only for his expertise, but also for his enthusiasm and keen wit and intellect.

Last week, we released our spring *Monetary Policy Report*, in which we discuss economic and financial trends in the context of Canada's inflation-control strategy. I last testified before this committee in October, following the release of our autumn *Monetary Policy Report*.

To place our recent experience in some context, let me go back a bit further than that. Following the 11 September 2001 terrorist attacks in the United States, the Bank of Canada quickly and aggressively cut its policy interest rate to shore up confidence and support domestic demand. By the spring of 2002, evidence had already started to build that demand was growing faster than the economy's production capacity.

Monetary policy actions must always be forward looking. So, even though demand pressures were not yet showing up in prices, we raised our key policy rate three times between April and July 2002, by a total of three-quarters of a percentage point.

When we met with you last autumn, inflation in Canada was on the rise. But we refrained from raising interest rates because of the prevailing geopolitical and financial uncertainties, high yield spreads and restricted access to funding for riskier corporate borrowers, and the expectation that global economic weakness would restrain total demand for Canadian goods.

Since then, inflation has been above the 2 per cent target. The total year-over-year CPI inflation rate reached a peak of 4.6 per cent in February, falling back somewhat to 4.3 per cent in March. Key factors behind the jump in inflation are the sharp rise in oil and natural gas prices, increases in insurance premiums, and strong domestic demand. That demand has led to price pressures in certain sectors, such as shelter and some services.

In this environment, some indicators of short-term inflation expectations have edged up. These include data from the survey taken by the Bank's regional offices and the average private sector consensus forecast. Longer-term expectations of inflation, however, remain around 2 per cent.

To assess the future trend of inflation, the Bank uses a measure of core inflation, which strips out the eight most volatile items in the CPI basket, and the effect of changes in indirect taxes on the remaining CPI components. Core inflation now sits around 3 per cent. It should fall to about 2 1/2 per cent in the second half of this year, and to about 2 per cent by early 2004.

Total CPI inflation will continue to be importantly affected by swings in crude oil prices. If oil prices were to settle at about $25 per barrel by mid-2003—as futures prices suggest—and if the Canadian dollar were to stay close to current levels, total CPI inflation would likely fall temporarily below the core rate in the first half of 2004, before steadying out at a rate close to core inflation.

In view of the domestic inflation situation and the underlying momentum of domestic demand, we have raised our target overnight rate by 25 basis points on each of our last two policy announcement dates—in March and in mid-April—bringing it to 3.25 per cent.

As I said before, economic, financial, and geopolitical uncertainty figured prominently in the global picture last October. Some of the geopolitical and financial uncertainty has lifted in recent months, and the Bank expects that it will continue to recede. However, weak domestic demand in some regions of the world is still a concern. So, over the near term, a degree of global economic uncertainty remains.

Even with all this, the risks confronting the world economy now appear to be better balanced than they were last autumn. And, by year-end, we expect that business and household confidence levels should improve.

In Canada, domestic demand has remained quite strong. There is uncertainty, however, about the possible economic impact of Severe Acute Respiratory Syndrome (SARS), particularly in the Greater Toronto Area. As I said last week, we expect that economic growth in the second quarter will be somewhat weaker than we projected in the *Monetary Policy Report* because of the impact of SARS. But it is too soon to make an assessment of the magnitude of its effect on economic activity. We continue to monitor the situation very closely.

We expect that the Canadian economy will strengthen towards the end of 2003, partly thanks to a pickup in economic activity in the United States. Average annual growth in Canada is expected to be about 2 1/2 per cent this year. During 2004, our economy should strengthen further, expanding at a rate above its 3 per cent growth of potential. This means that most of the small amount of economic slack that is likely to open up in Canada during 2003 will have closed by the end of next year.

For this reason, the Bank continues to believe that further reductions in monetary stimulus will be necessary over time to return inflation to its 2 per cent target and to sustain output levels close to capacity. The timing and pace of further increases in policy interest rates will depend on the strength of domestic demand, the evolution of inflation expectations, and the pace of economic expansion in the United States and in overseas economies.