David Dodge: Monetary policy developments in Canada

Opening statement by Mr David Dodge, Governor of the Bank of Canada, to the Senate Banking, Trade and Commerce Committee, Otttawa, 30 April 2003.

* * *

Good afternoon, Mr. Chairman, members of the committee. I would like to start by saying how much we appreciate the opportunity to meet with you following the release of the Bank's semi-annual *Monetary Policy Report*. It's important for us to be able to explain our views on the economy and on inflation.

I'd like to spend a few minutes summarizing the key points of our most recent *Report*, which we released last week. But first, I'd like to introduce my colleagues—Deputy Governors Chuck Freedman and Pierre Duguay. Chuck will retire in September, after almost 30 years at the Bank. His leadership in the areas of monetary policy, financial institutions, and Canada's clearing and settlement systems has been invaluable. We will all miss his expertise, his enthusiasm, and his keen wit and intellect.

The last time I testified before this committee was in the spring of 2002, because we were unable to arrange our regular meeting last fall. You will recall that following the 11 September 2001 terrorist attacks in the United States, we quickly and aggressively cut our policy interest rate to shore up confidence and support domestic demand. By last spring, 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 the autumn, inflation was on the rise. But we refrained from raising interest rates because of geopolitical and financial uncertainties, high yield spreads and restricted access to funding for riskier corporate borrowers, as well as the expectation of weaker foreign demand for Canadian goods.

Since then, inflation has been above the 2 per cent target midpoint. The total CPI inflation rate peaked at 4.6 per cent in February, falling back somewhat to 4.3 per cent in March. The jump in inflation reflected the sharp rise in oil and natural gas prices, increases in insurance premiums, and strong domestic demand that had led to price pressures in certain sectors, such as shelter and some services.

In this environment, certain indicators of short-term inflation expectations have edged up—although longer-term expectations remain around 2 per cent.

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, is a better indicator of the future trend of inflation. It now sits around 3 per cent. But 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 fluctuate with swings in crude oil prices. If these prices settle at about US$25 per barrel by mid-2003—as futures prices suggest—and if the Canadian dollar stays close to current levels, total CPI inflation will likely fall temporarily below the core rate in the first half of 2004, before steadying out at a rate close to core.

In view of the domestic inflation situation and the underlying momentum of domestic demand, we raised our target overnight rate by 25 basis points on each of our last two policy announcement dates. It now stands at 3.25 per cent—still relatively low by historical standards.

Some of the geopolitical and financial uncertainty we saw last fall has lifted in recent months, and we expect that it will continue to recede. Economic uncertainty in some regions of the world is still a concern. But overall, the risks confronting the world economy now appear to be better balanced than last autumn. And business and household confidence should improve by year-end.

In Canada, domestic demand has remained quite strong. But now there is uncertainty about the economic impact of Severe Acute Respiratory Syndrome (SARS), particularly in the Greater Toronto Area. Second-quarter economic growth will be somewhat weaker than we projected in our latest *Monetary Policy Report* because of SARS. But, while the developments of the past few days suggest the worst is behind us, it is still too soon to put a number on the effect of SARS on economic activity.

The Canadian economy should strengthen towards the end of 2003, partly thanks to a pickup in U.S. economic activity. Average annual growth in Canada is expected to be about 2 1/2 per cent this year. During 2004, our economy should expand at a rate above its 3 per cent growth of potential. Therefore, most of the small amount of economic slack that is likely to open up this year will have closed by the end of 2004.

For this reason, we still 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 the Bank's target overnight rate will depend on the strength of domestic demand, the evolution of inflation expectations, and the pace of economic expansion in the United States and overseas.