Stephen S Poloz: Opening statement before the Standing Senate Committee on Banking, Trade and Commerce

Opening statement by Mr Stephen S Poloz, Governor of the Bank of Canada, to the Standing Senate Committee on Banking, Trade and Commerce, Ottawa, Ontario, 19 October 2016.

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Good afternoon, Mr. Chairman and committee members. Senior Deputy Governor Wilkins and I are pleased to be back before you today to discuss the Bank's *Monetary Policy Report*(MPR), which we published this morning.

It has been six months almost to the day since we were last here, and several of the broad themes that we spoke about back in April remain in place today. The Canadian economy continues to adjust to low resource prices against a backdrop of weak global demand. This weakness, particularly in the United States in the first half of the year, has combined with ongoing competitiveness challenges to hold back export growth. In this environment, many businesses have continued to be reluctant to invest. These issues are not new. However, there have also been several developments over the past six months that affected the outlook for our economy. So, allow me to me fill in some details and outline the Bank's current economic forecast, before we turn to your questions.

The second quarter of 2016 was a difficult one for the Canadian economy, which shrank at an annual rate of 1.6 per cent. The two main drivers of this result were a large, broad-based decline in goods exports and the impact of the Alberta wildfires. These factors more than offset the strength we saw in household and government spending.

However, the economy is poised to rebound in the second half of the year. This reflects, in part, a return of oil sands production and rebuilding activity in Alberta. Indeed, we saw non-conventional oil output jump by almost 20 per cent in July. As well, exports of goods increased in July and August, pointing to a solid third quarter. A pickup in the US economy should help goods exports recover some—but not all—of the ground they lost earlier this year.

Let me spend a couple of minutes on the export story, because a revised export forecast was a central part of our deliberations. Even though exports of goods have more than fully recovered from their dramatic plunge in 2007–09, that recovery has persistently lagged our forecasts. The strong export performance of 2015 gave us new confidence, but this was shaken again in the first half of this year, when we experienced a sharp decline over five months.

In our July MPR we advanced what we viewed as a conservative forecast for exports, in the sense that it assumed only that exports would grow roughly in line with the US economy. We have seen a significant recovery in exports since then, but the net effect of these choppy data is that the level of exports is well below where we thought it would be by now.

It is true that international trade has been surprisingly weak globally, and we offer a box in this MPR discussing a range of interpretations. Also, the US economy was quite weak in the first half of the year in dimensions that are important to Canadian export demand. These factors explain about half of the shortfall in exports relative to what we were expecting. For the remainder, we are looking at a range of structural factors, including lost export capacity and competitiveness challenges.

In our surveys, companies have mentioned a number of factors that can influence competitiveness or hinder exports directly. These include deficient infrastructure, regulatory uncertainty, rising trade barriers, relatively high electricity costs and the unknown status of current and future trade agreements.

This analysis suggests that more of our export shortfall may be structural than previously believed, rather than cyclical. This is what led us to indicate in our September decision that the risks around our July inflation projection were tilted to the downside. Our latest projections incorporate a permanent shortfall in exports relative to our understanding of fundamentals in order to rebalance our forecast risks, reducing the projected level of GDP by about 0.6 per cent by the end of 2018 compared with our July projection.

Such a reduction in our outlook for exports may sound odd, given the depreciation of the Canadian dollar against the US dollar. However, some of our competitors have also seen large depreciations in their currencies. For example, the Mexican peso has fallen by more than 30 per cent against the US dollar since mid-2014, while the Canadian dollar has slid by less than 20 per cent over the same period. So while the exchange rate will continue to support the current level of Canadian exports, most of its impact on export growth has probably already taken place.

The export weakness is expected to lead to somewhat softer business investment. However, there are signs that the worst may be behind us in terms of investment. Our most recent survey of Canadian companies found that many businesses believe resource-related activity may be near a low point. Resource companies are expecting their sales to either level off or increase modestly over the next year. Overall, more firms than in recent surveys say they plan to boost investment spending over the next 12 months.

Household spending has continued to support the economy, with employment and income continuing to grow outside of energy-intensive regions, particularly in service industries. The Bank's accommodative monetary policy will continue to buffer the impact on wealth and income stemming from the fall in resource prices. The rollout of the Canada Child Benefit should start giving an extra boost to households in the second half of this year. As well, the impact of the federal infrastructure spending that was announced in Budget 2016 should begin to be felt. We continue to project that these measures together will boost the level of Canadian GDP by about 1 per cent over the 2017–18 fiscal year.

One other new development I'd mention is the government's measures to promote stability in the housing market. With house prices still elevated in the Vancouver area and resales and starts still robust around Toronto, these measures should dampen resale activity in the near term. Our analysis and historical experience suggest these measures will reduce the level of GDP by about 0.3 per cent by the end of 2018, although there is much uncertainty around that estimate. While household debt levels have continued to increase, these measures should, over time, help ease the growth of economic vulnerabilities related to household debt and housing.

All told, we now expect growth over the third and fourth quarters to average about 2 1/2 per cent, which is lower than we anticipated in our last MPR in July. This reduction reflects the downward revision to exports, the pullback in housing and a shift in the timing of federal infrastructure measures that pushes some of the impact into 2017.

We have reduced our growth estimate for this year to 1.1 per cent. The expansion in both 2017 and 2018 should be about 2.0 per cent, higher than the growth rate of potential. However, because the output gap is now somewhat larger than we projected and will close later than we expected in July, the profile for inflation is now slightly lower. We project that total CPI inflation will remain below 2 per cent through the end of the year, as disinflationary pressures linked to excess capacity and year-over-year price swings for gasoline will more than offset the inflationary pressure coming from a lower exchange rate. Total inflation should be close to the 2 per cent target in 2017 and 2018.

As always, there are a number of risks surrounding our base case. These include the risks of sluggish business investment and weaker household spending, slower growth in emerging markets, stronger growth in the US economy and higher oil prices. We judge that the risks to our inflation profile are roughly balanced. I would point out, Senators, that we have changed the way we present these risks, beginning with this MPR. We are now reporting on how we see various aspects of the risks developing, as well as setting out the indicators we are watching in evaluating the risks. I invite you to take a look.

With that, Mr. Chairman, Carolyn and I would be happy to answer questions.