Gordon Thiessen: The economic situation in Canada and the prospects for inflation

Opening Statement by Mr Gordon Thiessen, Governor of the Bank of Canada, before the House of Commons Standing Committee on Finance, Ottawa, on 16 May 2000.

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Mr Chairman, and members of the Committee: it is always a pleasure to appear before you. Since other Parliamentary business precluded my appearance before you last fall, I especially welcome this opportunity to discuss the economic situation in Canada and the prospects for inflation.

Last week, we released our 11th *Monetary Policy Report*. Since our November Report, the Canadian economy has outperformed expectations. Bolstered by vigorous external and domestic demand, Canada's economic expansion strengthened in the second half of 1999 and into early 2000.

The buoyant US economic picture, combined with Canada's high levels of business investment and solid employment gains, augurs well for continued strong growth in Canada. Given the strong momentum of demand, the Bank of Canada has raised its projection for growth in 2000 to a range of 4 to 4.5%.

The trend of inflation in Canada over the past six months has been lower than expected and is among the lowest in the industrial countries. Nevertheless, pressures on capacity will likely intensify through the year. Consequently, we expect the trend of inflation, as measured by the consumer price index excluding food, energy, and indirect taxes, to rise gradually to close to the middle of our 1 to 3% inflation-control target range. To keep this core rate of inflation steady near 2%, some deceleration in economic expansion or a more rapid increase in productivity and production capacity will be required during 2001.

When it comes to the production capacity of the economy, there is currently even more uncertainty than usual. The lower-than-expected rate of core inflation would suggest that conventional measures may be underestimating the economy's capacity to produce goods and services without adding to inflationary pressures. While the conditions that would permit an increase in productivity growth and in capacity have improved substantially in recent years, there has so far been no significant hard evidence of such an increase. This makes judging the balance between aggregate demand and supply in the economy an even greater challenge than usual for monetary policy.

The other main risks to Canada's economic outlook include the possibility that the momentum of aggregate demand from the US economy will continue to be stronger than expected and the likelihood of a buildup of inflationary pressures in the United States spilling over into Canada. The US economy has continued to steam ahead. There is a clear need for the pace of expansion in the United States to slow as we progress through this year and into 2001.

Prudent monetary management dictates that we in Canada do not underestimate the upside risks for inflation, especially given the strong growth of aggregate demand in Canada, the United States, and elsewhere. Because of a lag of some 18 to 24 months in the effect of monetary policy on prices, the Bank is always trying to anticipate inflationary pressures one to two years ahead.

Productivity growth is the only way to achieve long-term gains in incomes and living standards. The technological revolution that is currently sweeping the world provides Canada with a golden opportunity to improve its productivity. The best contribution monetary policy can make to enhancing productivity is to provide a low-inflation environment. Low and stable inflation reduces uncertainty about future price movements, lowers the incidence of boom-and-bust cycles in the economy, and helps keep interest rates down. All of this encourages investment in the equipment and software needed to take advantage of the new technology.

Canada’s inflation-control target and the Bank’s commitment to maintaining that target, should ensure that monetary policy fosters a climate conducive to continued improvement in the performance of our economy.