David Dodge: Brief outlook for economic growth and inflation in Canada

Opening statement by Mr David Dodge, Governor of the Bank of Canada, before the House of Commons Standing Committee on Finance, Ottawa, 7 November 2001.

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We are pleased to appear before this Committee, on the occasion of the release today of our autumn Monetary Policy Report, which provides our latest assessment of the outlook for economic growth and inflation in Canada. Mr. Knight and I hope to be able to return for future issues of the Report, every six months.

Right now, all national economies face difficulties—difficulties stemming from the further weakening of the world economy and from the terrorist acts in the United States. As businesses, governments, and individuals in Canada—and around the world—strive to come to terms with the implications of those acts, the main preoccupation is, naturally, with the near term. But, as I said in a speech in Moncton two weeks ago, at times like this, it is also very important that we step back and look past current developments, to the longer-term trends and potential of our economy. Viewed from this angle, the outlook is brighter. The progress that we have made over the past decade in strengthening our economic foundations is remarkable. And it should stand us in good stead, no matter what short-term turbulence and uncertainties we face.

True, at the moment, we are beset by tremendous uncertainties. And I would like to turn to those now, as I discuss the economic outlook and the steps that the Bank is taking to support growth in Canada.

When I appeared before you in May 2001, the incoming information was broadly in line with the Bank's expectations of a modest pickup in growth in the second half of 2001 and further strengthening in 2002. Among the factors that would bring this about, we counted the completion of the inventory adjustment, tax cuts, the easing in domestic monetary conditions, and a recovery in U.S. business investment.

But, by midsummer, evidence began to accumulate that the expected rebound in U.S. investment would be delayed and that the economic slowdown there would be deeper and more protracted than previously expected. Economic activity outside North America had also begun to show more clearly the effects of weaker U.S. growth and of the ongoing global retrenchment in the information and telecommunications sectors. In Canada too, there were signs that domestic demand, which had held up through the first part of 2001, was softening and that the inventory adjustment, particularly in the electrical and electronic sectors, was less advanced than expected.

Accordingly, we revised down our projections for the second half of 2001 and the first half of 2002. And, at the end of August, we lowered interest rates to support domestic demand growth and to keep inflation near the target of 2 per cent over the medium term.

The terrorist acts in the United States, and their worldwide fallout, greatly heightened the degree of uncertainty, further dampening near-term growth prospects. To underpin confidence in the face of this uncertainty, we took the exceptional step of lowering interest rates by ½ of a percentage point on 17 September, outside our regular schedule of fixed announcement dates.

The ongoing economic consequences of the terrorist acts are very difficult to assess. These developments are unlike anything we have ever experienced in North America, and it will take some more time to understand their full implications.

If we consider the direct effects of the attacks, their immediate impact on consumer and business confidence, and adjustments to address increased security risks, the Bank expects that output growth in Canada will be close to zero or slightly negative in the second half of 2001. For all of 2001, this implies growth of about 1½ per cent.

As we look to 2002, the timing and strength of a recovery will depend crucially on geopolitics and on how soon confidence returns to normal in North America. But once the uncertainty stemming from terrorist acts dissipates, I expect that healthy growth in output, investment, and employment will resume, given Canada's sound economic fundamentals.

At present, one can envisage two scenarios with respect to confidence. In the first, confidence could be restored quickly, and robust growth could resume, supported by the substantial monetary and fiscal stimulus already in place. In the second, confidence could stay weak for some time and, consequently, growth would remain sluggish through most of 2002.

Under either scenario, by the end of 2002, our economy would still be operating at levels that are below capacity. Core inflation is thus expected to fall to about 1½ per cent by the second half of 2002. Total CPI inflation is also expected to decline to about 2 per cent by the end of 2001 and to move below that during 2002, if energy prices remain at or below their early-September levels.

Based on these considerations, on 23 October, we again lowered our key policy interest rate by ¾ of a percentage point. The cumulative reduction of 3 full percentage points since January aims to support growth and to keep inflation close to the 2 per cent target over the medium term.

Given the many unknowns in the current environment, we will continue to monitor the situation very closely and adjust our outlook in the light of new information.