David Dodge: Review of Canada's recent economic performance and prospects

Remarks by Mr David Dodge, Governor of the Bank of Canada, at a luncheon at the Canadian Consul General's residence Chicago, Illinois, 9 May 2002.

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Thank you for the invitation to this luncheon and for the opportunity to speak to you this afternoon. I want to take this time to review Canada's recent economic performance and prospects and to hear your views as to how you see things evolving in the U.S. economy.

Canada's recent economic performance

In Canada, the economic weakness that we experienced was really concentrated in the third quarter of last year, particularly in September. The terrorist attacks in September created a great deal of uncertainty, and so the Bank of Canada, like the U.S. Federal Reserve, provided an extraordinary amount of stimulus by aggressively lowering interest rates.

But with the improvement in the geopolitical situation, consumer confidence recovered rapidly, and consumers responded strongly and quickly to the monetary stimulus. Interest-sensitive sectors, such as housing and automobiles, showed remarkable strength. As a result, we saw annualized growth of 2 per cent in the fourth quarter of last year, when many analysts were expecting the Canadian economy to continue to shrink.

Canada's economic outlook

In the *Monetary Policy Report*, which we published a couple of weeks ago, we forecast growth in the first half of this year of between 3 1/2 and 4 1/2 per cent at annual rates, although data released since then suggest that the first quarter may have been slightly stronger than we had thought. Second-half growth is expected to be in a range of 3 to 4 per cent.

With growth at the end of last year and early this year being stronger than we had earlier assumed, the economy is operating at a higher level than anticipated. Indeed, this strength led us to sharply raise our forecast for average annual growth this year. In the *Monetary Policy Report Update* published in January, we pegged average annual growth for 2002 at just over 1 per cent. When we published our full *Report* in April, we raised that forecast to between 2 1/4 and 3 1/4 per cent.

With the economy now operating at a considerably higher level, the gap between the actual level of economic activity and the level of potential output is smaller than we had predicted, and is currently narrowing. We now expect that the output gap will close in the second half of 2003.

In these circumstances, our job will be to gauge the strength of the economy as it approaches its capacity to produce and to reduce the amount of monetary stimulus in place in a timely and measured manner.

What do we mean by those terms? "Timely" relates to the fact that there is always a lag between our policy actions and their effect on the economy. We must be timely because our actions take a year to 18 months to have their full effect on output, and 18 months to 2 years to have their full effect on inflation.

"Measured" relates to the judgments that we will make as we approach full capacity. If the economic data going forward tell us that we are taking up excess capacity more quickly than expected, we would have to reduce monetary stimulus more quickly. But if the data suggest that the return to full capacity is going more slowly than we thought, we would then need to move more slowly.

There are still important risks and uncertainties in the outlook. Some are working on the upside and others on the downside. Given the amount of monetary and fiscal stimulus in the economy, output growth could be even stronger than projected. But it is also possible that some of the recent strength in spending on consumer durables may have been borrowed from the future, so that the growth of household expenditures may be weaker than expected. At the same time, there is still considerable uncertainty about the timing and strength of the pickup in business investment in North America, mainly because of the continued weakness in profits. Moreover, recent developments in the Middle East could have implications for crude oil prices and the global economy.

The Canadian and U.S. situations

On 16 April, Canada became the first G-7 country to raise interest rates following the most recent economic slowdown. Central banks should always tailor their monetary policies to their own circumstances. And while Canada faces many of the same risks as the United States, there are some differences in our situations that are worth noting.

Although the first-quarter national accounts data are not yet out in Canada, we expect that final demand has made up a larger share of Canada's growth in the first quarter, while the contribution to growth from inventories constituted a smaller share than in the United States.

It is always difficult to measure excess capacity with precision. However, it is clear that the Canadian economy is now nearer its level of potential than we expected it to be just a few months ago.

The key issue facing both the U.S. and Canadian economies is business investment—when it will resume and how strong that pickup will be. In this context, I would certainly be very interested to hear your views on the situation here in the Midwest, and in the United States as a whole.

As I recently said to our Parliamentary committees, we see two or three key differences in the Canadian and U.S. situations.

First, it is clear that there was a tremendous buildup of capacity in the telecommunications and information technology sectors in recent years, and some analysts expect that it will likely be well into 2003 before we see any recovery in investment there. But I would note that these sectors represent a smaller proportion of the Canadian economy than the U.S. economy.

The second issue we have noted is that small- and medium-sized firms tend to be more bullish about their outlook and investment intentions than large, multinational firms. I'd certainly be interested in hearing your perspective on this. But again, I'd point out that these smaller companies make up a larger share of the Canadian economy than of the U.S. economy.

The final point I made to the committees has to do with the potential impact of higher oil and natural gas prices on investment. While higher oil and natural gas prices stemming from developments in the Middle East could hurt consumers, they could lead to much greater drilling and exploration activity in Canada. Of course, that sector remains a significant part of our economy.