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

Speech by Mr Stephen S Poloz, Governor of the Bank of Canada, to the Senate Standing Committee on Banking, Trade and Commerce, Ottawa, 30 April 2014.

* * *

Thank you for the opportunity for Tiff and me to be here today to share with you highlights from the Bank of Canada's recent economic outlook.

The Bank aims to communicate openly and effectively so that Canadians know how we are achieving our mandate to promote the economic and financial welfare of this country. One of the best ways we do this is by appearing before this committee and answering your questions.

I will discuss the Bank's outlook for inflation, then move on to our outlook for global and Canadian economic growth; I will touch on some recent Bank research and finish with trends that we are observing.

Inflation

Inflation in Canada remains low. We expect core inflation to stay well below our 2 per cent target this year, returning to target over the next two years.

Total CPI inflation, however, will move closer to the target in the coming quarters, due to temporary factors.

Allow me to explain.

We expect economic slack and heightened retail competition to keep core inflation below target until early 2016, while higher consumer energy prices and a lower Canadian dollar will contribute to total CPI inflation moving up.

Total CPI inflation will remain fairly close to target throughout our projection period, even as upward pressure from energy prices dissipates, because the impact of retail competition will gradually fade and excess capacity will be absorbed.

When this happens, core inflation will gradually make its way up to 2 per cent and catch up with total CPI inflation from below.

Economic outlook

Moving to our economic outlook, global growth should gather steam in the coming three years as the headwinds that have dampened growth dissipate.

Overall, we see global economic growth picking up to 3.3 per cent in 2014, moving to 3.7 per cent in 2015 and 2016. In Canada, real GDP growth is expected to average about 2 ½ per cent in 2014 and 2015 before easing to around 2 per cent.

These numbers are essentially in line with the Bank's January outlook, but they don't reflect the actual quality of the outlook, which has changed in meaningful ways, especially for emerging-market economies and Europe.

Growth in Europe is modest, but inflation remains too low, and hopeful signs of recovery might be stalled by the Russia-Ukraine situation.

China and other emerging economies are showing solid growth, although there are some growing concerns about financial vulnerabilities – specifically, increased market volatility in response to political uncertainty.

The economic recovery in the United States, however, is proceeding as expected, despite recent softer results largely due to unusual weather. In fact, private demand could turn out to be stronger than we had thought.

The issues Canada's economy faces are not unfamiliar to you. Competitiveness challenges continue to weigh down our export sector's ability to benefit from stronger growth abroad.

Given the importance of the export sector to an open economy such as ours, and given the growing wedge between Canada's exports and foreign demand, the Bank has deepened its analysis of the export sector, specifically, non-energy exports.

Non-energy exports

By breaking down the non-energy export sector into a large number of subsectors, interesting facts and trends emerge.

To start, we are discovering that there are subsectors, such as machinery and equipment, building materials, commercial services, and aircraft and aircraft parts, that are in line with fundamentals, or even doing better than their respective U.S. benchmarks.

This suggests that, as the U.S. recovery gathers momentum and becomes more broadly based, many of our exports will benefit.

The lower Canadian dollar will also contribute to the recovery of these subsectors.

Other subsectors, including auto and truck makers, food and beverage suppliers, and chemicals, will also be helped by a lower dollar, but to a lesser extent, since they are experiencing greater competitiveness challenges. Their recovery will be slower.

The big picture tells us to expect a gradual convergence between the growth rate of Canada's exports and that of the U.S. economy. But this more granular research indicates that the wedge between exports and foreign demand will endure.

And make no mistake. This wedge is real and it is big. The good news is that we now know more precisely just where it is – with about half of our non-energy exports. The bad news is that these subsectors are doing worse individually than we thought before. This deeper understanding of our export sector is valuable, but it does not make us any less concerned about the challenges ahead.

Looking forward, we continue to believe that rising global demand for Canadian goods and services, along with the assumed high level of oil prices, will stimulate business investment in Canada and help shift the economy to a more sustainable growth track.

Trends

We continue to expect a soft landing for the housing market and Canada's household debt-to-income ratio to stabilize. Nevertheless, the imbalances in the housing sector remain elevated and would pose a significant risk should economic conditions deteriorate.

We are observing, anecdotally at least, an increased awareness of this risk. Consumers are showing responsibility; for example, homebuyers who opt to buy less house than they qualify for so they don't find themselves overextended if interest rates rise. Banks, as well, are underwriting loans more carefully, ensuring that people can service their debts if rates go up.

So, while the risk could be significant, we are comfortable that it is not outsized.

To sum up, the Bank continues to see a gradual strengthening in the fundamental drivers of growth and inflation in Canada. But this view depends largely on the projected upturn in exports and investment.

There is a growing consensus that when we do get home, interest rates will still be lower than we were accustomed to in the past – both because of our shifting demographics and because, after such a long period at such unusually low levels, interest rates won't need to move as much to have the same impact on the economy.

With underlying inflation expected to remain below target for some time, the downside risks to inflation are important, as are the risks associated with household imbalances.

The Bank judges that the balance of these risks remains within the zone for which the current stance of monetary policy is appropriate and, as you know, we decided on 16 April to maintain the target for the overnight rate at 1 per cent.

The timing and direction of the next change to the policy rate will depend on how new information influences the balance of risks.

Conclusion

Before Tiff and I respond to your questions, I would like to take just a moment to say a few words about the man sitting next to me.

Tiff's contributions at the Bank started long ago as a new recruit with a fresh master's degree in hand. His contributions throughout his career have been significant. At the Bank, we will miss him for his intellect and management skills. But we will also miss a great friend to many, myself included.

We can rest assured that Tiff's contributions to the financial welfare of Canada will continue as the Dean of the Rotman School of Business, where he will be busy ensuring that the next generation of economists and business leaders are prepared to take Canada into a prosperous future.

Tiff did such a great job as Senior Deputy Governor that, to find his replacement, we have had to split the position and look for two people to fill his shoes.

I am pleased to report that we will be in safe hands. And, I look forward to introducing you to Carolyn Wilkins, the incoming Senior Deputy Governor, who will oversee the Bank's strategic planning and operations and will share responsibility for the conduct of monetary policy. I also look forward to working with our new Chief Operating Officer, Filipe Dinis, who will be responsible for managing all of the Bank's administrative functions.

And with that, Tiff and I are happy to take your questions