Stephen S Poloz: Opening statement before the House of Commons Standing Committee on Finance

Opening statement by Mr Stephen S Poloz, Governor of the Bank of Canada, before the House of Commons Standing Committee on Finance, Ottawa, Ontario, 28 April 2015.

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Good morning, Mr. Chairman and committee members. Carolyn and I are happy to be here for one of our twice-yearly meetings on our *Monetary Policy Report* (MPR). Today we will outline for you the Bank's latest economic outlook, published in our MPR on 15 April.

In this volatile and uncertain environment, it is helpful to maintain a historical perspective. When we appeared before this committee a year ago, the price of Brent crude oil was at $100 per barrel. It had risen steadily for a decade, from $25 in 2002 to a peak of just over $110 in 2012.

By November, when we last met with you, oil prices had fallen to what was then their lowest level in four years. The average price of Brent was $90 per barrel. It was clear to us that while lower oil prices would benefit consumers, the net impact on the economy would be negative. Lower oil prices would reduce Canada's terms of trade and domestic income and have a material impact on investment, activity in the oil sector, and the associated manufacturing supply chain.

All of that happened quite quickly over the next two months. By January, Brent prices had dropped to an average of $60.

Oil prices are an important component of Canada's terms of trade and one of the key drivers of movements in the Canadian dollar. As oil prices rose over the 2002–12 period, so did the value of the dollar, increasing from around 63 cents to above parity.

Now, the fall in oil prices has set in motion complex dynamics, including sectoral and regional adjustments, which will take time to work their way through the economy.

The negative effects of lower oil prices hit some sectors of the economy right away. For example, the impact of lower prices on income and wealth has already led to a fall in household spending. The various positives – more exports because of a stronger U.S. economy and a lower Canadian dollar, and more consumption spending as households spend less on fuel – will arrive only gradually, and are of uncertain size. Therefore, in January we faced a risk that returning the Canadian economy to full capacity and stable 2 per cent inflation would be delayed significantly. Accordingly, we took out some insurance against that risk, in the form of a 25-basis-point reduction in the policy interest rate.

Our interest rate cut occurred in the context of widespread easing in financial conditions around the globe. No fewer than 25 central banks eased their monetary policies in the early months of 2015. All of this monetary policy easing led to lower rates across the entire yield curve.

What was behind this easing? Many central banks were adding stimulus in response to persistent economic slack and below-target inflation. This easing, coupled with the positive implications of lower energy prices for world growth, should help the global economy pick up through the year. The Bank expects global economic growth to strengthen and average about 3 1/2 per cent over the 2015–17 period.

Here in Canada we saw that some of the effects of lower oil prices, such as the lower household spending I mentioned earlier, were clearly being felt in late 2014 and early 2015. Our updated forecast in the April MPR suggests that the Canadian economy saw no growth in the first quarter. While the impact of the oil price shock is happening faster than initially expected, it does not appear to be larger than we anticipated in January.

Outside of the energy sector, other areas of the economy appear to be doing well. The segments of non-energy exports that we expected to lead the recovery are doing so, and we expect this trend to be buttressed by stronger U.S. growth and the lower Canadian dollar. The results of our *Business Outlook Survey* suggest that capacity constraints are beginning to emerge for exporters, which is promising for new investment. And, although we still have material slack in our labour market, the market's fundamentals have begun to improve. Even so, companies remain cautious about new investment and hiring intentions.

Weighing these various forces acting on the economy, we anticipate a partial rebound in growth in the second quarter, and a move to above-trend growth thereafter, for annual growth of 1.9 per cent this year. This projected growth profile gets us back on track to absorb our excess capacity around the end of 2016, at which time inflation will settle sustainably at 2 per cent. We see the risks around this projection as roughly balanced, but they will be reassessed continuously as new data become available.

The main risk to our outlook is the size and duration of the negative impact of the oil shock, weighed against the positive forces that are building in the non-energy sector. Our outlook is for the positives to begin to reassert themselves during the second quarter, and to do so clearly in the second half of the year. The interest rate cut in January and the lower Canadian dollar are working to speed up the transition.

Inflation, as measured by total CPI, is running at about 1 per cent, well below our 2 per cent target. This is largely due to the drop in gasoline prices, a temporary effect. Total CPI inflation would be quite close to zero were it not for exchange-rate effects and some additional one-time factors. Core inflation is a little over 2 per cent, but it is also being boosted by exchange-rate effects and other one-time factors. In our projection, total inflation and core inflation converge on 2 per cent as these temporary factors dissipate and the economy reaches full capacity, around the end of 2016.

Meanwhile, financial stability risks remain front-and-centre in our deliberations. These risks are evolving in line with our expectations. The level of indebtedness, as measured by the ratio of debt-to-disposable income, continues to edge higher. It is likely to rise further as the decline in gross national income caused by the drop in oil prices works its way through the system.

On the surface, lower interest rates would be expected to promote more borrowing, which would increase this vulnerability. However, in the near term, lower borrowing rates will actually mitigate this risk, by reducing payments for mortgage holders and giving us more economic growth and employment gains. We believe that the best contribution the Bank can make to lowering financial stability risks through time is to help the economy return to full capacity and stable inflation sooner, rather than later.

With that, Carolyn and I would be happy to take your questions.