Stephen S Poloz: Release of the Monetary Policy Report

Opening statement by Mr Stephen S Poloz, Governor of the Bank of Canada, at the press conference following the release of the Monetary Policy Report, Ottawa, Ontario, 25 October 2017.

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Good morning. Senior Deputy Governor Wilkins and I are pleased to be here to answer your questions about today's interest rate announcement and our *Monetary Policy Report* (MPR).

As you know, Governing Council decided to raise interest rates at each of its July and September meetings, in the context of stronger-than-expected economic growth and a very strong labour market. Furthermore, over the course of the summer, we saw a firming of inflation indicators and a rapidly closing output gap. As we predicted in July, the economy is showing signs of moderating in the second half of the year. Nevertheless, we expect the economy to continue to grow at an above-potential pace.

Today, we left our policy rate unchanged at 1 per cent. We regard this level as appropriate in light of our updated projection for the economy and inflation—in particular, we expect inflation to reach our 2 per cent target in the second half of 2018. This is a little later than we projected in July, primarily because the Canadian dollar has strengthened in 2017.

Before taking your questions, let me offer a few comments around Governing Council's deliberations.

Governing Council agreed that the economy is likely to require less monetary stimulus over time, but we will be cautious in making future adjustments to our policy rate. Four key issues are adding uncertainty to the projection. These are the same four issues that I highlighted in my recent speech in St. John's, and they played an important role in our deliberations for today's decision. Discussion of these issues features strongly in today's MPR.

The first issue on which Governing Council spent considerable time is around inflation itself. In this MPR, we investigate a number of conjectures around the apparent softness of inflation in several advanced economies. I refer you to Box 1 of the MPR. These conjectures include a role for technology, specifically digitalization, which may be putting downward pressure on inflation; a role for imported disinflation from lower-cost countries; or more generally, a role for the forces of globalization. Suffice to say that for the Canadian data, this work has generally confirmed our faith in our model of inflation, in which inflation depends mainly on the degree of excess demand or excess supply in the economy, and this process operates with a lag. In short, we believe that we understand how Canada's inflation rate has been evolving. If we have been surprised in the past, it has been either because of sector-specific shocks, or because economic growth was slower than expected and there was more excess capacity than we previously believed.

Indeed, the second issue that preoccupied Governing Council was the degree of excess capacity in the economy. The economic growth we experienced in the first half of the year has been sufficient to bring the level of production close to our estimates of capacity. Let me reiterate, inflation has always been and remains a question of supply and demand. Therefore, one might expect continued above-potential economic growth—which we are forecasting for the next few quarters—to cause inflation to rise over time. However, the economy builds new capacity every day, through new companies and through investment and increased employment. We note that there is still some excess capacity in the labour market: there are people who are working part time who would prefer full-time work, there is still below-trend participation in work by youth, and hours worked are lower than we would expect. Accordingly, what we expect to see—and what occurs at this stage of virtually every economic cycle—is capacity-augmenting investment and the creation of new jobs at existing firms or at new firms, along with rising productivity. All of this could mean higher potential output than we have built into our projection. Because this process is highly uncertain as to timing and size, we build it into our projection conservatively. But the bottom line is that the economy could be capable of generating more non-inflationary growth than we are assuming.

The third issue is the continued softness in wage growth in the context of an unemployment rate that is now about the same as it was prior to the global financial crisis. While employment growth has certainly been strong, wage increases have not kept pace. This softness is due in part to the excess capacity in the labour market that I just mentioned, and the link between excess demand and higher wages also operates with a lag. But it is also possible that other factors, including globalization, may be affecting wage dynamics.

The fourth issue that preoccupied Governing Council was elevated household debt and how that might affect the economy's response to higher interest rates. We have enhanced our main macroeconomic model used for projections to capture relevant details around housing and debt, and we have re-estimated all of our model's parameters using advanced methods. You can find details in the appendix in the MPR. We do find that the economy is likely to respond more to higher interest rates at today's debt levels than historically. Even so, we have to allow for the possibility that these improved estimates fall short of the mark. Furthermore, we have to watch how the household sector reacts to the new rules around mortgage underwriting. It will take time to understand the impact of these changes as well as the economy's sensitivity to higher interest rates.

Governing Council expects that incoming data and new research will shed more light on these four issues as we move forward. There is also a range of other risks that we outline in the MPR, which, taken together, give us a balanced outlook for inflation. As well, there is uncertainty surrounding the possibility of a significant shift toward more-protectionist trade policies in the United States, which we have chosen not to incorporate in our projection.

Given our recent history with inflation running below target, we continue to be more preoccupied with the downside risks to inflation. The bottom line is that Governing Council will be cautious in considering future interest rate adjustments and will be guided by incoming data to assess the sensitivity of the economy to interest rates, the evolution of economic capacity, and the dynamics of both wage growth and inflation.

With that, Senior Deputy Governor Wilkins and I will be happy to take your questions.