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

Opening statement by Mr Stephen S Poloz, Governor of the Bank of Canada, to the Standing Senate Committee on Banking, Trade and Commerce, Ottawa, Ontario, 25 April 2018.

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Good afternoon, Mr. Chairman and committee members. Senior Deputy Governor Wilkins and I are pleased to be back before you today to discuss the Bank's *Monetary Policy Report* (MPR), which we published last week.

When we were last here at the beginning of November, we saw signs that the Canadian economy was moderating after an exceptionally strong first half of the year. That moderation turned out to be greater and to last a bit longer than we expected. Still, it is important to recognize that inflation is on target and the economy is operating close to potential. That statement alone underscores the considerable progress seen in the economy over the past year.

The slower-than-expected growth in the first quarter reflected two main issues. First, housing markets reacted to announcements of new mortgage guidelines and other policy measures by pulling forward some transactions into the fourth quarter of last year. That led to a slowdown in the first quarter that should naturally reverse. Second, we saw weaker-than-expected exports during the quarter. This weakness was caused in large part by various transportation bottlenecks. Some of this export weakness should also reverse as the year goes on.

So, after a lacklustre start to 2018, we project a strong rebound in the second quarter. All told, we expect that the economy will grow by 2 per cent this year, and at a rate slightly above its potential over the next three years, supported by both monetary and fiscal policies. The composition of growth should shift over the period, with a decline in the contribution from household spending and a larger contribution from business investment and exports.

Inflation should remain somewhat above the 2 per cent target this year, boosted by temporary factors. These factors include higher gasoline prices and increases to the minimum wage in some provinces. Their impact should naturally unwind over time, returning inflation to 2 per cent in 2019.

Of course, this outlook is subject to several important risks, and a number of key uncertainties continue to cloud the future, as was the case in November.

In terms of risks to the outlook, the most important remains the prospect of a large shift toward protectionist trade polices around the globe. I should be clear that our forecast already includes the negative effect of increased uncertainty on companies' export and investment plans. Otherwise, it assumes that the trade agreements now in place will continue. The range of possible outcomes is far too wide to incorporate into an economic projection.

The four main uncertainties around the outlook for inflation are the same as six months ago, but good progress has been made on some of them. First, in terms of economic potential, our annual review led us to conclude that the economy currently has more capacity than we previously thought. As well, this capacity is growing at a faster pace than we expected. This means we have a little more room for economic demand to grow before inflationary pressures start to build. That said, some firms, particularly exporters, are operating at their capacity limits but are hesitating to invest. This hesitation may be due to trade uncertainty, transportation bottlenecks, shortages of skilled workers or other reasons. Regardless, it is limiting growth of our exports and economic capacity.

The second source of uncertainty concerns the dynamics of inflation. Here, recent data have been reassuring. Inflation measures, including our various core measures, have been behaving very much as forecast and are consistent with an economy that is operating with very little slack. This gives us increased confidence that our inflation models are working well.

The third area of uncertainty is about wages, and data here are also encouraging. Wage growth has picked up significantly over the past 18 months, approaching the 3 per cent growth rate one would expect from an economy that is running at capacity. However, the most recent figures are being boosted temporarily by the minimum wage increases in some provinces.

The fourth source of uncertainty is the increased sensitivity of the economy to higher interest rates, given elevated levels of household debt. The concern is that as interest rates rise, the share of household income going to service debt will also rise, leaving less to spend on other goods and services, and putting downward pressure on inflation. It will take more time to assess this issue, particularly because new mortgage guidelines are currently affecting the housing market and mortgage lending. However, the growth of household borrowing is slowing, which is consistent with the idea that consumers are starting to adjust to higher interest rates and new mortgage rules.

So, as you can see, there has been some progress on these four key areas of uncertainty, particularly the dynamics of inflation and wage growth. This progress reinforces our view that higher interest rates will be warranted over time, although some degree of monetary policy accommodation will likely still be needed to keep inflation on target. The Bank will continue to monitor the economy’s sensitivity to interest rate movements and the evolution of economic capacity. In this context, Governing Council will remain cautious with respect to future policy adjustments, guided by incoming data.

With that, Mr. Chairman, Senior Deputy Governor Wilkins and I would be happy to answer questions.