Remarks by David Dodge
Governor of the Bank of Canada
on Current Developments in the Canadian Economy

For reasons explained in our media advisory of 17 September, the annual out-of-town meeting of the Bank's Board of Directors that was to take place on 19 September in Moncton was held in Ottawa instead. A scheduled speech by Governor Dodge to the Moncton Chamber of Commerce was postponed. The following is the section of that speech dealing with current economic developments.

Right now, last week's tragic events in the United States are uppermost in people's minds. Like millions of people around the globe, Canadians are very concerned about the situation. We all share in the sheer horror of what has happened.

In circumstances like these, part of our job as Canada's central bank is to respond by addressing the financial needs of the country. That is why the Bank of Canada, like other major central banks, moved swiftly last week to provide liquidity to ensure that financial markets continued to function effectively. In addition, the Bank of Canada and the U.S. Federal Reserve agreed to temporarily increase the amount of their existing swap facility to provide liquidity in U.S. dollars to Canadian banks, should they need it to settle their U.S. dollar transactions. And this past Monday, we took action to counteract potential effects on confidence in the aftermath of the extraordinary events in the United States, by lowering our key policy rate outside our normal schedule of announcement dates.

Clearly, the events in the United States have increased the uncertainty surrounding global economic prospects in the short run. It is important, however, that we look through the short term to the longer-term trends and potential of our economy.

The first decade of the twenty-first century will continue to bring to Canada and to the rest of the world important technological changes—changes that will transform our economies through the widening application of new information, communications, and other general-purpose technologies. This transformation can be expected to raise the potential of our economy to grow and to generate income gains in the decade ahead. Once the cyclical forces that are currently constraining investment and innovation are behind us, we should see productivity and income gains from past investments and adjustment. And the way will be clear for further innovation and growth.

In addition, Canada has made great progress over the past decade in strengthening its economic foundations: low inflation has been firmly established; the fiscal health of governments has been largely restored; and Canadian businesses have undertaken major restructuring.

Thus, the medium-term outlook for growth in output, employment, and incomes in Canada is very favourable.

Let me now put the short term in perspective.

Around this time last year, both the Canadian and the U.S. economies were pushing against, or through, their capacity limits. Because of that, some slowing was anticipated, and indeed was desirable, to keep inflation in check. However, the economic slowdown in the latter part of 2000 was more abrupt than had been foreseen, especially in the information and communications sectors.

At the beginning of 2001, the Bank of Canada expected that the economic slowdown in this country would continue through the first half of the year and that inflationary pressures would therefore be reduced. Thus, we began to lower interest rates.

We also expected that, as the process of adjusting inventories and excess capacity was completed in most industries, capital spending in the United States, which had been sharply curtailed, would begin to recover in the second half of 2001.

With the pace of economic expansion thus picking up in the United States, we expected that growth in Canada would also rebound—to above the growth of the economy's production potential—during the first half of 2002. Consequently, the small output gap that had opened in 2001 would begin to close. The economic data received through last winter and spring were broadly consistent with this scenario, and the pace of monetary easing was set accordingly.

By mid-summer, however, evidence began to accumulate that the U.S. slowdown would be more protracted than anticipated and that economic activity outside North America would be much weaker. At the same time, there were indications that domestic demand in Canada, which had held up well through the first part of the year, was softening.

In view of these developments, at the time of our last fixed announcement date, on 28 August, we revised down our expectations for economic growth in the period ahead. We projected that output growth in the second half of 2001 would be only slightly stronger than in the first half. The pace of economic expansion would then start to gain momentum in the first half of 2002 and would move above potential growth in the second half. This meant more economic slack going into next year than we had previously anticipated, and it would take longer to absorb.

In these circumstances, the Bank lowered interest rates again, at the end of August, to support domestic demand growth and to keep inflation near the target of 2 per cent over the medium term. And in our press release of 28 August we indicated that, given the continuing uncertainties in the global economy, particularly the timing and strength of the recovery in investment in the United States, and the uncertainty surrounding domestic demand growth in Canada, we would continue to monitor developments closely.

Last week's tragic developments in the United States, and their reverberations around the world, obviously bring with them further uncertainty with respect to the timing and extent of a rebound in economic activity.

Although it is too early to fully assess the likely consequences for our economy, the Bank's initial efforts involve trying to estimate the direct effects of disruption in sectors such as transportation, finance, and tourism. The terrorist attacks on the United States will also affect consumer and business confidence worldwide, including here in Canada. It is precisely for this reason that we moved promptly this week to lower interest rates by one-half of one percentage point. This action, which leaves short-term interest rates 2 ¼ percentage points lower than at the beginning of the year, aims to provide further support for economic growth in Canada.

The Bank also recognizes that a key factor in preserving the confidence of Canadians in the prospects of our economy is a financial system that continues to function effectively. That is why, as I said earlier, we took steps, together with the other G-7 central banks, to inject liquidity into the financial system to support its smooth functioning in the wake of the tragic events in the United States. We stand ready to do so whenever necessary. But it is encouraging that at this juncture, with each passing day, we seem to be moving back to a more normal state of affairs in the financial system.

Right now, it is difficult to look too far ahead in terms of the economic implications for Canada of last week's events. Nevertheless, economic growth in the third quarter will likely be close to zero or slightly negative, and we will continue to feel the adverse effects into the fourth quarter. With the economic slack that is opening up, we continue to see core inflation falling to about 2 per cent by year-end. We also project that total CPI inflation will drop to close to 2 per cent over the same period, assuming that energy prices remain near current levels. There is a risk that world oil prices could rise sharply, depending on the fallout from last week's events.

A more complete analysis of the impact of last week's events on the Canadian economy, including the effects on output and inflation in 2002, will be carried out as we prepare for our next policy announcement on 23 October. This analysis will be presented in our November 2001 *Monetary Policy Report*. Clearly, there are adverse effects that need to be assessed, but there will also be offsetting factors, from such activities as rebuilding in the United States and a return to more normal operations in both Canada and the United States, that need to be considered. Given the uncertainties surrounding all these elements, there will be a wider-than-usual confidence band around the economic outlook for next year.