**Remarks by David Dodge**
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**to The Canadian Club of Winnipeg**
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# Challenges and Changes in an Eventful Year

Thank you for the invitation to speak to you today. I'm delighted to have the chance to visit Winnipeg.

As you may know, the end of this week will mark the first anniversary of my appointment as Governor of the Bank of Canada. It was an honour to be appointed, and it has been a privilege to serve Canadians in this role. I have had the opportunity to work with an extraordinarily talented group of professionals at the Bank, as well as a supportive Board of Directors. Together, with input from Canadians across the country, we have worked hard to conduct monetary policy as well as we could during rapidly changing, and increasingly difficult, economic times.

As I come to the end of my first year, it seems natural to look back on the past 12 months and review some of the challenges and changes that have taken place. The main economic concern of the past year was the slowdown that occurred not just here in Canada, but in most major economies. Compounding the economic concerns were the 11 September terrorist attacks in the United States.

Inside the Bank of Canada, there were some major developments as well. Two things in particular stand out for me. We went through our first year with our new system of fixed announcement dates for interest rate decisions. And we renewed our inflation-control agreement with the federal government. In my remarks today, I'd like to talk to you about our fixed announcement dates and about the process we go through in reaching our interest rate decisions. Then I'd like to take a few minutes to review the current state of the economy and touch on Canada's economic outlook. I will also have a couple of words to say to reinforce the Bank's views about the Canadian dollar.

**Fixed Announcement Dates**

Towards the end of 2000, under the leadership of my predecessor Gordon Thiessen, the Bank established a system of pre-set or fixed dates for announcing interest rate changes. We now set eight dates per year when we will announce either a change, or no change, to our key policy rate—the target for the overnight rate of interest.

This system marks the latest development in the way the Bank implements its monetary policy. This process has been through quite a transformation in recent years. It was not that long ago that the Bank "announced" interest rate changes by conducting transactions in money markets. There was no press release explaining the rationale for our moves, no confirmation of the moves to the media, and no set time for these transactions, which could come on any business day.

Over time, the deficiencies in this system began to be addressed. The Bank settled on a set time during the day—9 a.m. Eastern Time—to make its interest rate moves. It began to confirm the changes publicly, issuing a press release to explain the factors behind the moves. And now, with our new system of fixed announcement dates, Canadians know, in all but the most extraordinary circumstances, when the central bank will make an interest rate announcement.

Previously, financial markets could not be sure on which day we might move. So, when there was an expectation that we were about to act, trading would be slow in the early mornings—sometimes for several days. We have found that removing this uncertainty has improved the workings of the market.

But other benefits are more directly apparent to the public. When the Bank first announced this system, we said that we hoped it would help focus public attention and commentary on the economic factors behind our interest rate decisions. Indeed, from what we have seen in the past year, the commentary in the media and financial markets about monetary policy has become more focused and relevant to the Canadian situation. The fact that the media and the markets know when an announcement will be made has resulted in more and better analysis and market commentary leading up to the announcements, as well as afterwards. The media have used this approach to improve the depth and quality of their analysis. And the discussion now tends to be about the state of the Canadian economy and about the rationale for the Bank's decisions.

Just as our fixed-date system has allowed the media to improve their coverage of the Bank, it has also provided the framework for financial analysts to improve their work as well. Their analysis is important. It should help the market work better, and should also help us to improve our understanding of the views in financial markets. But in the end, of course, we will take whatever actions that we think are appropriate for the economy, even if these actions are different from the expectations reflected in the market.

The fixed announcement dates also give us another opportunity to bring

Canadians up to date on the Bank's views about the economy. On every fixed date we issue a press release, whether or not we've changed interest rates. In it, we briefly explain our decision. These press releases work with our *Monetary Policy Report*, the *Updates* to the *Monetary Policy Report*, and speeches by me and other senior Bank officials, to provide a regular, ongoing account of our views. In doing so, we hope to contribute to greater public awareness and discussion of both economic developments in Canada and the role of monetary policy.

But information flows both ways. Through all of our communications, we are providing the opportunity for public critique of our economic analysis. And this critique is an essential part of the process by which we conduct monetary policy.

I should point out that we have now shortened the time lag between the fixed announcement dates and the *Monetary Policy Report* or *Update* that is released following four of the eight fixed dates each year. We will now publish the *Report* or *Update* in the week following the fixed date, rather than two weeks later as was the case last year.

**How Decisions Are Reached**

The decisions taken on fixed announcement dates reflect the consensus of the six members of the Bank's Governing Council: Myself, Senior Deputy Governor Malcolm Knight, and the four Deputy Governors. It might be helpful at this point to expand a bit more on the process we go through as we approach each announcement date.

The Bank is always closely monitoring developments in the domestic and global economies. But the fixed-date calendar has led to a more structured process for considering the impact of these developments and their implications for monetary policy. In the week to 10 days leading up to an announcement, the Governing Council first receives views from staff at the Bank. Initially, we hear from our analysts in our Research Department who, with the aid of sophisticated economic models, provide projections for the Canadian economy. They also keep us informed of what private-sector forecasters are saying. Our International Department provides the outlook for the U.S. and overseas economies, and the global context in which we in Canada make our decisions. Bank staff from across the country report on economic developments, and on the views of businesses, in their regions. Our Monetary and Financial Analysis Department interprets the signals coming from credit markets and monetary aggregates. And our Financial Markets staff assess financial market developments and expectations.

The staff present their analyses to Governing Council in a series of meetings during the week prior to each fixed announcement date. Since these staff analyses come from such different perspectives, it is probably not too surprising that they sometimes have differing viewpoints as to what is the appropriate stance for monetary policy. However, these differing viewpoints are very valuable, as they enrich the discussion during the decision-making process. The final staff views on the economy and the implications for policy are formally presented to Governing Council on the Friday morning before an announcement. It is the role of the Governing Council to take all of this analysis and apply our best judgment to it. It usually requires a lively and thorough discussion among Governing Council members to reach a consensus decision.

The Governing Council reconvenes on Monday, and by the end of the day we tentatively decide on our action and on the wording of the accompanying press release. Our consensus decision is finalized on Tuesday morning, just before the 9 a.m. release time.

With our press releases, periodic reports and speeches, we try to explain our thinking. In doing so, we hope to help Canadians, including those in the financial markets, anticipate the general *direction* of monetary policy. But this should not be interpreted to mean that we try to influence or condition market expectations about our likely policy moves just before an announcement date.

The Bank puts a lot of emphasis on developing a complete picture of the economy, not on reacting to any particular piece of information or even a particular series of economic data. An almost constant stream of what is called "high-frequency data" is published by Statistics Canada and other government and other private agencies about various sectors of the Canadian economy. However, "high frequency" does not mean "high fidelity." In fact, there is a lot of "noise" in these data—incomplete or misleading signals about the future course of the economy. It is a crucial part of our job to filter out this noise, and put the pieces together to get to the underlying trends in the economy.

Since monetary policy works over long periods of time, we cannot, and should not, have a knee-jerk reaction to each and every piece of these high-frequency data that we see. For this reason, we publish our *Monetary Policy Report* and *Updates* every three months, taking into account all the information that has come in during that past quarter.

We don't generally provide material updates on our views of the trends in the economy and the implications for monetary policy between announcement dates. But sometimes there could be developments that lead us to significantly change our views from the scenario that we had most recently laid out in our public statements. In that case, we would seek to provide a clear signal of the change in our views.

I hope I have been able to give you an idea of how we go about making our interest rate decisions. But I should stress that we always have a medium-term focus—our goal is to take whatever steps are needed to aim inflation at our 2 per cent target over a 6- to 8-quarter horizon.

**The Slowing Economy in the Past Year**

Let me now look back at a rather difficult year for the economy. During 2001, we lowered interest rates at every fixed announcement date, in order to adjust to the changing economic circumstances.

____________At the beginning of the year, our main concern was the impact that a slowing U.S. economy would have on Canada. Although domestic demand in Canada was holding up, against a backdrop of weaker foreign demand, we lowered our target for the overnight rate through the first half of the year.

But by mid-summer, 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. So at our 28 August fixed announcement date, we said that we had revised down our expectations for growth.

Then came the terrorist attacks of 11 September. The immediate impact and the subsequent fallout from the attacks compounded the problems of the economic slowdown. The attacks presented a pressing challenge to the Bank of Canada and other central banks: to keep the world's financial systems operating smoothly.

One of the Bank's key functions is to promote financial stability in Canada. That means keeping markets functioning well, even in times of extreme stress, such as the days immediately following 11 September. The Bank of Canada, as did other central banks around the world, stepped in to provide financial markets with ample access to domestic liquidity. And we reached an agreement with the U.S. Federal Reserve that would have permitted us to provide extra U.S.-dollar liquidity to Canadian banks had it been necessary. In short, we made sure that the disruption did not turn into gridlock. If there was one positive thing to emerge from this terrible event, it was that the global financial system kept running as well as it did.

But in the aftermath of these events, we were left with another challenge. That was to try to minimize the economic impact of the attacks. It was obvious that consumer and business confidence would suffer. We needed to do our part to help keep the loss of confidence as small as possible, which would help the economy recover as quickly as possible.

That is why in the days following the attacks, we took the extraordinary step of lowering interest rates outside our fixed announcement dates. It then became clear that the economy would continue to operate below its capacity throughout 2002, with resulting downward pressure on inflation. So we sped up the pace of interest rate reduction at the next two fixed announcement dates. We wanted to support economic growth, which would help keep inflation within our target range of 1 to 3 per cent.

The terrorist attacks created all sorts of uncertainties—economic, political, and military. So it was extraordinarily difficult last fall to be very certain about the future track of the economy. Now however, a clearer picture is beginning to emerge.

**The Current Economic Situation and Outlook**

One way for us to get that clearer picture is to actually get out across the country to see what is going on in Canada's regions. These opportunities to get away from the frenetic world of financial markets, and to see what is happening in the real economy, are extremely important to me, and to the Bank.

Let me focus on Manitoba for a moment. With economic growth estimated to have been about 1.75 per cent, the province appears to have posted the third fastest growth rate in the country last year, behind only Alberta and Newfoundland. Diversification, not just within the agricultural sector but across the whole economy, has been enormously helpful. This has allowed the province's unemployment rate to remain well below the national average. Manitoba has also been helped by a modest debt-to-GDP ratio and by a record of fiscal prudence that continues today.

Still, the local economy has felt the after-effects of the terrorist attacks. The aerospace industry, in particular, has been hit hard by a downturn following the attacks. In a more indirect way, the slowing world economy has led to a weakening of many commodity prices, including agricultural commodities. This, coupled with low crop yields last year and the threat of poor growing conditions again this season, could lead to some difficulty for the agricultural sector.

In looking at the country as a whole, some sectors of the economy have recovered smartly from 11 September, but in other areas the adverse effects have persisted. Certainly air travel, both for business and tourism, continues to be weak.

Last week, we published our *Monetary Policy Report Update*. In it, we said that the economy looked increasingly likely to find itself between the two extreme possibilities we had sketched out in last November's full *Monetary Policy Report*. On the plus side, geopolitical developments have been positive. Indeed, consumer confidence seems to be recovering in the absence of new terrorist attacks.

But it is difficult to pinpoint the exact moment that the economy will begin to recover or precisely how strong that recovery will be. What I can say is that the conditions for strengthening world economic growth are in place. Excess capital stock is being worked out of the system, leading to expectations of greater investment ahead. And low commodity prices should rebound as global demand picks up.

All told, we see Canadian growth in the first half of 2002 averaging between 1 and 2 per cent on an annualized basis. But growth should accelerate in the second half, with an average in the range of 3 to 4 per cent on an annualized basis.

What does this mean for inflation? We saw total consumer price inflation dip sharply in November, then stabilize in December. At the same time core inflation, which is a measure we use to predict future inflationary trends, also fell during those two months. This is consistent with an economy operating below its capacity.

With the economy growing more slowly than potential output through the first half of the year, excess supply will continue to build. So both total and core inflation are expected to remain near current levels for the next few months. But by lowering our target for the overnight rate, the Bank of Canada has taken vigorous action to stimulate domestic demand. We expect that as this excess supply begins to be taken up, both core and total CPI inflation should move back up close to our target of 2 per cent in about two years.

Businesses of all kinds are still adjusting to the security risks that the events of 11 September have shown to us. In our view, this should be a one-time adjustment. But it probably means there will be a small reduction in the level of our economy's potential output.

I would now like to say a few words to reinforce our views about recent exchange rate developments that are a source of concern.

Over time, exchange rates should reflect underlying economic and financial developments and prospects. But in the short run, there can be volatility as markets gauge those prospects.

As I have already noted, it is becoming clearer that our economy will strengthen as we go through this year and into 2003. Recent data increasingly support the view that a recovery is taking hold. Household spending in Canada, particularly on interest-sensitive purchases, has been stronger than expected. The latest data on exports and manufacturing activity show signs of recovery. The inventory adjustment is progressing. And with early evidence of a revival in the U.S. economy, the world prices of non-energy commodities appear to have bottomed out.

These signs of a pickup in economic activity in Canada are encouraging. But the recent movements in the Canada–U.S. exchange rate do not appear to have reflected those developments and the depreciation we saw over the last couple of weeks is not helpful for the economy. Economic recovery in Canada does not hinge on the current low levels of the Canadian dollar against its U.S. counterpart.

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So to conclude, this past year has certainly been full of challenges. I know, however, that we have done the right things to get the economy growing strongly again, and that we are in good shape to take advantage of better times when they arrive. I feel confident in predicting that one year from now, when I'm looking back over my second year as Governor, I'll be looking back over a recovering economy, one that is much stronger than it is today.