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Remarks by David Dodge
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Recent Economic Developments and the Conduct of Monetary Policy

Good afternoon, and thank you for the invitation to speak with you today. It's great to be back in Halifax, one of Canada's most colourful port cities. It is the wonderful juxtaposition of the new with the old—Halifax's modern focus with its rich maritime traditions—that makes this city special.

It's been a year since I last spoke in Halifax, and a lot has changed since then. We've witnessed some extraordinary events, both in Canada and around the world. On the whole, Canada's economy has withstood the turmoil quite well. The impact of some more recent events is not yet clear. Still, I will try today to outline how our economy has evolved over the past year and to lay out the issues that we'll be assessing as we prepare our July *Monetary Policy Report Update.*

Watching Conditions and Demand Pressures

As we at the Bank of Canada set monetary policy, we watch all the events affecting our economy, including global geopolitical, economic, and financial conditions. We do this with a view to keeping domestic inflation near the 2 per cent midpoint of Canada's inflation target range of 1 to 3 per cent. As we have often said, delivering an environment of low, stable, and predictable inflation is the best contribution that monetary policy can make to a strong, sustainable economy and rising living standards for Canadians. Such a low-inflation environment also helps keep our economy near its production potential over time.

To achieve those goals, we keep a close eye on the factors influencing demand and production capacity—factors that will, in turn, influence inflation over the medium term. And we adjust monetary policy to keep the future trend of inflation near the 2 per cent target midpoint.

Where We've Been

As I've said, it's been a year since I last spoke in Halifax. But to place our recent experience in some context, I should go back a bit further than that—to the 11 September 2001 terrorist attacks in the United States. In the wake of that terrible event, the Bank of Canada quickly and aggressively cut its policy interest rate to shore up confidence and support domestic demand. This action, together with earlier reductions in our policy interest rate, meant that the Bank had injected considerable stimulus into the economy.

By the spring of 2002, evidence had already started to build that demand was recovering more quickly than had been anticipated. So, even though demand pressures were not yet showing up in prices, we began to remove some of that monetary stimulus. We raised our key policy interest rate three times between April and July 2002, by a total of three-quarters of a percentage point.

By last autumn, inflation in Canada was on the rise. But we refrained from raising interest rates any further at the time, because we judged that the pickup in inflation was mainly the result of one-off factors and would be reversed over the next year or so. As well, there was considerable geopolitical and financial uncertainty, which, combined with global economic weakness, pointed to restrained total demand for Canadian goods and services.

Through the first quarter of this year, CPI inflation climbed well above the 2 per cent target. Much of the rise was the result of higher energy prices. We also saw a marked increase in our measure of core inflation, which strips out the eight most volatile items—including gasoline, heating oil, and natural gas—from the CPI basket, as well as the effect of changes in indirect taxes on the remaining CPI components. The rise in core inflation was exacerbated by further increases in automobile insurance premiums. But even allowing for the unusual and extraordinarily large increases in insurance premiums, inflation was well above target. This suggested that strong domestic demand was putting pressure on production capacity. In this environment, some indicators of short-term inflation expectations edged up, although longer-term expectations remained around 2 per cent.

In view of these inflation developments, the momentum of domestic demand, the narrowing of interest rate spreads in credit markets, and diminishing geopolitical uncertainty, we raised our target overnight rate by 25 basis points in March and again in mid-April—bringing it to 3.25 per cent.

In our April *Monetary Policy Report*, we stated that the risks confronting the world economy appeared to be more evenly balanced than they had been in the autumn. The Canadian economy was projected to strengthen appreciably towards the end of 2003 and to grow somewhat above its production potential during 2004, thanks to a pickup in economic activity in the United States and further improvements in business and consumer confidence.

We concluded in April that although growth would likely remain somewhat below potential in Canada for the first three quarters of this year, most of the small amount of economic slack that would open up this year would have closed by the end of 2004.

We projected that core inflation would likely fall to about 2 1/2 per cent in the second half of this year and to about 2 per cent by early 2004 as some of the special factors pushing up inflation ran their course. We also pointed out that total CPI inflation would continue to be importantly affected by swings in crude oil prices and that it would likely fall temporarily below the core rate in the first half of 2004 before steadying out at a rate close to core inflation.

Factors Influencing Monetary Policy

In the April *Monetary Policy Report*, we listed a number of factors that we intended to watch closely as we set monetary policy. These factors are the pace of economic expansion in the United States and overseas, the strength of domestic demand, financial market conditions, and the evolution of inflation and inflation expectations.

So, let me review how we have seen these factors evolving. I'll start with the external environment. In Europe, domestic demand and economic growth have continued to disappoint. Japan's economy has also remained weak. While demand growth in the rest of Asia has been strong, the outbreak of Severe Acute Respiratory Syndrome (SARS) is clearly going to slow growth in some countries.

In the United States, domestic demand has not been recovering as quickly as expected, which has negative implications for Canadian exports, at least over the short term. Consumer spending continues to underpin economic activity in that country. However, business fixed investment has not yet picked up. Expectations as to when the U.S. recovery will occur have been pushed back until late this year when confidence levels should improve, and when the impact of very expansionary monetary and fiscal policies should begin to be fully felt.

Now, let's turn to the second factor—domestic demand in Canada. On the whole, demand has remained quite strong, supported by a healthy employment market, low interest rates, and a recovery in corporate profits. While growth in consumer spending slowed slightly in the first quarter, it was still quite strong, especially on housing. Governments and businesses both increased their spending. As a result of strong domestic demand, gross domestic product grew at an annual rate of almost 2 1/2 per cent in the first quarter, up from about 1 1/2 per cent in the final quarter of 2002.

In Nova Scotia, we are seeing some fall-off in consumer spending. Business investment prospects have also been dampened by the postponement of natural gas projects. Still, most forecasters predict Nova Scotia's economy will continue to grow at the Canadian average rate this year.

A third factor on our watch list is the evolution of conditions in financial markets. Last autumn, we witnessed sharp increases in risk premiums because of uncertainty in financial markets. In recent months, these risk premiums have declined, and conditions in both debt and equity markets continue to improve. This reflects reduced uncertainty and bodes well for business spending going forward.

Before moving on to the fourth factor, I'd like to mention several developments since April that have implications for the economic outlook. Together, these developments point to near-term growth in Canada that will be lower than we expected at the time of our April *Monetary Policy Report*.

SARS is having a significant impact on the hospitality industry, not just in Toronto, but across the country—including here in Atlantic Canada. More recently, the closure of export markets because of the discovery in Alberta of an isolated case of Bovine Spongiform Encephalopathy (BSE) is having an impact on the beef and beef-processing industry. And, of course, problems in several important East Coast fisheries are affecting employment and production in this region.

As you well know, since mid-April there has also been a further sharp adjustment in the value of the U.S. dollar against major currencies, including ours. The magnitude and speed of the Canadian dollar's rise has been greater than anyone had anticipated and will have a dampening influence on aggregate demand later this year and next. We are working to understand all the factors behind these exchange rate movements. In setting monetary policy, we have to take into account the effects on aggregate demand of these factors, as well as the effect of the exchange rate movements themselves.

Exchange rate movements also have a direct effect on the prices of traded goods and services and, therefore, on inflation. However, our research has shown that, in economies such as Canada's, the effect of exchange rate movements on consumer prices has been less pronounced in recent years, when inflation was relatively low, than was the case in earlier years when inflation was high.

The Inflation Picture

This leads me to the fourth factor that we watch closely in setting monetary policy—the evolution of inflation and inflation expectations. Let me start with inflation.

In the 3 June press release that announced our latest interest rate decision, we pointed out that inflation has declined more than expected. Some of this decline is due to transitory factors, most notably, the rebate on electricity prices in Ontario. Thus, we expect some temporary rebound in core inflation in the coming months, as these factors unwind. Nevertheless, it now appears that both core and total CPI inflation will return to the 2 per cent target somewhat earlier than the Bank had anticipated in April. This is, in part, because of some near-term softness in demand. Also, the appreciation of the Canadian dollar will somewhat dampen the rise in total CPI, although it is not expected to have as large a direct effect on core CPI.

Now, a word on inflation expectations. As I mentioned, we were concerned in April that the sharp rise in CPI inflation last winter was starting to push up Canadians' expectations of inflation. The recent easing in inflation is likely to act as a moderating influence on those expectations. We will be seeking evidence of this in our regular survey of businesses prior to our next fixed announcement date.

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Let me sum up. Today, I have outlined some of the recent developments that will influence the demand for Canadian goods and services. They include continuing weakness in the U.S. and global economies, and concerns about the economic impact of SARS and BSE. These developments likely mean a very weak second quarter and point to some continuing softness in the Canadian economy in the third quarter.

Looking forward, it remains our view that growth in Canada's economy will be underpinned by the strength of domestic demand and a rebound in the U.S. economy towards the end of 2003 and through 2004. However, the appreciation of the Canadian dollar against the U.S. dollar, which is an outcome of various influences at work in both the Canadian and global economies, will be a factor influencing aggregate demand. We will provide Canadians with a more considered and complete picture of our views on the economy in our next *Monetary Policy Report Update*, which will be published on 17 July.

Ladies and gentlemen, Halifax is a city that has withstood some extraordinary events in its long history. The Canadian economy, too, has been buffeted by some remarkable winds this year—some fair and some foul. But we have weathered them well, and I believe we will continue to do so. I can assure you that the Bank of Canada will continue to provide monetary policy that contributes to a strong, stable, and sustainable economy.