CHECK AGAINST DELIVERY

Remarks by David Dodge
Governor of the Bank of Canada
to the Conseil du patronat du Québec
Montréal, Quebec
12 June 2003

Recent Economic Developments and the Conduct of Monetary Policy

Good afternoon, and thank you for the invitation to speak with you today. It's always a pleasure to be in Montréal. It has given me particular pleasure to visit in the past two or three years, and to see the renewed vitality that is transforming this wonderful city.

I want to talk to you about the Canadian economy—how it has evolved over the past few months and what are the prospects ahead. In doing so, I will review the economic forecast from our latest *Monetary Policy Report*, which we published in April. Then I will talk about what has changed since that time.

After we published the *Monetary Policy Report*, I spoke to committees of both the House of Commons and the Senate about our views on the economy. One of the senators asked me what keeps me, and my colleagues at the Bank of Canada, awake at night. I told him that we central bankers are paid to worry. But it's true that we've had lots to keep us awake over the past few months. The economic picture has been clouded by extraordinary events in Canada and abroad. Indeed, it's been a bit like the old saying: if you're not confused, you haven't been paying attention.

Watching Conditions and Demand Pressures

We have been closely monitoring the events that have buffeted the Canadian economy, as well as global geopolitical, economic, and financial conditions. At the Bank of Canada, we do this with a view to keeping inflation near the midpoint of Canada's inflation target range of 1 to 3 per cent. Delivering an environment of low, stable, and predictable inflation is the best contribution that monetary policy can make to a healthy economy with strong and enduring growth, thereby increasing the standard of living of Canadians. Low inflation also helps keep our economy near its production potential over time.

To that end, we keep a close eye on the factors influencing demand and production—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

Now, to place our recent experience in some context, let me remind you where we've come from over the past year and a half. Following the 11 September 2001 terrorist attacks in the United States, the Bank of Canada quickly and aggressively cut its policy interest rate to shore up confidence and support domestic demand.

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 the monetary stimulus that we had put into the economy following 11 September. Our key policy interest rate rose 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.

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 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 start expanding at a rate above potential towards the end of 2003, thanks to a pickup in economic activity in the United States and further improvements in business and consumer confidence.

We concluded 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 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 picked up, and expectations as to when this recovery will occur have been pushed back until late this year, when confidence levels should improve.

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 for 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.

A number of recent adverse developments are going to reduce near-term economic growth in Canada. SARS is having a significant impact on the hospitality industry, not just in Toronto, but across the country. 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 across Canada.

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

As you well know, since mid-April there has also been a 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. In setting monetary policy, we have to take this influence into account. We also need to understand all other factors behind these exchange rate movements and take them into account as well.

In addition to their impact on aggregate demand, movements in exchange rates 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 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 because of an expected moderation in auto insurance premium increases, and because of some near-term softness in demand. As I said earlier, the appreciation of the Canadian dollar is not expected to have a large direct effect on core CPI, although it will act to dampen the rise in total CPI.

Now, a word on inflation expectations. As I mentioned, we were concerned 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.

****

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. These developments point to some near-term softness in the Canadian economy. The appreciation of the Canadian dollar against the U.S. dollar is another factor influencing demand—although it is also an outcome of other influences at work in the economy.

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.

We will continue to assess the economic data carefully. We will continue to talk to businesses about their plans. And we'll pursue our analysis to try to better understand the forces operating on our economy over the medium term.