**Remarks by David Dodge**
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**at the University of British Columbia**
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# Canada's Economic Performance After an Eventful Year

Good afternoon. I was delighted to accept your invitation to speak to you today. I'd like to spend some time reflecting on the evolution of the Canadian economy and what we as Canadians have achieved in the past few years. Then I will talk a bit about the outlook and the uncertainties facing the global economy, and how Canada's successes on the fiscal and monetary fronts will help us weather those uncertainties.

But first, I'd like to say how much I appreciate the chance to return to the University of British Columbia campus. Five years ago, I was here as a Senior Fellow in the Commerce Faculty. While my current job is different, there is one common thread that unites this institution and, indeed, all Canadian universities, with the Bank of Canada—a commitment to excellence in research.

## The Bank of Canada Fellowship Program

Indeed, a strong research environment has long been a hallmark of the Bank. We also want to encourage research relevant to our business, especially with respect to monetary policy and financial system stability, at universities all across Canada. That is why I am very pleased to announce today that the Bank of Canada is launching a Fellowship Program to foster high-calibre research in crucial economic areas.

The program will be open to professors at Canadian universities who have a record of high-quality research. The Bank fellowships will pay a salary stipend and provide funding for graduate research assistants and expenses.

We plan to award two fellowships the first year, and one each year after that, for a total of six fellowships by 2007. We hope the program will expand the pool of leading-edge research conducted across this country and strengthen Canadian expertise in areas critical to our mandate, such as macroeconomics, monetary economics, international finance, and the economics of financial markets and institutions.

Expanded research and a broader knowledge base will benefit the Bank of Canada, universities working to build strong economics departments and, indeed, all Canadians. And I am particularly pleased to be launching our Fellowship Program here, at a university that is committed to producing the type of ground-breaking analysis we hope to encourage.

**Improving the Policy Framework**

When I first arrived at UBC in the fall of 1997, Canada was completing a decade of struggle to get our economic policies right.

During the period 1988 through 1997, we took some important steps towards improving both our monetary and fiscal policies. The Bank of Canada, responding to the high and unpredictable inflation rates of the 1970s and early 1980s, adopted at the end of the 1980s a monetary policy aimed at achieving price stability. To make this commitment more concrete, the Bank and the Government of Canada agreed in 1991 on a series of inflation-control targets aimed at bringing the 12-month CPI inflation rate down to 2 per cent—plus or minus 1 per cent—by December 1995. The decline in inflation was achieved in fairly short order—by January 1992, inflation was close to 2 per cent. The agreement has subsequently been extended three times, retaining the 2 per cent target midpoint.

For almost ten years now, inflation has been well under control, and households and businesses now believe we will continue to achieve the inflation targets. Inflation expectations are well anchored, not just for the near term, but well into the future. Almost a decade of low inflation makes it easy to forget how difficult it was to achieve our inflation targets, and the economic price that was paid to achieve the tremendous benefits of low and stable inflation.

Back when I was teaching here, federal and provincial governments were in the midst of the painful but necessary process of fiscal consolidation. The federal government had been working to curb the rising debt-to-GDP ratio, but it really wasn't until 1995 that the government had done enough to tip the scales decisively toward deficit reduction. And it was 1997 before the cumulative effects of all those deficit-reduction measures put federal fiscal policy back on a sustainable track.

The debt-to-GDP ratio at the federal level has since fallen to less than 50 per cent, from a peak of 71 per cent in 1995. And while some provinces are still struggling to maintain budget surpluses, all have taken important steps to put their fiscal houses in order.

Governments and the Bank of Canada were working to get public policies—the fiscal and monetary framework—right. The private sector was also restructuring to take advantage of the opportunities provided by the Canada-U.S. Free Trade Agreement and to increase its productivity and competitiveness. It is not surprising that during those years of adjustment we had slower growth than the United States. But by the late 1990s, our economy was beginning to reap the benefits of those restructuring efforts. The end result of all this effort—the adoption of inflation targets, the fiscal improvement and the private sector restructuring—was that Canada's economy became better able to weather major shocks such as the Asian crisis, or last year's global slowdown.

Indeed, over the period from 1997 to 2001, Canada averaged annual economic growth of about 4 per cent, while the U.S. average was about 3.5 per cent. And while the U.S. economy fell into recession last year, ours did not.

Although the productivity growth of Canadian companies has not been as strong as that of firms in the United States, we have seen encouraging signs that investments in technology and training are leading to greater productivity gains here. Indeed, business sector labour productivity in Canada grew at an annualized rate of 2.0 per cent from 1997 to 2001, much higher than the 1.2 per cent average over the 1990-96 period, and only a bit below the revised 2.3 per cent rate of productivity growth recorded in the United States.

As we look forward, we see positive signs for future productivity growth in Canada, thanks to the efforts of Canadian firms to adjust to new technologies and incorporate them into their business processes.

**The Shocks of 2000-2001**

Indeed, the economy has held up remarkably well when you consider that we have been hit with four major shocks during the past couple of years. First, there was the meltdown in the technology and telecommunications industries, which began in late 2000 and the effects of which are still being felt today. The second was the broader economic slowdown in 2001 that affected, to various degrees, the economies of most countries.

Third, and overshadowing every other event last year, was the 11 September terrorist attacks. With the first anniversary just passed, this seems like an appropriate time to reflect on the extraordinary events that have buffeted the North American economies since that terrible day, and to review how the Bank of Canada responded to those events.

Our most immediate responsibility was to keep Canada's financial system functioning. Our next responsibility was to promote consumer and investor confidence. Therefore, the Bank of Canada took extraordinary monetary policy action. On 17 September last year, we reduced our key policy interest rate outside our scheduled announcement dates. Between September 2001 and January 2002, we lowered interest rates by a total of 200 basis points to help mitigate the impact of 11 September on an already-weakening economy.

It turned out that consumer confidence in Canada was not as badly shaken as had been feared. As the immediate geopolitical and economic uncertainties diminished, consumers responded strongly and quickly to the monetary stimulus. Interest rate-sensitive sectors, such as housing and automobiles, showed remarkable strength. Indeed, in the fourth quarter of last year we saw annualized GDP growth of almost 3 per cent, when most analysts were expecting the Canadian economy to shrink.

However, as we recovered from the 2001 slowdown and from 11 September, the U.S. economy was hit by a fourth shock—loss of confidence in the integrity of financial reporting and analysis as a result of Enron, WorldCom, and other accounting and corporate governance scandals. Unfortunately, the uncertainty caused by these problems in the United States has spilled over into other financial markets, including ours. This has created additional caution for businesses and appears to have delayed the expected recovery in investment worldwide.

In spite of these four economic shocks, Canada's economic performance has been, in comparison with other countries, rather good. Clearly, this has been a difficult year for the mining and forestry industries in British Columbia, for grains and oilseeds producers in the Prairies, and for the telecom industry across the country. But overall, our economy has consistently exceeded the average growth rates of the G-7 countries since 1997. And both the IMF and the OECD predict that Canada will post the strongest growth rate of the G-7 in both 2002 and 2003.

I want to emphasize that Canada's recent strong performance isn't just good luck. It is the result of having a solid policy framework, both in terms of inflation and fiscal control. The benefits of this framework are well understood, not just by the government and the Bank of Canada, but by Canadians in general. We stuck to that framework during the recent economic turmoil, and we are now seeing a clear payback for the tremendous investment that Canadians made in opening this country to free trade, and in getting our macroeconomic framework right in the 1990s.

That framework holds and will continue to serve us well. If anyone still needs convincing of that, Canada's recent economic performance provides compelling evidence.

**Canada's Economic Prospects**

Canada's economic growth so far this year has exceeded expectations. Real GDP jumped by 6.2 per cent at annual rates in the first quarter of 2002 and rose by 4.3 per cent in the second quarter.

The Bank of Canada believes that keeping inflation low, stable, and predictable is the best contribution monetary policy can make to strong and sustained growth in Canada. We run monetary policy in a symmetrical way. That is to say, we pay equal attention to persistent pressures that could move us away from our 2 per cent target—whether above or below.

When strong demand pushes the economy against the limits of its capacity and threatens to raise future inflation above the target, the Bank will raise interest rates to cool off the economy and mitigate those inflation pressures.

When demand is weak, as we saw in 2001, future inflation is likely to ease. So the Bank will lower interest rates to stimulate the economy, and absorb economic slack, consistent with keeping inflation on target. The significant easing of monetary policy during 2001 was a key factor behind the strong growth of household demand in the first half of this year.

Let me now turn to the outlook. In our April *Monetary Policy Report*, we said that the recovery in the Canadian economy began sooner, and was considerably stronger, than anticipated. Consumer spending and residential construction were reflecting the stimulus from both monetary and fiscal policy. Canada's export volumes had begun to grow once again, as the U.S. economy began to recover. By the time of our *Monetary Policy Report Update* in July, we were also seeing a rebuilding of inventories and an increase in spending on machinery and equipment. These were suggesting a broadening of the recovery across economic sectors.

The July *Update* still reflects our view of the economy. As we said two weeks ago, domestic demand in Canada remains stronger than expected, bolstered by the substantial amount of monetary stimulus still in the economy. Canada's record of job creation has been nothing short of remarkable, with almost 400,000 new jobs since the beginning of the year. This strong job growth is reinforcing the confidence of Canadian consumers. In addition, medium and small businesses continue to invest. All this paves the way for higher output and ongoing strong domestic demand.

But at the same time, there are downside risks and uncertainties, mostly originating from outside Canada. Near-term prospects for growth in the United States and the major overseas economies appear to have weakened. Private and public sector economists have revised down their near-term growth forecasts for the United States, Europe, and Japan. This could imply that Canada's exports, which were already slightly weaker than anticipated in the second quarter, could continue to be affected by slower growth in global demand.

The geopolitical situation remains quite unsettled. Finally, in the United States and Canada, we are still working through the corporate governance issues that have contributed to this year's financial market volatility. History has taught us that during periods of uncertainty, business and consumers tend to sit on their hands until the outlook is clearer.

Let me conclude. It remains the Bank's view that as the Canadian economy continues to expand and to approach capacity, further timely and measured reductions in the amount of monetary stimulus will be necessary. Let me remind you what I mean by "timely and measured." "Timely" relates to the fact that there is always a lag between our policy actions and their effect on the economy. "Measured" relates to the judgments that we make at each fixed announcement date about the pace at which the economy is approaching full capacity, taking into account new information and data as they become available.

Our current view is that the fundamental underlying strength of the Canadian economy has not changed since our July *Monetary Policy Report Update.* Domestic demand may well be stronger; at the same time, the external uncertainties bearing on the outlook appear to be greater than they were in early July.

We will provide a detailed view of our outlook for the Canadian economy in our next *Monetary Policy Report*, on 23 October.

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This past year has certainly been full of challenges. Over the last decade, Canada has put in place the right macroeconomic policy framework to weather major shocks and take advantage of opportunities. We are confident that this framework will stand us in good stead in the future.