Gordon Thiessen: Update on economic and monetary developments in Canada

Opening Statement by Mr Gordon Thiessen, Governor of the Bank of Canada, before the Standing Senate Committee on Banking, Trade and Commerce, Ottawa, on 6 April 2000.

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I very much appreciate the opportunity to appear regularly before your Committee. I would like to use this particular occasion to update you on economic and monetary developments as well as to discuss any issues that you may want to raise.

Let me first give you an overview of the developments in the past year. When I appeared before you last April, there was still a high degree of uncertainty in the global economy related to the 1997-98 financial crisis in emerging markets and the associated fall in world commodity prices. And because of these difficulties, the pace of economic activity in Canada had slowed. But by mid-1999, our economy had regained its momentum, supported by buoyant US demand, a rebound in commodity prices, and a pickup in domestic spending. Over the four quarters of 1999, output expanded by about 4¾% and 425,000 new jobs were created, taking the national unemployment rate down to 6.8% by this February - its lowest level in 23 years. At the same time, the underlying rate of inflation remained low.

Why has Canada rebounded so quickly from the external shocks of 1997-98? I believe it is because Canada’s economic policy foundation is stronger today than it has been in several decades. This foundation has two cornerstones. One is the improved fiscal positions of governments that have led to a declining ratio of public sector debt relative to the size of our economy. The second is an environment of low and stable inflation that is expected to persist because it is anchored by the Bank of Canada’s target for inflation control.

Since the early-1990s, Canadian monetary policy has been based on a commitment to explicit targets for inflation control. This commitment has helped to moderate fears of a resurgence of inflation, has assisted the Bank in taking timely action in response to changing economic and financial conditions, and has improved our public accountability.

A crucial part of our monetary policy regime is our floating exchange rate. Without that, we could not have Canadian inflation targets. A good measure of the success of our monetary policy framework based on inflation targets and a flexible exchange rate is that Canadian interest rates have remained lower than comparable US rates, apart from the period of turbulence in 1998. These lower rates reflect Canada’s lower inflation rate, and the expectation that low inflation will continue. In the past, a depreciation of our currency has frequently fed fears of inflation and has led to interest rate increases.

The difficulties of the past couple of years also illustrate the value of a flexible exchange rate as a shock absorber. The downward movement of the Canadian dollar from mid-1997 to the end of 1998 was largely a response to the sharp decline in world prices of the primary commodities that Canada exports. Our economy had to adjust to this reality; the exchange rate decline facilitated a shift in activity from the primary sector to manufacturing and other export sectors. It also provided an additional incentive for these sectors to take advantage of a strong US economy. Because of these adjustments, the Canadian economy continued to expand during 1998 and recorded a substantial upswing in 1999.

When I last appeared before this Committee, Mr Chairman, there were a number of questions about Canada’s rate of productivity growth and about the gap in productivity levels with the United States. I am happy to report that there have been some positive developments over the past year. Not only have we had better productivity gains through 1999, but purchases of machinery and equipment climbed 18% during the course of the year. This continues the increase in investment in machinery, equipment and technology that began in 1996 and that mirrors the increase in investment that began somewhat earlier in the United States.

While we are certainly heartened by the better productivity outlook in Canada, we are not sure how large these gains are likely to be, how long they will last, or by how much they will eventually enhance our economy's production capacity. This uncertainty raises an important issue for monetary policy, especially since, by some measures, the Canadian economy is currently operating at or above full capacity.

On the one hand, our low-inflation environment and the Bank of Canada's commitment to maintaining it give us more room than we have had for some time to explore the economy's full potential. However, because of the current strong momentum of the economy and the high levels of activity, the Bank must be careful to avoid approaching capacity limits too rapidly. We do not want to trigger bottlenecks and shortages that can put unnecessary pressure on inflation. Because of the time it takes for monetary policy to have its full impact on the economy, we can best achieve and maintain full potential if we approach capacity constraints gradually and carefully.

We had these considerations in mind when we increased the Bank Rate in November, February and March. These increases followed similar rate hikes by the US Federal Reserve. The US actions provided additional evidence of the likely further spillover of US demand to our export sector. Altogether, this suggests an overall demand for Canadian output that is stronger than previously expected. Under these conditions, it has been essential for the Bank of Canada to be vigilant.

As I said before, our inflation performance, up to now, has been good - in fact, somewhat better than we had expected. While the 12-month rate of increase in the total CPI moved up to 2.7% in February because of sharply higher energy prices, when one looks through those developments at the underlying trend of inflation, our core CPI measure (which excludes food, energy, and the effect of changes in indirect taxes) was at 1.6% in February. This is within the lower half of the 1 to 3% inflation-control target range.

When it comes to the surge in energy prices, let me just say that the Bank of Canada will be watching closely to ensure that the recent increase in energy prices does not show up in higher expectations of inflation. We expect that the recent decline in world energy prices will persist, bringing the rate of increase in the total CPI down, closer to the centre of our target range by late this year.

I cannot stress enough the importance that we at the Bank of Canada place on keeping the future trend of inflation in Canada low and stable. This is the best contribution that monetary policy can make to the continued expansion of the Canadian economy and to further productivity gains.