Mr. Thiessen looks at the recent economic record in Canada and the challenges ahead for monetary policy Notes for remarks by Mr. Gordon Thiessen, Governor of the Bank of Canada, to the New England-Canadian Business Council in Boston, USA, on 16/9/97.

It has been a little over two years since my last public speech to an audience in the United States. During this time, a lot has happened in terms of economic developments in our two countries.

One thing that continues to impress me is the remarkable performance of the U.S. economy, which has achieved six years of steady economic expansion, with high rates of job creation and low inflation.

As a neighbour and major trading partner, Canada has certainly benefited from the strong U.S. economy.

But I think that what is happening in the United States is relevant to Canada in other ways. First, it offers a yardstick that we Canadians often use to judge the performance of our own economy. Second, as the unused capacity in the Canadian economy is gradually absorbed, monetary policy in Canada will be facing challenges similar to those that the Federal Reserve has had to confront in trying to steer the U.S. economy on a path of durable, non-inflationary expansion. The recent U.S. experience in this area is, therefore, particularly interesting for us.

Today, I would like to discuss the recent economic record in Canada and the challenges ahead for monetary policy. In doing so, I will emphasize the Bank of Canada's continued commitment to explicit targets for keeping inflation low. Along with their other benefits, these targets help anchor market expectations about future movements in the exchange rate. The role of the exchange rate in the operation of Canadian monetary policy is another topic I will discuss today.

The recent economic record in Canada

Let us first take a quick look at how the Canadian economy has performed in the recent past, in comparative terms.

In terms of economic growth and job creation, there is no doubt that Canada has not done as well as the United States in the 1990s. And even though, in my view, there are good explanations for this, the fact remains that Canada has some catching up to do in this regard.

Why has the growth in output and employment been more modest in Canada than in the United States in recent years?

I believe that the reasons lie in the major transformation that the Canadian economy has been going through since the beginning of this decade. This transformation has been in response both to the universal forces of globalization and technological change, and to the need to unwind the domestic excesses and imbalances that had built up in the 1970s and the 1980s. Let me remind you that, through that period, high actual and expected inflation had led to escalating production costs, speculative activity, and the accumulation of debt by households, by businesses, and by Canadian governments. Our foreign indebtedness was also rising rapidly, as were the risk premiums in our interest rates, leaving us in a very vulnerable position indeed. By the late 1980s, the situation had become untenable. Canada had to adjust.

Of course, the United States also had to cope with many of these changes. Why has the restructuring been more intense and disruptive in Canada? In my view, the most important reasons are that the distortions arising from high inflation were more severe in Canada and that the adjustments to globalization and technological change were slow in coming. As a result, Canada had to do more and do it faster.

The short-run disruptions associated with the economic restructuring have been significant. Plant closings, cutbacks in major government programs, and layoffs in both the private and public sectors caused a great deal of uncertainty among Canadian households. And it did not help that interest rates rose sharply in 1994 and early 1995 as investor nervousness about Canada’s fiscal and political situation increased in the wake of turbulence in global financial markets. All of this left Canadians anxious about the future and cautious about spending, which acted as a drag on output and employment.

But there have also been some particularly encouraging results from the restructuring. Canada has made rather dramatic economic adjustments in recent years, and as a result has emerged with a much sounder economic foundation. Inflation has averaged just under 2 per cent during the past five and a half years -- well below that in the United States. With the benefit of low inflation and low interest rates, Canadian businesses have been investing in new technology and streamlining their operations to become more efficient, productive, and internationally competitive. Canadian governments have taken steps to reduce their deficits and to move towards less vulnerable debt positions. And, with our success in exporting and these improved fiscal positions, the persistent large shortfall in the current account of our international balance of payments has narrowed markedly.

These improvements in Canada’s economic fundamentals have not been lost on financial markets. They are the reason why risk premiums demanded by investors on Canadian dollar assets have declined sharply over the past two years. They are also the reason why the markets today see a potential for upward movement in the Canadian dollar over time, thus allowing interest rates on maturities up to 30 years to remain below comparable U.S. rates. This is a view of the Canadian dollar that we at the Bank of Canada share.

These low Canadian interest rates represent a substantial stimulus to domestic spending. Because of the lags involved, it has taken households and businesses some time to respond. But now we have strong evidence, particularly from the interest-rate-sensitive sectors of the economy, that the consumer is back. And businesses continue to increase their capital spending. Moreover, the latest surveys of consumer and business confidence point to continued expansion in domestic spending in coming months. What is particularly heartening is that total employment growth has picked up recently, despite the cutbacks in the public sector, and that the number of full-time jobs has increased significantly.

Altogether, it seems to me that the Canadian economy has the potential for a long period of sustained growth in output and employment, with rising productivity and improving living standards.

<u>The challenge ahead</u>

What does monetary policy need to do to help realize this potential?

With the economy gathering momentum, the challenge for monetary policy in the period ahead will be to encourage monetary conditions that preserve Canada's good inflation performance, because low inflation is a prerequisite for a durable economic expansion.

Experience has taught us that monetary stimulus which pushes too hard on the economy's capacity limits for too long inevitably leads to rising inflation and painful boom and bust economic cycles of the kind we suffered in Canada from the 1970s to the early 1990s.

Concern about inflation risks at this stage may seem misplaced. But monetary policy actions have their full effects on the economy with relatively long lags. So what we must be concerned with is not the current rate of inflation but rather what may happen in 1998 and beyond.

To maintain a low and stable rate of inflation in the period ahead, we must conduct monetary policy in a forward-looking, pre-emptive manner. This means that we should be ready to take action early to ensure that, as slack is absorbed, the pace of economic activity converges smoothly with the path implied by potential output -- that is, the economy's capacity to produce on a sustained basis.

It is our view that the Canadian economy should indeed absorb the existing unused capacity over the course of the next couple of years. Thus, there will be a need to move to less-stimulative monetary conditions in the period ahead. Taking timely, measured steps in that direction is the recipe for avoiding the more substantial, and potentially more disruptive, tightening that would be required later if monetary policy actions were unduly delayed.

As the Canadian economy approaches full capacity, we will have to contend with the considerable uncertainty that surrounds the estimation of potential output. The recent experience in the United States, where despite a high level of resource utilization there has been no sign yet of generalized inflationary pressures, raises the possibility that past relationships have been altered by structural changes at both the national and international levels. It is possible that technological innovations have increased the flexibility and efficiency of production processes. Heightened global competition and low inflation worldwide may have led to a reduction of inflation expectations and to a change in price- and wage-setting behaviour.

Monetary policy must somehow find a way to take all of these factors into consideration in order to avoid systematic misjudgements on potential output and the risk of inflation. I believe that Canada's inflation-control target provides a useful framework within which to do that. Let me explain.

Our target, set jointly with the Government of Canada, calls for inflation to be held within a range of 1 to 3 per cent. One attraction of an explicit inflation-control target is that it allows a ready assessment of macroeconomic performance by looking at the trend of the inflation rate relative to the target range. If it looks as though the trend of inflation will push through the top of the target range, this implies that demand in the economy has been unsustainably strong. Conversely, if it appears that the trend of inflation is about to fall through the bottom of the range, this suggests weak demand and a persistent margin of unused capacity.

Moreover, if we somehow continually misjudge the economy's capacity to produce, we will in all likelihood witness an unexpected trend in the inflation rate. For example, if the rate is persistently lower than would have been expected in the past at the current levels of aggregate demand, and it is tending to press the bottom of the target range, chances are that the economy has more room to absorb higher levels of demand than previously thought. Thus, the targets provide a check on systematic errors in estimating potential output.

However, if monetary policy is going to take account of such signals, the central bank had better make sure that its inflation-control strategy is a credible one. Why? Because only if it is widely accepted that the central bank will keep inflation under control, will businesses and individuals not respond immediately to signs of strong demand pressures by seeking to raise prices and wages. The recent U.S. experience attests to this. Indeed, strong credibility has been a key factor that has enabled the Fed to take account of the possible changes in economic structure that I mentioned earlier and to steer the U.S. economy successfully towards levels of aggregate demand and employment that in the past would have been thought incompatible with maintaining low inflation.

It is by conducting monetary policy prudently during the economic upswing that we at the Bank of Canada will have the credibility needed when our economy begins to operate at levels that test its potential to produce.

The role of the exchange rate

I would now like to take a moment to underscore the important role that the exchange rate plays in the conduct of Canadian monetary policy and to explain what I meant earlier when I used the term “monetary conditions”.

In a medium-sized, open economy, like Canada’s, a good deal of the impact of monetary policy actions is channelled through the exchange rate. But because financial markets do not always respond to events in completely predictable ways, we do not know exactly how interest rates and the exchange rate will move and interact. That is why we at the Bank have found it useful to construct an index of monetary conditions to help us keep track of the combined effect of these two variables on aggregate demand in Canada.

To understand how we use monetary conditions in practice, let us look at the recent situation where cyclical differences have meant that the Canadian economy has been weaker than the U.S. economy. In these circumstances, the need for accommodative monetary conditions in Canada required the Bank of Canada to take action to lower interest rates. But the magnitude and timing of those interest rate reductions depended, to an important degree, on the exchange rate response. With the Canadian dollar roughly stable between late 1995 and late 1996, the easing in monetary conditions could take place through measured declines in interest rates. The strengthening Canadian dollar through the latter part of 1996 accelerated the decline in interest rates, as the Bank of Canada sought to maintain the degree of monetary ease achieved in the autumn of 1996. With the economy gathering momentum since then, persistent weakness in the Canadian dollar through June 1997 prompted a small increase in interest rates in order to offset an undesired further easing in monetary conditions.

I might add that, since cyclical differences have required interest rates in Canada to be below those in the United States, there has been -- rightly -- a strong market perception that the relative weakness of the Canadian dollar is temporary and that a future appreciation will compensate investors for the lower yields on Canadian dollar assets. But experience has taught us that this process of exchange rate/interest rate interaction works well only if there are no concerns in the markets about Canadian economic policies. As we found out in 1994-95, when there were concerns about fiscal policy, a decline in the value of the Canadian dollar can generate a loss of confidence and expectations of further depreciation of the currency, not of subsequent appreciation.

The upshot of all this is that, with a floating currency, market participants need a consistent and credible policy framework to help anchor their expectations about future movements in the exchange rate. Such a framework rests, above all, on a firm undertaking by the authorities to preserve the domestic purchasing value of the currency. I believe that our inflation-control targets, by giving a clear, precise view of this commitment, provide a strong underpinning for the external value of the Canadian dollar.

What is my main message to you today?

Canada is in better shape now than it has been for many years to face the economic challenges of the future and to reap the benefits of changing technology and an increasingly integrated world economy. But, for this scenario to unfold, there will have to be continued commitment by the authorities to prudent, credible economic policies. As far as monetary policy goes, this means a pledge to maintain Canada’s good inflation performance. That is a pledge I can give without reservation.