Mr. Thiessen's remarks to the Canadian Club of Toronto Notes for remarks by the Governor of the Bank of Canada, Mr. Gordon Thiessen, to the Canadian Club of Toronto in Toronto, on 1/12/97.

What can monetary policy do to help the economy reach its full potential?

Today, we meet against a backdrop of some uncertainty in the international economy. I would like to begin my remarks with an assessment of what the recent financial and economic events in Asia could mean for Canada.

The nervousness and uncertainty that spread around the world in the wake of the problems in Southeast Asia highlight the growing interactions among national economies and financial markets. The events in Asia also underscore how crucial prudent macroeconomic policies and sound financial sector management are to good economic performance.

The measures that have been taken, mainly through the International Monetary Fund, are important first steps for the affected Asian economies in dealing with their problems. I believe that these measures have helped to contain at least some of the potential spillover effects to other countries and, thus, they are helping to settle global financial markets.

Canada's direct trade links with Southeast Asia are not large. However, those with Japan and Korea are more important to us, and there are also potential effects on our other trading partners that need to be taken into account. The problems in Asia and their possible implications for the world economy are probably the source of some of the recent softening in world commodity prices. Because of the importance of commodities to Canada, this softening has been a factor behind the recent weakness in our currency.

Our judgment at this stage is that the overall impact of these recent developments on Canada does not look likely to be large. However, we are sensitive to the fact that some industries and regions will be affected more than others. I can assure you that we will continue to monitor the situation very closely, in view of the uncertainty that remains about the likely outcome of events in Asia.

Even with this uncertainty, however, recent suggestions that there is a risk of worldwide deflation strike me as being very pessimistic. Developments in Asia will slow somewhat the pace of global economic expansion. But as long as the world's largest economy, the United States, is pressing against its capacity limits, with the possibility of upward pressure on its inflation rate, the risk of worldwide deflation looks rather remote. Certainly, from Canada's perspective, the U.S. economy is by far the most important influence.

I would now like to turn from these recent events and talk about the Bank of Canada's longer-term strategy for monetary policy.

In any discussion of strategy, the place to start is with the objective. In conducting monetary policy, the Bank of Canada's ultimate objective is to help the Canadian economy achieve its full potential. And that means more jobs and rising standards of living. I am sure that all Canadians would agree that this is an appropriate objective.

The Bank pursues this objective through a policy aimed at keeping inflation low and stable. Today, I would like to explain why such a policy is the best way to achieve Canada's full economic potential and to extend the current expansion. In this connection, I will review the recent U.S. experience in this area -- an experience that I find both relevant and instructive.

On the road to full economic potential

The performance of the Canadian economy over the past 25 years has been rather disappointing. The economy has suffered from recurring bouts of boom and bust, and unemployment has been very high. The growth of productivity and, thus, the improvement in our standard of living have been very gradual.

Canada is not unique in this respect. Most industrial countries have shared this experience to varying degrees. And that includes the United States. Since the early 1990s, however, the U.S. economy has performed remarkably well and substantially better than other industrial economies. That country has enjoyed a solid, six-and-a-half-year-long economic expansion. Over that period, employment growth has averaged 2 per cent per year. The unemployment rate has declined from a peak of 8 per cent to under 5 per cent. Household incomes have risen by 2½ per cent a year (after correction for inflation). U.S. businesses have become highly competitive, even in areas where prospects did not look all that good at the end of the 1980s. What's more, inflation has been on a declining path, albeit with some help from temporary factors (such as an appreciating U.S. dollar, declines in energy prices, and the slack in overseas economies).

Why has the U.S. economy done so well? Are there any lessons here for Canada?

Lessons from the U.S. experience

There are, undoubtedly, a number of factors behind this striking U.S. performance. But, to me, there are at least two that seem to have been particularly important: the early adjustment of that economy to changing technology and globalization; and the credible, low-inflation policy pursued by the U.S. central bank.

The Americans started adjusting in earnest in the 1980s to the new realities of heightened global competition and rapidly changing technology. As a result, they are ahead of most other industrial countries on that score. And, with improving productivity and highly competitive enterprises in a wide range of sectors, the U.S. economy has been able to expand rapidly and to support rising employment on a sustained basis.

But taking full advantage of that improved potential for economic growth has required a climate of confidence in monetary policy. Bringing inflation down in a credible manner has helped to create that climate. And because of this, the U.S. monetary authorities have been in a position to encourage the economy to test its full capacity to produce, to create jobs, and to support rising incomes. This would not have been possible in an environment of high inflation and high inflation expectations. In such an environment, businesses, workers, and investors respond swiftly to any signs of demand pressures by pushing up prices, wages, and interest rates. And this has the effect of undermining the sustainability of the economic expansion.

What precisely did the U.S. Federal Reserve do? In the early 1990s, problems in the banking sector were restraining the economic recovery in that country by limiting access to financing and undermining confidence. To counter these “headwinds”, as Alan Greenspan called them, the Fed responded by providing a high degree of monetary stimulus. Then, in early 1994, when it became evident that the economy had started to pick up steam and move ahead on its own, the Fed began withdrawing the excess monetary stimulus.

This timely, pre-emptive action to moderate monetary stimulus accomplished two things. First, it sent a strong reassuring signal to investors, businesses, and consumers that the Fed would not let inflation break out as the economy surged ahead. Indeed, after short-term rates went up in 1994-95, long-term rates declined, as investors became more confident that the economic expansion would remain non-inflationary and, thus, sustainable. Second, the pre-emptive action helped avoid the need for stronger, more disruptive, tightening later on.

The less-accommodative monetary conditions that have prevailed since then certainly have not stopped the U.S. economic expansion dead in its tracks, as some had feared at the time. On the contrary, the expansion has continued at a healthy pace. And with widespread belief in the Fed’s commitment to low inflation, there has been some room to explore the possibility that capacity has improved. As a result, the Fed has been able to set monetary conditions that have encouraged output and employment to expand at rates that in the past could not have been sustained. And both unemployment and inflation have come down at the same time.

To be sure, with tightening labour markets, there is some risk of an increase in inflation pressures in the United States. Thus, one cannot rule out the possibility that the Fed may have to raise interest rates somewhat further at some point. But any future increases in interest rates should not have to be large and may be conditioned by the implications of the recent international developments I mentioned earlier.

What parallels can we find in all this for Canada?

The recent Canadian experience

The adjustment in Canada to the forces of technological change and globalization has run behind that in the United States. Because the restructuring was delayed, Canada had to respond in a more dramatic fashion. We had to do more and do it faster. More importantly, our fiscal situation was more precarious and required stronger medicine. As a result, we ended up with more pronounced short-run disruptions and more catching up to do in terms of output and employment.

These difficult but necessary adjustments in the private and public sectors of our economy were Canada’s parallel to the U.S. headwinds.

To compensate for the direct impact of these adjustments, as well as for their indirect effects on consumer confidence, the economy needed a substantial amount of monetary support. The Bank of Canada was able to provide such support once investor concerns about Canada’s fiscal and political problems began to subside in late 1995. We did that by systematically reducing interest rates over the next year or so. As in the United States in 1991-92, short-term rates in Canada were brought down during 1995-96 from over 6 per cent to about 3 per cent -- their lowest level in over 30 years. At the same time, the Canadian dollar has

been relatively low, providing support to the export sector. When we put interest rates and the exchange rate together -- as we must in order to correctly gauge the amount of monetary stimulus -- it is clear that monetary conditions in Canada have been exceptionally stimulative for well over a year.

This was entirely appropriate while our economy was still struggling against the headwinds of private and public sector restructuring. To return to my automobile analogy of recent speeches, we needed to put the “pedal to the metal” to buck those headwinds and get the economy going.

The monetary stimulus has done its job. The economy has been gathering speed and absorbing unused capacity. We now expect it to have expanded by about 4 per cent from the end of 1996 to the end of 1997. The diminishing effects of fiscal restraint, along with evidence of continued strong demand, output, and money growth, suggest another year of healthy expansion in 1998.

Thus, in terms of the economic cycle, we are about where the Americans were in 1994.

What should the role of monetary policy be in the period ahead?

As we move towards full capacity over the next year or so, the task for monetary policy will be to try to ensure that this process goes smoothly and that inflationary pressures do not re-emerge.

I want to make it clear that the Bank does not see an overheated economy at this point, nor a threat of inflation lurking around the corner. There is still unused capacity and, thus, room for strong expansion for some time yet. But, with monetary policy actions taking between one to two years to have their full effects on the economy, we always have to look ahead. And we have to ask, What sort of monetary support will the economy need at that point? The measures -- especially the fiscal measures -- needed to restructure our economy will be largely in place by then. Thus, monetary policy will no longer need to compensate for these sources of restraint on demand. By gradually easing off on the monetary gas pedal, we can steady our economy at a safe cruising speed down the road.

As we look still further down the road, we will face other important issues. How well will our economy perform once it reaches full capacity? How rapid can growth be and still be sustainable? And how far can we reduce our unemployment rate?

Given the complexity of the factors affecting economic performance, it is not possible to make precise predictions on these matters. Much will depend on the flexibility, efficiency, and productivity of Canadian enterprises; on how effectively new technology is used; on the skills, training, and adaptability of our labour force; on our ability to control costs; and on the initiative and ability of Canadian businesses to develop new products and new and expanded foreign markets for those products.

Still, I believe that the restructuring that has taken place in the Canadian economy provides good reason to think that our potential to grow and create jobs is the best we have had in years. I also believe that continued credible fiscal and monetary policies have an important role to play.

The best contribution monetary policy can make towards achieving that potential is to ensure that the economic expansion remains sustainable over the medium term.

As we have learned over the past 25 years, a sustained expansion is not possible unless we can avoid a resurgence of inflation and the painful cycles of boom and bust that go with it. Thus, the challenge for monetary policy will be to set monetary conditions at levels that allow the economy to expand at a pace that makes full use of its production capacity and at the same time preserves low inflation.

It is by conducting monetary policy prudently during the upswing that the Bank can assure Canadians that inflation will not break out when the economy begins to operate at levels that push against capacity limits. If we succeed in providing that confidence, we will then have the flexibility that will allow us to carefully explore the limits of growth and employment without immediately putting the economic expansion at risk.

Concluding remarks

Let me summarize my main messages to you today.

The extraordinary monetary stimulus of the recent past has accomplished its task. It has supported the economy through a period of difficult but necessary restructuring. As the impact of this restructuring subsides and our economy enters a phase of self-sustaining expansion, we will no longer need the same amount of monetary stimulus.

Because the economy takes time to respond to monetary policy actions, the Bank has to focus on the future. This means taking steps early to ensure that we will reach full capacity at a sustainable cruising speed.

Of course, projections of future economic trends need constant reassessment. And that is particularly true at a time of nervous financial markets and uncertainty about the implications that events in Asia may have for the world economy. As I said earlier, the Bank continues to monitor the current global situation carefully.

Aside from any complications that could arise from a prolonged period of international instability, the Canadian economy in the next year or so should absorb the unused capacity that we now see. At that point, we will begin to see concrete evidence of the kind of payoffs we are going to get from the economic restructuring process we have been through.

With low inflation and a sound fiscal position, the Canadian economy is now in a better position than it has been for years to weather the impact of unexpected international developments and to make progress in generating higher incomes and employment.