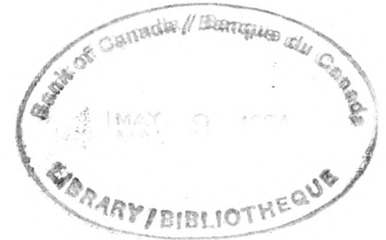

Monetary policy and the current economic situation

Notes for remarks by
Gordon G. Thiessen
Governor of the Bank of Canada

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Monetary Policy and the Current Economic Situation

I am pleased to have been invited to Winnipeg today to deliver one of my first speeches as Governor. I thought this would be a good occasion to talk about the goals that have been set for Canadian monetary policy. I would also like to comment on the Bank of Canada's view of the current economic situation, including recent developments in financial markets.

The objective and targets of monetary policy

Let me begin with the objective of policy. The objective continues to be price stability, that is, to protect the value of the currency we use in Canada from being eroded by inflation. However, I would like to stress that this objective is not an end in itself, but rather a means of contributing to good economic performance, in other words, to rising living standards for Canadians.

Why is price stability important for good economic performance? As we have seen over the last twenty years, persistent inflation has increasingly detrimental effects on the functioning of the economy. Inflation creates increased uncertainty about the future, making it more difficult for households and businesses to make sound long-run savings and investment decisions. Price stability removes this major source of uncertainty about the future. Price stability also means that no one has to spend time and money protecting himself or herself against the effects of inflation. For these reasons, price stability contributes to a more efficient economy. Moreover, a policy of consistently pursuing price stability is likely to reduce the size and extent of cyclical fluctuations in the economy, and make possible sustained economic growth over extended periods of time. Finally, price stability eliminates the inequitable effects of inflation that arise because some groups in society are not able to protect themselves against general and continued price increases.

These then are the reasons why price stability is the objective of monetary policy -- an objective that was reaffirmed in the joint statement issued by the government and the Bank of Canada when I was appointed in December. The Bank attaches great importance to this joint statement as it not only sets out price stability as the agreed objective of policy, but also specifies the target ranges for controlling inflation in the period to 1998. We are currently aiming to hold inflation inside a range of 1 1/2 to 3 1/2 per cent. The target range will decline to 1 to 3 per cent by 1995 and remain there to 1998.

Let me say a word about what we mean when we talk about controlling inflation. What the Bank is concerned with is to ensure that the <u>trend</u> of inflation remains within the target bands. By the trend rate of inflation we mean the ongoing momentum in the process of cost and price increases.

However, there can also be movements in the Consumer Price Index, the index we use to measure inflation, that are the result of developments that have only transitory or one-time effects on the level of consumer prices without affecting the momentum of inflation. A recent example of this is the reduction in tobacco tax rates, which resulted in a drop in the CPI inflation rate to 0.2 per cent. The underlying trend of inflation is not that low. And as long as developments like this tax cut do not trigger a shift in the momentum of inflation, the Bank does not need to respond to them. What matters is that we keep our eye on the trend of inflation, and for that purpose these days, we are monitoring the CPI excluding the effects of indirect taxes. And should there be a shift in that trend, it would be important for the Bank to react in a timely and forceful way since it takes time to turn inflation around once its momentum begins to build.

The Canadian economy

To this point, I have been talking about the goals of monetary policy. I would now like to review our economic situation and, in particular, how it has been influenced by monetary policy.

We are already seeing the benefits for the Canadian economy of our commitment to price stability. Inflation has come down a long way in the last few years. At the moment, the underlying rate of inflation (i.e., excluding the effects of indirect tax changes) is about 1 1/2 - 2 per cent, compared to an annual rate of close to 7 per cent over the 1970s and 1980s. And the prospects are excellent that inflation will stay in the lower part of our target band.

I know some people are concerned that as the economy picks up steam, inflation will accelerate. However, let me reassure you that the economy can expand for some time before it reaches capacity constraints. Pressing on those constraints is what leads to inflation pressure. Since we are a long way from that point, there is no immediate risk of pushing up inflation because of continued economic recovery.

And even over much longer periods of time, we can have good, solid, sustained growth without inflation breaking out. Indeed, there is no such thing as growth sustained over extended periods without inflation being under control. And I would note that the experience of the 1970s and 1980s threw cold water on the view that over time inflation helps the economy by bringing about higher employment.

The reason why I believe that inflation will remain low is that we have been seeing a change in people's behaviour. There is increasing confidence in a non-inflationary future, and more and more savers, investors, businesses and households are acting on this basis. Moreover, such a change in attitudes and behaviour -- with Canadians seeing less need to protect themselves against future inflation -- will help monetary policy keep actual inflation under control. The task for the Bank of Canada in the period ahead is to encourage and sustain these expectations of low inflation.

Let me be more concrete about how our current low inflation and these better expectations concerning inflation are helping to improve the prospects for the Canadian economy. The shift in inflation and inflation expectations has been behind the major downtrend in Canadian interest rates that has taken place over the last few years. And despite the recent backup, current short-term and long-term interest rates are still well below those that have been experienced until recently.

These lower interest rates have alleviated considerably the burden of servicing debts for households. They also have meant that housing is more affordable than it has been for years.

Lower interest rates and associated higher equity prices have permitted businesses to improve their balance sheets, and facilitated an increase in spending on machinery and equipment as part of the process of industry restructuring. This restructuring should improve productivity and efficiency in the years to come. With the better cost control that has also come with lower inflation, businesses have been able to take full advantage of the depreciation of the Canadian dollar to improve their competitiveness. Let me hasten to add that a low dollar is not a miracle cure. Nevertheless, Canadian businesses, all in

all, are now in a much better position to compete in world markets.

Thus monetary policy has helped to provide a considerable strengthening of some underlying factors that are important for sustained economic growth. As a result, the Canadian economy is now well-positioned to improve its performance over the next few years. Indeed, we have already seen an acceleration of growth in output in 1993, and indications are that this recovery is now becoming more broadly based. I am also pleased to see that employment has increased over the last few months.

How well the economy functions over longer periods is also affected by the debts and deficits of governments. On this point, let me reiterate what the Bank has said before. Fiscal positions need to be on a sustainable track. And a rising ratio of government debt to the size of the economy is not sustainable over time. Moreover, government efforts to contain and reduce deficits will help to maintain a low interest rate environment and to free up savings for investment.

I have heard the criticism that with fiscal policy constrained by debts and deficits and with the battle against inflation won, the Bank should now turn its attention to other aspects of the economy where the battles are not going so well. I find this military analogy misleading. I prefer the motoring analogy that I made use of recently. A monetary policy directed to inflation control is like driving a car down the highway. Even though you are in your lane and heading in the right direction, you cannot stop steering the car and divert your attention to other things.

Therefore, I would like to reiterate that we have to continue to steer monetary policy towards low inflation, and eventually price stability, if we are to reap the benefits that this direction can bring over time. This means that we must continue to build confidence through keeping inflation within our target bands and by acting in ways that are consistent with our commitment to price stability. For this is the best way that we can support sustained growth in employment and in output.

It is also true that the road is not always smooth and driving hazards arise from time to time. While I talked earlier about the fact that interest rates have come down considerably over the last few years, rates do not always move in a smooth fashion. At times, there can be turbulence in financial markets resulting in some backup in interest rates. We have seen a number of such episodes over the last few years; the most recent

episode began a few weeks ago and since then, interest rates have risen sharply and the dollar has fallen.

What gave rise to this recent episode of turbulence? One important factor was the tightening of monetary policy in the United States and the rise in short-term interest rates there. This triggered a rise in bond rates, not only here in Canada but in a number of other countries. However, the rise in bond rates here was larger than in many other countries, as were the pressures on short-term interest rates and the exchange rate.

These developments suggest that domestic factors also played a part in this latest episode of turbulence. These factors seem to have included market concerns about the debts and deficits of governments in Canada and the forthcoming Quebec election. And, as frequently happens in such episodes, there was an interaction between developments in the various financial markets -- the decline in the exchange rate contributed to the upward pressure on domestic interest rates as investors sought compensation for increased uncertainty about the value of the Canadian dollar.

In these circumstances, the Bank seeks to offer a steadying hand to the market. This does not mean that interest rates will not move. Actions to prevent any movement would be unsuccessful and even counterproductive. Rather, the Bank seeks to help the markets find viable trading ranges for money market rates and for the dollar -- ranges where savers and investors are comfortable holding their investments. The Bank also, by its actions and its public statements, tries to draw attention to the basic factors that underpin the value of investments in Canadian dollar assets. The monetary foundations that underlie our financial markets are good -- low inflation and the Bank's commitment to price stability -- and these should provide a bedrock of support for investor confidence.

I understand why there may be concerns that the recent increase in interest rates could undermine a fragile economic recovery. But in fact the recovery is more robust than many people realize. As I said earlier, the underlying fundamentals of our economy are good, and the economic expansion in the United States is strong. And while interest rates in Canada have risen in response to the weakness of the Canadian dollar, overall monetary conditions -- which include the effects of both interest rates and the exchange rate -- continue to provide substantial support for the economic recovery.

* * *

I would like to end this speech by summarizing very quickly some of the main points I have tried to make. First, I would like to emphasize the continuity of monetary policy: policy has not changed with a new Governor. Secondly, we are on track to meeting our inflation control targets. Thus I hope you will start planning on very low inflation, if you are not already doing so. Finally, although we still have some distance to go, the economy is looking better, and the monetary foundations for more stable financial markets and a sound recovery have been laid.