BANK OF CANADA

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

to the
Canadian Club of Vancouver
and the Kiwanis Club of Vancouver
Vancouver, British Columbia
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I am pleased to be in Vancouver and to have the opportunity to speak to you today. The members of the Board of Directors of the Bank of Canada have come to Vancouver for one of the Board's regular meetings. It is our practice to meet in a different part of the country at least once every year. I strongly believe that it is important for the Bank to be well informed about the economic situation in all regions of Canada and to explain and discuss monetary policy with interested Canadians everywhere.

I would like to start by talking briefly about the objectives of monetary policy and what we hope to accomplish. The objective of monetary policy in Canada has been and continues to be to protect the value of money so that Canadians will have confidence that the money they hold will retain its value in terms of what it can buy. In other words, our objective is price stability so that inflation does not erode the value of our money.

Why has price stability been chosen as the objective of monetary policy? Not as an end in itself but because our economy simply works better when the price level on average does not change over time. The economy is more efficient, and this helps to support growth in output, high employment and rising living standards. This policy of reducing inflation and creating price stability is not just a Canadian idea -- all other major countries are also pursuing this objective.

So how are we doing in achieving this goal in Canada? The government and the Bank of Canada have set an inflation-control target band for mid-1994 of 1 1/2 to 3 1/2 per cent. Thereafter, our inflation-control target declines to 1 to 3 per cent by end-1995 and remains there until 1998. And we are on track to meeting those targets. In fact, the underlying rate of inflation is currently at the bottom of the band. And the prospects for inflation remaining in the bottom part of the band are very good as people increasingly seem to be accepting the idea that inflation will remain low.

It is almost impossible to overstate how important it is to encourage and justify this belief that inflation will stay low. It is only if people believe that inflation will remain low that we will see the full benefits of a non-inflationary economy. Let me explain. If we all feel able to plan for the future with more confidence -- without the uncertainties that come with inflation -- we will make better decisions about saving, investing, and producing. Moreover, the progress that we have made in persuading people that low inflation will persist has been the main reason for the significant reduction in interest rates in Canada over the last few years. Despite the recent backup in interest rates, current short and long-term rates are below those experienced for most of the period from the late 1970s to the early 1990s.

The declines in interest rates benefitted both households and business. They have meant that the cost of servicing debt has been reduced. Thus, housing has been more affordable. And lower interest rates, together with the stronger stock market, have helped to encourage the high level of business investment we have had in new machinery and equipment. I will return later in these remarks to the issues raised by recent increases in interest rates.

Another effect of expectations of low inflation has been that firms have been much more careful about keeping their costs under control. This has meant that Canadian producers have been able to take advantage of the decline in the exchange rate to improve their ability to compete both in Canada and abroad.

I must stress this improvement in containing costs because it is all too easy to conclude that exchange rate depreciation is a simple solution to the problems of inadequate competitiveness and slow economic growth. The depreciation of the last two years has contributed to an improvement in competitiveness because, with low inflation and expectations of continued low inflation, we have been able to avoid the cost-price spiral that accompanied depreciation all too often in the past. However, depreciation will not improve competitiveness if costs do not remain under control.

These good things that I have been talking about -- the better competitiveness, the reduction in cost pressures, the more affordable housing and the better financial condition of businesses -- are underlying factors that will determine how the Canadian economy does over time. These factors have been moving us in the right direction, even if they have not yet taken our economy as far as we would have liked.

Looking outside our borders, there are also reasons to be optimistic about Canada's future economic prospects.

With the continued improvement in economic activity in the United States and with other industrial countries beginning to expand, we have started to see some revival in international prices for primary commodities that are still very important to Canada. This bodes well for primary products industries, not only here in British Columbia but in the rest of the country as well.

Another reason for optimism is that Canadian producers have reacted in a timely and positive way to the revolution which is taking place in global trade and production. This revolution has made the international environment much more competitive and, in my view, we are now very well placed to take advantage of expanding global markets.

This revolution has come about for a number of reasons. Technological progress has made possible changes in the way we do business and has reduced costs. The most important example of this is the rapid advance in the use of computers and the big drop in computer prices over the last several years. This has led to rapid progress in the application of computer-assisted production methods. Another example is improved communications. In addition, many countries in Southeast Asia and Latin America have been developing very quickly and opening up their economies to international trade. This has created opportunities for us. However, the development of these countries has also meant that they have become a competitive force to be reckoned with.

So businesses in Canada have had to become more cost-efficient in their production in order to compete here and abroad, especially since our costs, particularly in manufacturing, had got out of line in the late 1980s. Some of the changes required by this restructuring effort have been painful. There have been permanent job losses, and the jobs being created are different jobs, requiring different types of education and training. Many established companies have had to change significantly -- making much greater use of new automated equipment and of more effective ways to manage inventories.

We are starting to see the benefits of this restructuring. Productivity is improving. And over time, it is growth in productivity that will raise our standard of living. Already, better productivity has contributed to the improvement in the international competitiveness of Canadian businesses.

With this improvement in competitiveness, our exports have been growing substantially over the last two or three years and have been an important element in the economic recovery. This together with the expansion in investment in machinery and equipment and most recently in consumption led to growth in the economy of close to 3 1/2 per cent over the last year. And employment has been increasing.

As the momentum of the Canadian economy has accelerated, a good deal of the strength has tended to reflect buoyant conditions in British Columbia. And employment has also been much stronger in B.C. than in other regions.

In part the stronger growth you have been experiencing in British Columbia reflects very strong in-migration, which has provided considerable support for industries geared to providing households with housing and other goods and services. In addition, the strengthening trend of commodity prices was led by the sharp rise in lumber prices. Also the restructuring efforts appear to have started earlier in a number of sectors here in British Columbia.

Because of regional differences in economic activity, there are frequently concerns that monetary policy does not reflect adequately the problems of a particular region. But monetary policy is a national policy. And while the Bank looks carefully at economic developments in each individual region, our main concern must be to assess the aggregate situation for the country as a whole. There will be times when monetary conditions do not seem to suit any one part of the country, but if national monetary policy is correct, and we achieve our goal of sustained price stability, this has to be good for all regions.

I would like to finish by talking about the uncertainty and volatility which have plagued financial markets this year, and which have led to increases in interest rates in Canada. This episode began because of international developments, but domestic factors, both economic and political, have played a major role. The U.S. monetary authorities have been tightening their policy stance, which has led to an increase in interest rates in the United States. That in turn has caused increases in interest rates in a number of countries, not just in Canada. But the increases have been larger here than in most countries. Why is that?

As frequently happens in such episodes, when international markets take on a negative tone, there is a much more critical assessment of Canadian events. In the current circumstances, this assessment has been rather negative. In recent months, the focus has been on debts and deficits of Canadian governments and the upcoming election in Quebec. Not only did interest rates at all maturities in Canada rise as a result, but the Canadian dollar also fell. And as the dollar fell, there was still further upward pressure on Canadian interest rates as investors sought compensation for what they perceived to be increased risks that the value of the Canadian dollar might continue to fall.

What can and should the Bank of Canada be doing about this? Why don't we do something to hold all the interest rates down? The answer is that we cannot do so. While the Bank has a good deal of influence over very short-term rates in the money market, our effect on other interest rates stems mainly from the confidence we generate that we will keep inflation low into the future. We cannot offset the risk premiums demanded by savers and investors because of their concerns about future fiscal and political developments. What the Bank can do in the first instance is to help steady the market at trading ranges where savers and investors, both Canadians and foreigners, feel comfortable with their investments in Canada. And over time, by maintaining confidence in monetary policy, we seek to provide a stable environment in which financial markets can operate. Indeed, the fundamental factors that underpin the value of Canadian dollar investments are good: low inflation and the commitment of monetary policy to price stability.

Where does this leave the Canadian economy? There is no doubt that the higher interest rates are costly, but the effects of financial developments on the economy should be judged by looking at the movements in both the exchange rate and interest rates, something we at the Bank call monetary conditions. Provided domestic costs remain under control, the decline in the exchange rate which has taken place helps to offset the recent increase in interest rates. In other words, present monetary conditions are less restrictive than one might think from looking at the recent increases in interest rates alone.

In fact, our economic recovery is more robust than many people realize, and overall prospects for continued growth are favourable. Our largest trading partner, the United States, is expanding strongly, and there are signs of some improvement in the economies of the overseas industrial countries. Commodity prices are improving, and we are already seeing the beneficial effects of our move to low inflation and of business initiatives to restructure industry -- prices and costs are under control, productivity is rising and business has become much more competitive. In short, the basic monetary and economic foundations for solid and sustained growth in the economy are in place. I recognize that there are still serious challenges before us. But I believe that our capacity to deal with them is much better because of these good foundations.