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

to

the Rotary Clubs of Kitchener and Waterloo
and the Kitchener-Waterloo Chamber of Commerce
Kitchener, Ontario
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I am pleased to be here in Kitchener today and to have the opportunity to speak to you. Kitchener-Waterloo is an important manufacturing and high-technology area that not only caters to the Canadian market but also exports a good part of its products and services. I thought that this would be a good occasion to address some of the issues and concerns that I have heard expressed about recent financial market developments and about the volatility of the Canadian dollar -- issues that are no doubt on the minds of many business people in this area and across Canada.

But first I would like to summarize the Bank's view of the state of the economy and review the role of monetary policy in promoting Canada's economic and financial welfare.

The Economy

The Canadian economy has been expanding strongly over the past year. Output rose by more than 5 1/2 per cent between the last quarter of 1993 and the last quarter of 1994. Employment has also shown good growth over the past year or so, reducing our high unemployment rate and boosting consumer confidence. The Kitchener-Waterloo area has contributed importantly to this improved economic performance and shared in its benefits. Indeed, employment growth in this region has been about double the Canadian average over the past year. And at 6 1/2 per cent, the unemployment rate for Kitchener-Waterloo is the lowest among all Canadian metropolitan areas.

What are the sources of strength behind this recent favourable economic performance in Canada? Will the Canadian economy continue to expand at a solid pace?

The export sector led the recovery and continues to remain a significant source of buoyancy in the Canadian economy. The strength in exports has also encouraged increased activity in other areas of the economy, in particular business investment. And with a growing economy generating increased incomes and employment, consumer spending has also strengthened. However, spending on big-ticket items, such as housing and motor vehicles, has been weak recently as a result of the back up in interest rates.

The record levels of Canadian exports that we have seen in the last year no doubt reflect in part the strength of world economic activity, particularly in the United States -- our major trading partner. The marked increases in the world prices of the primary commodities that Canada produces have also helped. But I believe that Canada's improved competitive position has also been an important factor behind this recent remarkable export performance.

This is a most significant achievement, especially if you recall the concerns not too long ago -- as recently as 1992 -- about the deterioration of Canadian competitiveness and the gloomy predictions at the time that this would inevitably lead to the "hollowing out" of Canadian manufacturing. How is it that these concerns about Canada's ability to compete in international markets have proven to be unfounded? I would say that the explanation lies in the impressive willingness of Canadian businesses to invest in modern machinery and equipment and to restructure their operations to make them more productive and competitive, both at home and abroad.

I believe that the Bank of Canada's commitment to low inflation has helped to encourage this response among businesses. A more stable monetary environment has allowed them to plan and to take difficult investment decisions with greater confidence than in the past. Low inflation has also encouraged them to pay more attention to controlling production costs. By focusing more on the fundamentals of improving productivity and cost control, Canadian businesses have been able to benefit from a lower dollar and become more competitive internationally than they have been in many years. And by laying down sound foundations in this way, and constantly looking for better ways to produce and market their products, businesses can expect to remain competitive in the future without having to rely on a low dollar.

Canadian economic policy

It is because of such benefits that we at the Bank continually talk about the contribution that a monetary policy geared to price stability can make to the efficient operation of the economy. We believe that in helping businesses to undertake improvements in cost control and productivity, price stability contributes to sustained gains in real incomes, employment and the long-run prosperity of Canada. We are not alone in thinking this way. Central banks in all the major industrial countries share this view. But what is more important is that there seems to me to be a broader understanding and acceptance among Canadians of the importance of price stability for steady and sustainable economic growth. It may be that those who were uncertain about low inflation and its benefits can now see that it works, that it delivers the goods.

Price stability as the objective for monetary policy was formally acknowledged in a joint declaration by the Bank of Canada and the federal government in February 1991. At that time, a set of explicit targets was established to define the path to price stability -- a set of guideposts, as it were, along the way to our final destination. The targets aimed at bringing the rate of inflation down to 2 per cent (the mid-point of a band of 1 to 3 per cent) by the end of 1995. This band has since been extended to the end of 1998, by which time the Bank of Canada and the federal government are committed to having an operational definition of price stability.

How are we doing in meeting these targets and how does the Bank see inflation evolving in the future? The trend of inflation has declined significantly since the targets have been in place and has essentially stayed within a range of 1 1/2 to 2 per cent over the last three years. In assessing inflation, we use the annual increase in the Consumer Price Index but look through short-run fluctuations such as those arising from changes in indirect taxes and the volatile food and energy components.

More recently, inflation has moved closer to 2 per cent -- that is, closer to the middle of our 1 to 3 per cent inflation-control band. There are some special factors currently at work that are pushing prices up and that could temporarily move measured inflation above the centre of the band. The increased prices in world markets for primary commodities in the past year are one factor. The lingering effect on import prices of the past depreciation of the Canadian dollar is another. However, we do not expect these factors to have a significant persistent upward effect on the trend rate of inflation, which should settle back down to around the middle of the target range. Why? Because even though our economy has recently been growing more rapidly than generally expected, there is still a margin of unused capacity. And firms are keeping good control over their costs. I also think that businesses and individuals have adjusted downward their inflation expectations because of the inflation-control targets and our commitment to them. So, the bottom line is that the inflation outlook remains favourable and consistent with our targets.

Does this mean that Canada has won the battle against inflation and that the Bank can relax? No. In fact, I would say that it is precisely at this stage of the economic cycle that we need to be especially vigilant. Past experience has taught us that this is the point when the strength of the economic momentum and the consequent inflation risks have often been misjudged. Put this together with the fact that monetary policy actions have their effects on inflation with a long lag and you can understand why it is important that we at the Bank stay alert and ready to take action as soon as we see signs that there could be generalized upward pressures on prices several quarters down the road.

From this perspective, the recent restraint measures announced in the federal budget, and in the provincial budgets that have been brought down so far, are helpful. With governments easing their demands on the economy, there will be more room for the private sector to expand and less need for monetary conditions to tighten as we approach the capacity ceiling of the economy.

When central bankers talk like this, often people react by saying: surely economic expansion is good, why do you want to restrain it? But all economies have limits to their capacity to expand in the short run. What the Bank of Canada is seeking to do is to ensure that the economic expansion in Canada remains sustainable. We do not want a boom that leads to inflation, misguided investments, and an inevitable recession after that.

Financial markets and the Canadian dollar

Let me now turn to another issue related to monetary policy which may well be on your minds. That is the value of the Canadian dollar. The exchange rate matters -- and not just to policy makers. It matters to you and to me, as consumers, tourists, investors. And it very much matters to business people who are contemplating investing in export and import-competing industries. There are times when all of us, but perhaps especially exporters, facing important economic decisions about the future have wished that somehow the uncertainty about possible exchange rate movements could be eliminated. I am well aware of the concerns caused by swings in the value of the Canadian dollar in recent years and by talk about the dollar being increasingly pushed around by speculators. Let me try to address some of these issues now.

In Canada, we have a floating exchange rate system, which I believe has served us well. A floating exchange rate allows us to pursue an independent monetary policy that is in tune with Canadian economic conditions. This means that, in general, the dollar will move over the economic cycles, rising at times of strong demand pressures and falling at times of economic slowdown. Moreover, in an open economy like Canada's, movements in the exchange rate can facilitate the adjustment required as a result of pressures that originate abroad. For example, movements in the dollar have helped the Canadian economy through the post-war period to cope with swings in the international prices of primary commodities, which are still an important component of our exports (despite the success of many of you in diversifying our industrial and export base).

So, while exchange rate fluctuations may be a source of uncertainty for producers and consumers, any move to restrict the ability of the dollar to act as a "shock-absorber" would almost certainly come at a cost of more pronounced swings in our economy -- that is, more uncertainty about output and employment. Furthermore, the recent experience of other countries around the world indicates that even when exchange rates are fixed, the existence of economic imbalances (such as large public debts and deficits and external payments deficits) can lead to exchange rate crises which often culminate in large adjustments in currency values. These sharp adjustments are much more costly for the economy than the frequent and more orderly adjustments we have typically experienced under floating exchange rates.

But does the dollar move too much? And is that because it is increasingly being pushed around by speculators?

Despite the positive fundamentals of the Canadian economy, financial markets for the Canadian dollar and Canadian dollar-denominated assets have been nervous and volatile over the past year. This nervousness was triggered by increases in international interest rates which heightened concerns among investors about the rising costs of servicing our large government debt. In turn this led to concerns about a further widening of the deficits and an even faster pace of debt accumulation. In response to this market perception of increased risk, the Canadian dollar fell and interest rates rose. Over the last year, financial markets have also been affected by political uncertainty related to the referendum in Quebec. And at times over the last two years, the Canadian dollar has been caught in bouts of international financial turbulence. This happened recently, for example, when markets became concerned about developments in Mexico, and subsequently about Italy, Spain and Sweden -- countries that also face economic imbalances.

These episodes have probably contributed to a perception of increased short-term volatility in the Canadian dollar, especially over the past year. However, viewed from a longer-term perspective, and after looking carefully at the data, it is not apparent that such volatility has increased. Moreover, relative to other major currencies, the volatility of the Canadian dollar has actually been modest. And, of course, with the development of hedging techniques, such as forward contracts and other derivative instruments, firms can protect themselves against short-term volatility.

Nonetheless, there have been times when the Canadian dollar has not just been volatile but has also moved a long way in a direction which seemed inconsistent with economic fundamentals faced by Canadian businesses. However, when this has happened it has more often than not been because of concerns among investors about domestic economic policies. Experience elsewhere also shows that it is the currencies of countries with significant economic and financial imbalances and weak domestic economic policies that usually come under speculative attacks. That is why it is so important that we in Canada follow sound economic policies and have a coherent plan to address any remaining problems.

As I noted earlier, an important factor that has been weighing heavily against the Canadian dollar recently is the rising level of our public debt. So, from this perspective too, one is encouraged by the measures taken in the recent federal budget to reduce and eventually erase the deficit, and by the move to balanced budgets in a number of provinces. Balanced fiscal policy will contribute to exchange rate stability.

At the Bank we also believe that strong monetary discipline -- in other words, a policy directly aimed at preventing the domestic value of the Canadian dollar from being eroded by inflation -- provides a strong underpinning for the external value of the currency. Moreover, even though the Bank has no target for the level of the Canadian dollar, we do take into account its effects on demand and inflation in conducting monetary policy. And we stand ready to take action if ever confidence in the dollar is being undermined.

I would like to end my remarks by saying that we have a lot of good things going for us in Canada today. Despite some areas of weakness, we have an economy that still has considerable momentum. We also have improved cost control and rising productivity -- which together provide the promise of continued, solid economic expansion in the future. However, to sustain that promise we need economic policies which will deliver sound fiscal positions and low inflation so that Canadians can be confident in planning for the future and in undertaking the initiatives and innovations that underlie a prospering economy. I can assure you that the Bank of Canada is firmly committed to its part -- delivering a monetary policy that keeps inflation under control.