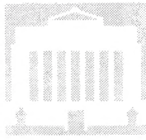

BANK OF CANADA

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

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R= 013342 I= 0054 C= 001 G= DATE: 950717

to the
Winnipeg Chamber of Commerce
Winnipeg, Manitoba
29 June 1995

Not for publication before 29 June 1995
1:00 p.m. central daylight time
(2:00 p.m. eastern daylight time)

Notes for remarks by
Gordon G. Thiessen
Governor of the Bank of Canada
to the Winnipeg Chamber of Commerce
Winnipeg, Manitoba
29 June 1995

I am pleased to be here today in the company of so many with a keen interest in things economic. These days, all across Canada, a growing number of people are taking a greater interest in the major economic issues of the day. This is very encouraging as over time it will make for better economic policy. And it has meant that our efforts at the Bank of Canada to be open in communicating to the Canadian public what the Bank is up to, and why, have met with an interested and demanding audience.

However, we are not always quite as successful as we would like to be in conveying our views and intentions on monetary policy. Indeed, recent comments in the press give me the impression that some people are still not clear about where the Bank of Canada stands with respect to inflation. Specifically, there seems to be some uncertainty among the public as to how to interpret the latest inflation statistics and the Bank's likely response to what appears to be an acceleration of inflation this year.

I would like to take this opportunity to try to clear up some of this uncertainty. In the course of doing so, I shall also talk about the economy more generally and the role of monetary policy in promoting Canada's economic and financial welfare.

Why price stability?

There is in Canada a formal commitment to price stability that has taken the form of joint declarations by the Bank of Canada and the federal government in 1991 and again in 1993. To make this commitment more credible and concrete, explicit targets were set for reducing inflation and then keeping it under control.

Why has there been so much official concern in Canada about controlling inflation and achieving price stability? It is not because price stability is an end in itself, but because

price stability will contribute to a better Canadian economic performance.

I do not intend today to give you a list of the benefits of price stability, or talk about the many costs that "living with inflation" entails. We at the Bank have done this many times in the past. For those interested in the details, I would refer you to the appendix of our first semi-annual Monetary Policy Report published last month. The proposition that inflation is bad for the economy does not require a lot of analysis to justify it. One has just to think of our experience with inflation during the 1970s and 1980s. Inflation led to a great deal of speculative activity and a boom and bust economy, with little overall gain in productivity. Now, after 3 1/2 years of very low inflation, we have already seen improvements in the productivity and cost control of Canadian businesses and in their ability to compete internationally.

Nonetheless, there are still some people who are concerned that the Bank's commitment to controlling inflation may interfere with the current economic expansion and prevent the Canadian economy from generating the increased employment that everyone would like to see. They view monetary policy as having to make a choice in the period ahead between maintaining our good inflation performance and sustaining an expanding economy.

Let me be clear on this. Any compromise by the Bank in achieving our inflation-control targets would undermine, not help, the sustainability of the economic expansion. It would exacerbate concerns among investors in financial markets about Canada's commitment to price stability and would discourage the investment that we need in order to have rising living standards.

Moreover, I think there is some misunderstanding about what the sources of inflation pressures are, what risks we face that the rate of inflation will rise, and therefore what is required to keep it under control. Upward pressure on inflation comes about when excessive spending demands in the economy, which are not adequately resisted by monetary policy, persistently exceed the capacity of the economy to produce the goods and services that are being sought. This excess demand then triggers a continuous ratcheting up of prices and costs.

Thus, in looking at the risk of inflation pressures in the future, we must focus on the likelihood of any excess demand pressure leading to an ongoing rise in the general level of prices and costs. I stress "general" price and cost increases. Even in a non-inflationary economy, some prices and costs will be rising. But those increases will be offset over time by other prices and costs that are falling. That is how our economy works

to move workers and capital into or out of production in different economic areas. Individual prices, or even prices of a substantial group of products, that are rising, do not constitute an inflation risk unless an expansionary monetary policy encourages a response in the rest of the economy that leads to subsequent rounds of price and cost increases.

You can see from this description that what happens to the prices and inflation in our economy is unlikely to be a smooth process. Measures of inflation in Canada will therefore be subject to fluctuations. We at the Bank concentrate on the underlying trend in the overall level of prices because that is what indicates whether upward pressure on the process of inflation is at work in our economy or not.

The Bank must also be forward-looking in its assessment of inflation because monetary policy usually works slowly and has its effects on inflation over a long period. This means that monetary policy must be conducted with a medium-term perspective that emphasizes stability and predictability over time, rather than responding to every development in the economy or every wiggle in the inflation rate.

With this background, I would like to turn to some of the practical issues we face in operating monetary policy targets for inflation control.

The practical application of the inflation-control targets

The current target is to hold the rate of inflation to a range of 1 to 3 per cent (with a mid-point of 2 per cent) from end-1995 through to end-1998. By that date, the Bank and the government are committed to agreeing on a more precise definition of price stability.

The inflation-control targets are set in terms of the total consumer price index (CPI), the most familiar measure of inflation for many Canadians.

However, as I mentioned, there are frequently short-lived fluctuations in the rate of increase of the CPI. Common sources of such fluctuations are the volatile food and energy components and the effects on prices of changes in indirect taxes. Other influences, such as international price movements and changes in the exchange rate for the Canadian dollar, have also been important causes of fluctuations. All of these factors can make it difficult to identify underlying inflation pressures in the economy.

Nonetheless, a good reading of the basic trends is what matters when it comes to conducting monetary policy to meet the inflation targets. To try to get a good fix on the underlying rate of inflation, the Bank monitors a "core" measure of inflation which excludes food, energy and indirect taxes. But of course we do not stop there. To get a more rounded view of underlying price pressures in the economy, we also look at other broad measures of inflation, the growth of various monetary aggregates, and indicators of the pace of expansion of economic activity.

I would like to turn next to a discussion of Canada's recent inflation record and the short-term outlook. As you will see, my emphasis is on the factors likely to be influencing the underlying rate of inflation. I hope this will make clear the Bank's interpretation of the latest inflation numbers and why we have taken our recent policy actions.

Recent trends in inflation

Inflation has declined significantly since the targets have been introduced. After falling sharply in 1991, the rate of increase in the core measure of the CPI was relatively stable at about 1 1/2 to 2 per cent from 1992 to the end of 1994. At the same time, the inflation numbers from the total CPI that you read about in newspapers, were subject to a lot of fluctuation, in large measure because of the effect of indirect taxes. The introduction of the GST in 1991 and the reductions of tobacco taxes in 1994 contributed to a rise in the rate of increase in the total CPI to as high as 6.8 per cent in 1991 and a fall to close to zero in 1994. Because such tax changes do not typically affect the trend of inflation, the Bank does not react to them in its monetary policy operations, unless there is evidence that they are feeding into a wage-price spiral.

But what about the sharp rise in measured inflation since the beginning of 1995? Is this a sudden and surprising outbreak of inflation and will the Bank have to take strong actions to stop it? No, in fact, for some time now, we at the Bank have been saying that we expect the total CPI to run ahead of our measure of core inflation for the balance of this year; and that the core inflation measure will also be subject to some <u>temporary</u> upward pressure in 1995.

The main factors at work in pushing prices up have been the sharp rise in raw material prices over the past year and the past depreciation of the Canadian dollar. With an estimated 20 per cent of the total basket of goods and services purchased by the average Canadian consumer representing imported items, the

delayed effects on prices of the substantial decline in the value of the Canadian dollar over the past three years are significant. Indeed, rough calculations suggest that these effects contributed over 1 percentage point to measured inflation during the past 12 months.

The Bank of Canada expects these effects to be only temporary and not to cause a rise in the underlying rate of inflation. Some commentators have expressed concern about this judgement. They recall periods in the past when the Bank did respond actively to currency depreciations because of their potential effect on the momentum of inflation. What was different in those earlier periods was that we had a much higher rate of inflation to begin with, recurring bouts of excess demand in the economy, and expectations among most Canadians that inflation was likely to continue to be high and probably get worse. In those circumstances, what should have been a temporary effect on inflation from exchange rate depreciation led instead to increased fears of accelerating inflation and still more upward pressure on prices. By contrast, the current situation is one of low inflation, a margin of slack in the Canadian economy, and a monetary policy explicitly committed to keeping inflation within set target bands.

As I pointed out earlier, it is the ongoing pressure of excess spending demands accommodated by monetary policy that is the fundamental source of inflation. Despite the rapid expansion of the Canadian economy last year, spending demands were not pressing against the limits of production capacity in most sectors. Indeed, when you look at labour costs per unit of production, the most basic and important costs in the economy, they were falling as productivity rose. In these circumstances, increased prices of imports reflecting currency depreciation are unlikely to have more than a temporary effect on our measures of inflation.

The outlook for inflation

As we look forward, the crucial assessment that the Bank of Canada must make about the risk of inflation is the likelihood of generalized demand pressures in the economy.

Even after the surprisingly rapid growth of the economy last year, we estimate that there remained a significant margin of excess capacity going into 1995. Some slowing in the rate of economic expansion in the first part of 1995 was to be expected after the unsustainable pace of last year; and indeed, it was not unwelcome as we moved closer to the capacity limits of the economy. However, recent economic statistics suggest that the

slowing has been greater than we had anticipated. After very robust growth in the second half of last year, exports have eased, primarily as a result of the slowing U.S. economy. Rail and port strikes in Canada also affected economic activity temporarily in the first quarter. And Canadians responded very quickly to the sharp run-up in interest rates in late 1994 and early 1995, and to the actual and expected cutbacks in the public sector.

So, there have been a number of factors acting to slow the Canadian economy in early 1995. But the good fundamentals that have been underpinning the economy over the past year, such as improved productivity, cost control and strong Canadian competitiveness, have not disappeared. And with an external economic environment which, by and large, appears still to be positive for Canada, economic activity should pick up through the second half of the year. However, the pace of expansion will certainly be more moderate than in 1994, and there should remain a considerable margin of unused capacity in the economy through 1995.

Let me then summarize the situation. The CPI measures of inflation will likely remain in the top half of our target band for some time this year, primarily because of the lingering effects of the past depreciation of the Canadian dollar. But this temporary upward influence is expected to diminish towards year-end, and the slack in the economy, together with good cost control, should continue to put downward pressure on inflation. Add all this up, and in my view, our measure of core inflation should come back towards the middle of the target range of 1 to 3 per cent by the end of the year. Thus, the near-term inflation outlook appears favourable and consistent with our targets.

At the same time, the less rapid economic expansion this year means that slack in the economy will be taken up more slowly than we had anticipated a few months ago. This suggests that there is a good chance that the downward pressure on inflation will persist into 1996. In light of this, the Bank has recently taken actions to encourage lower short-term interest rates and thus some easing of the overall monetary conditions. This easing has been facilitated by the recent relative stability of the Canadian dollar after it recovered from its low point last January.

Nevertheless, we must remain vigilant; and so we shall continue to monitor the situation carefully. I can assure you that the Bank of Canada is firmly committed to delivering a monetary policy that keeps inflation under control and is not about to compromise Canada's recent hard-won status as a low-inflation country. That status is the best contribution monetary policy can make to a good performance by the Canadian economy now and in the future.