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Notes for remarks by Gordon G. Thiessen
Governor of the Bank of Canada
to the Regina Chamber of Commerce
Regina, Saskatchewan
April 2, 1996

I know that many Canadians feel we have been through some rather tough economic times lately. It is true that the Canadian economy has been struggling, turning in a sluggish performance that has left us with a high unemployment rate and a considerable margin of unused production capacity. That said, though, I believe that economic commentary in this country has become too pessimistic these days. There is a lot that is going on in the Canadian economy which is fundamentally positive.

Today, I would like to talk about some of the economic challenges we are facing as a nation and about some of the successes we have had in meeting those challenges. And, of course, I want to tell you about the role monetary policy has played in these developments. I will also comment briefly on the fiscal situation in Canada and the need to persevere in keeping budgets under tight control.

The Canadian economy in a changing world environment

The world around us has been going through rapid and profound changes. These changes have had, and will continue to have, lasting effects on the structure and functioning of the world economy. The globalization of the world economy, as we refer to these changes collectively, essentially means that national borders are rapidly becoming less important. Goods and services and financial capital now move much more freely across national frontiers -- the world is becoming one large, highly competitive marketplace.

Of course, changes like these can have disruptive economic consequences for individual countries in the short run and generate a lot of anxiety about the future. Fundamentally, though, these changes are positive. They should result in expanding international trade, more rapid increases in productivity and, hence, improved living standards worldwide.

This evolution of the international economic environment is by no means new; it has been going on for some time. However, one gets the impression that the pace of change has been accelerating in recent years. Perhaps that is because of the increasingly successful integration into the world economy of some of the developing nations, particularly in Asia. Another factor that may have reinforced this perception is the recent proliferation of multilateral and regional agreements for freer trade.

But my purpose today is not to talk about globalization. Rather the point I want to make is that the environment in which Canada operates these days has changed greatly. The problem is that, until recently, Canada was not doing a very good job of adapting to this changing world. A brief review of our economic performance over the period from the early 1970s to the early 1990s will serve to underscore this point.

Those two decades were generally marked by high inflation and rising government deficits and debts. During the late 1970s and again in the late 1980s, with many Canadians acting on expectations of accelerating inflation, Canada went through booms of speculative activity that resulted in serious economic distortions and eventually led to severe and painful recessions in the early 1980s and early 1990s. And unemployment rose to distressingly high levels.

With government deficits absorbing increasing amounts of domestic savings, we as a nation came to depend more and more on foreign borrowing during this period. And for various reasons, including high inflation and an expanded government sector, our productivity was increasing only very slowly. Because of this and poor cost control, Canadian businesses were not very competitive. As a result, the exports we needed to generate in order to service our foreign debts came to rely increasingly on a depreciating currency -- a situation that was not sustainable. All told, Canada was not a country seriously gearing up to meet the challenges of heightened international competition.

Over the last few years, however, there have been some dramatic changes in Canada in this respect. There is now a widespread recognition of the importance of global markets and of the reality of intensified international competition. And with it has come a remarkable transformation of much of Canadian business. Over the last 3 or 4 years, there has been substantial investment in machinery and equipment, particularly in equipment with computer-based technology, to improve productivity. And strict cost control is now the norm in Canadian businesses. All this has led to a marked improvement in our cost competitiveness.

As a result of this improvement, our exports have been growing rapidly over the past four years, providing solid support to the economy. What's more, strong gains have not been limited to exports of traditional primary products but have included an expanding range of manufactured goods. And importantly (though perhaps not as widely recognized), Canadian businesses have been competing successfully against imports within Canada.

The strength of the U.S. economy has no doubt been helpful to our export sector and so has the relatively low value of the Canadian dollar. But I believe that what we are seeing now is also an impressive demonstration of the new competitive strength of the Canadian business sector. And with the benefit of improvements in cost control and productivity, businesses are now using the low exchange rate to help them break into world markets and expand their market share. The result of this success has been a dramatic narrowing of the deficit in our balance of international payments and, thus, a reduction in our reliance on foreign borrowing.

The role of monetary policy

As you can see from this account of Canada's economic performance, inflation was a significant source of our problems in the period from the early 1970s to the early 1990s.

Thus, since 1991, the Bank of Canada and the Government of Canada have been formally committed to price stability as the appropriate objective of monetary policy. Specific targets have been set to bring inflation down and to keep it at a very low level. The current target calls for inflation to be held inside a range of 1 to 3 per cent through to the end of 1998. In point of fact, the average rate of inflation in Canada over the last four years has been about 2 per cent.

We are already reaping some of the benefits from this low inflation that we have had over the last four years. Our good inflation performance has been an important factor behind the economic improvements that I was emphasizing a moment ago. Low inflation has prompted businesses to pay closer attention to cost control. It has also meant a more stable economy and much lower average interest rates than over the previous 20 years. This has been an environment helpful to making the investment and restructuring decisions that have led to improvements in business productivity and competitiveness.

The conclusion that I reach when I focus on these recent developments in the Canadian business sector, is that our economy now has a much sounder foundation than it has had for many years. This augurs well for the future because it means that economic expansion is likely to be more stable and more sustainable than in the past. I believe that the Bank of Canada's policy of low inflation has made a significant contribution to this improved outlook.

The current economic situation

But I must add that this sound economic foundation does not mean that everything is now going smoothly in our economy -- because clearly it is not. The restructuring of many businesses has been difficult and stressful for owners, managers and employees alike. And even though a good deal of the necessary adjustment in the private sector has already taken place, the restructuring process that is now also going on in the public sector is more recent and, hence, has some way to go.

The fear of job losses through all this restructuring quite evidently has left Canadian households worried about the future and very cautious about spending. The economic recovery has, thus, been heavily dependent on exports and has turned out to be slower than it might otherwise have been. However, what we must not forget is that restructuring in both the private and public sectors was absolutely essential. And neither must we forget that this restructuring will have significant pay-offs -- in terms of productivity gains, improved competitiveness and a better standard of living for Canadians.

Here in Saskatchewan, you know only too well about restructuring, having made great efforts in recent years to diversify your economic base and at the same time improve your fiscal position. I am thinking, for example, of efforts to reduce dependence on wheat production, by shifting to other high-value crops (e.g. canola, flaxseed), to livestock, and to more value-added food processing activities. And Saskatchewan has become a world leader in agriculture biotechnology. In the all-important mining sector, Saskatchewan has been making strides in the use, but also the development for world markets, of sophisticated computer-based mining and geophysical exploration equipment and technology. Considerable progress has also been made in putting this province's public finances on a firmer footing. Altogether, the adjustments you have undertaken towards a more stable and productive provincial economy are impressive. And they should form the base for an improved economic outlook in Saskatchewan.

With the extent of restructuring that is going on across Canada these days, people often wonder if monetary policy could not somehow be more helpful to individual regions making these difficult adjustments. At times, the Bank of Canada has been criticized for not taking sufficient account of regional problems and differences in setting monetary policy. Let me assure you that the Bank closely monitors developments in all parts of Canada. However, there can only be one monetary policy in Canada, and it has to be based on an assessment of what is appropriate for the country as a whole.

I have no doubt that the best contribution that monetary policy can make to support the process of economic adjustment in Saskatchewan, or any other region for that matter, is to persevere with our policy of low inflation. High inflation only obscures the need for economic adjustments and delays the required changes, making the overall situation worse.

Still, questions that may be on your minds, given our recent good inflation performance, are why interest rates in Canada have been so slow to come down and why they have not declined even further. If low inflation is going to be helpful to economic adjustment and restructuring, why has it not delivered lower interest rates in Canada? Our inflation rate has been lower than in the United States over the past four years, but our interest rates have typically been higher than theirs. To be sure, short-term interest rates in Canada have come down significantly over the past year. However, medium- and long-term rates are still substantially higher than in the United States. Why is this, and where is the financial pay-off from reducing inflation to very low levels?

The explanation for this apparent inconsistency between our interest rates and our inflation rate lies mainly in Canada's fiscal situation, compounded by lingering concerns about our political future. Until recently, there had been a rather persistent deterioration of budgetary positions of Canadian governments and a dramatic accumulation of public debt since the early 1970s. By 1995, total public debt of all levels of government had grown to be about equal to the size of our economy -- that is, a debt-to-Gross Domestic Product (GDP) ratio of around 100 per cent.

Debt levels of this magnitude generate concerns among investors, both Canadian and foreign, about the capacity and willingness of governments to service their debts. Investors worry that the government may eventually resort to inflation and currency depreciation to reduce the burden of the debt, at their expense. And so they demand higher interest rates that include a premium as compensation for assuming these risks.

Fortunately, over the last couple of years, most governments in Canada have made a major effort to put their budgets on a sounder basis. This restructuring of the public sector will be beneficial for our economy, in and of itself. But from the point of view of monetary policy what is particularly important is the favourable impact that an improved fiscal situation has on the outlook for inflation. By lessening fears of future inflation, fiscal consolidation should allow us to benefit more fully from our record of low inflation.

We are already starting to see some of these benefits in the form of an increased margin for manoeuvre for monetary policy. The Bank of Canada's recent actions to ease monetary conditions have been successful in bringing short-term interest rates in Canada to levels somewhat below those in the United States. I would also expect to see some narrowing of Canada-U.S. spreads for medium- and long-term interest rates, as long as political uncertainty does not become a major concern again.

Looking ahead

So, what are the prospects for the Canadian economy?

With the U.S. economy expected to grow at a moderate, sustainable pace in the future, and with generally attractive prices for many of the primary commodities we produce, our export sector should remain a strong source of economic expansion. And as a result of the recent easing in monetary conditions, there is now substantial monetary support for more rapid expansion in the private sector. Indeed, we have seen encouraging signs recently of a pick-up in the growth of employment (for the months of

December through to February), and some recovery in household spending on consumer goods and on housing.

A stronger expansion in the private sector is exactly what is needed to bolster economic confidence in Canada, while governments get on with the job of achieving healthier fiscal positions.