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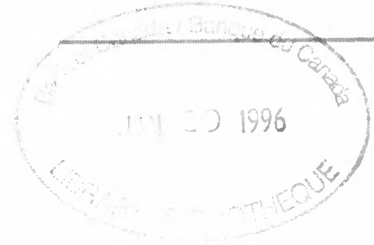

Monetary and fiscal policies: Orientations and interactions

Notes for remarks by

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Governor of the Bank of Canada

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Monetary and Fiscal Policies: Orientations and Interactions

Fiscal restraint is on people's minds a great deal these days. Most Canadians see the need to address the fiscal problem in this country, even though there is always a lot of debate about which expenditures to cut back and what revenues, if any, to increase. However, there is also considerable anxiety in some quarters that spending cuts will reduce demand and employment, leading to a weaker economy. Indeed, some people have expressed the view that fiscal cuts will never succeed in lowering the deficit because the economy will always be too weak. They seem to fear that monetary policy cannot or will not respond adequately to fiscal cuts. Your invitation gives me an opportunity to share with you some of my thoughts on these issues.

Monetary and fiscal policies in Canada share the common objective of promoting a healthy economy. But the important question is how they can best contribute to enhancing our economic performance. Today, I propose to discuss the orientation of these policies in Canada and to focus on the implications of fiscal restraint for the conduct of monetary policy.

The Orientation of Fiscal Policy

Let me start with the facts on the fiscal side. The various levels of government in Canada have collectively been running budgetary deficits since the early 1970s, that is, for nearly a quarter of a century. And total public sector debt levels in relation to the size of our economy have risen dramatically from a debt-to-gross domestic product (GDP) ratio of less than 30 per cent in 1977 to about 100 per cent by 1995.

Such a rise in government debt as we have seen in Canada has important economic effects. The most direct implication is that, at some point, government expenditures have to be reduced or taxes have to be increased just to service these higher debt levels, much less reduce them. And, as is quite evident, the longer a government waits to deal with its fiscal problem, the more painful the necessary expenditure and revenue adjustments will be.

Although most Canadians have become well aware of our worrisome public debt levels and of the difficult choices involved in dealing with the problem, the negative effects on our economy were not widely understood while governments were accumulating these debts. These negative effects have arisen because governments have borrowed to finance spending for current consumption purposes, including transfer payments. In a relatively small, open economy, like Canada's, increased borrowing by governments means that the country as a whole ends up having to rely more on foreign savings, thereby increasing its foreign indebtedness. Overall, borrowing for current consumption means less income for future consumption, since carrying a higher debt burden requires that more income be devoted to paying interest. Indeed, in building up a higher level of indebtedness, what happens to us as a nation is not unlike what happens to an individual in similar circumstances.

Another economic effect of a rising public debt is that it eventually creates nervousness in financial markets about how governments will ultimately deal with their obligations. This uncertainty causes investors to demand higher premiums for the increased risks that they are assuming in continuing to lend to those governments. These risk premiums raise interest rates, increasing the cost of capital throughout the economy. This discourages businesses from investing in the technology and equipment that would raise productivity and enhance competitiveness and living standards.

Higher risk premiums in our interest rates also increase the burden of servicing the debt, which puts added pressure on the fiscal position of governments. As a result, investors become even more nervous about the capacity and willingness of governments to service their debts in the future, and they demand still higher risk premiums for holding Canadian assets. Debt service costs, deficits, and the level of debt rise still further. Thus, a country can potentially find itself in a vicious circle of rising interest rates, rising deficits and rising debt. These were the kind of pressures that Canada, and

other major debtor industrial countries, faced for a time following the rise in U.S. interest rates in early 1994, and again in early 1995 in the wake of the Mexican crisis. This underlying concern in financial markets about the level of our public debt also increases our vulnerability to political uncertainty.

The economic fallout from high public sector debt levels that I have just described is no longer an abstract problem in Canada. The need to press ahead with fiscal adjustment is clear. This requires continued determined efforts to reduce public sector deficits in order to stabilize and then lower the high level of public debt relative to the size of our economy.

The Orientation of Monetary Policy

Before turning to the interaction between fiscal and monetary policy, I would like to spend a few moments on the role and objectives of monetary policy.

The focus of Canadian monetary policy is on price stability. However, the Bank of Canada does not pursue price stability for its own sake but rather as a means of contributing to a well-functioning, productive economy, capable of providing Canadians with a rising standard of living. How does this work? Simply put, people are likely to make better decisions, as savers and investors, when they do not have to worry about the future value of their money being eroded by inflation. And this, in turn, results in a better overall economic performance.

Since 1991, the Government of Canada and the Bank of Canada have made a joint formal commitment to price stability and to specific targets for inflation control on the path to this objective. The current target is a range of 1 to 3 per cent to the end of 1998. Because there is a relatively long lag -- of 1 1/2 to 2 years -- between central bank actions to influence monetary conditions and their effects on the rate of inflation, monetary policy must be forward-looking. The Bank continually reassesses the momentum of demand in the economy, in the light of new information and unanticipated developments that may hit the economy from time to time, and it adjusts accordingly the desired path for monetary conditions needed to achieve the inflation-control target. Included in this assessment is the impact on the economy of any new fiscal measures.

This medium-term focus of monetary policy on targets for inflation control provides a built-in stabilizer for the Canadian economy. For example, new information that points to excessive demand pressure from increases in either private or public sector spending, and that is likely to result in a rising trend of inflation, would lead the Bank to seek a more restrictive path for monetary conditions. By the same token, new information regarding either private or public sector spending that suggested a weaker economy, and consequently less inflation pressure, would lead to a revision in the direction of easier monetary conditions. In other words, this policy approach provides monetary support for a trend of expansion in the economy which is likely to be sustainable because it is consistent with continued low inflation.

Common ground: the interaction of fiscal and monetary policies

In essence, both fiscal and monetary policies require a medium-term orientation -- the former directed towards fiscal consolidation and a declining ratio of debt to GDP; the latter directed towards targets for inflation control.

Let me be more specific about how these two policies interact. In particular, what are the implications for monetary policy of government actions to reduce deficits and debt ratios? I believe we can offer some comfort to those who worry about the possibility of a weaker economy as a result of fiscal measures and about the ability of monetary policy to respond to fiscal restraint.

In our current circumstances, there are two main effects of fiscal actions that monetary policy must consider. First, credible fiscal consolidation measures that hold out the promise of lower debt-to-GDP ratios should reduce the risk premiums in our interest rate structure. Second, substantial reductions in government spending lower the pressures of demand in the economy, implying a lower trend of inflation.

If fiscal progress is significant, and is seen by the markets as lasting, there is a good chance that risk premiums would be reduced and the resulting decline in medium- and long-term interest rates would encourage increased private sector spending in the areas of housing, consumer durables and business investment. And, because of the forward-looking nature of financial markets, the decline in interest rates and the

resulting stimulus to private spending could start to happen before all the effects of multi-year budget restraint measures actually occur.

Working in the opposite direction, it is possible that, in an economic climate such as the one we currently face, public sector downsizing and expenditure cutbacks could cause Canadians to become particularly cautious in their spending plans.

If the net result of all these effects is a lower level of demand in our economy than otherwise, and thus greater downward pressure on the trend of inflation, it would call for an easing in monetary conditions in Canada.

Under ideal circumstances, the central bank can act quite promptly to adjust monetary conditions so as to encourage more private sector spending to offset fiscal restraint. By "ideal" circumstances, I mean a situation where both Canadian and foreign investors are confident that governments will achieve the necessary fiscal consolidation and that monetary policy will keep inflation low and where investor confidence is not affected by political concerns.

However, in our current circumstances, the situation may not be so straightforward. Judging from the relatively wide spreads that persist between Canadian and U.S. medium- and long-term interest rates, investors remain sceptical of fiscal plans, because, in the past, they have seen Canadian governments fail to meet their deficit-reduction goals. This scepticism adds to their continued concerns about the prospects for inflation and currency depreciation, given Canada's poor inflation performance during the 1970s and 1980s. Political uncertainty has also added to investor concerns and thus affected interest rate differentials.

Where does this leave us? First of all, it would be inappropriate for the Bank to take monetary action without clear government commitments as to the size and the timing of fiscal measures. Next, the reaction of market participants has to be assessed. What are the interest rate and exchange rate responses to the announcement of the fiscal policy initiatives? All the effects of fiscal actions on overall demand in the economy have to be factored in. And other influences affecting demand, unrelated to fiscal measures, such as foreign developments, have to be weighed.

Another important consideration is whether financial market participants change their view about the outlook for monetary policy in the light of fiscal restraint. Does fiscal restraint strengthen the view that monetary policy actions will be consistent with the Bank's inflation-control objectives and will not be directed to inflating away the fiscal burden?

As you can see, we are talking about a complex set of interactions between these two policies, one that implies that there can be no pre-set formula for monetary policy actions in response to fiscal policy measures. However, cutting through all this, one point seems very clear to me: the more credible monetary and fiscal policies are, the more reinforcing, or mutually supportive, they can be. Credible fiscal programs to reduce debt-to-GDP ratios would make it easier for the Bank of Canada to take actions to support the economy through an appropriate adjustment of monetary conditions. And a credible monetary policy implies lower interest rates than otherwise, which, in turn, would reduce government debt-service costs and speed deficit reduction.

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There is no doubt that the burden of public debt weighs heavily on the Canadian economy with concrete negative consequences. Given this situation, there is a crucial need not just to stabilize our debt-to-GDP ratio but to bring it down, particularly if we want to reduce our present vulnerability to nervous and uncertain financial markets.

The process of fiscal adjustment is neither easy nor painless. Restructuring, whether in the public or in the private sector, is always worrisome and stressful. The costs of adjustment are direct and immediate, while some of the payoffs may be slower to materialize and, as a result, may appear less tangible. It is important to realize the difficulties, but at the same time, we must never lose sight of the significant payoffs from fiscal consolidation -- in the form of lower interest rates, increased productivity and a rising standard of living.

There is a dividend for monetary policy, too, in a prudent fiscal policy. As fiscal positions become sounder, any remaining concerns that monetary policy could somehow be used to reduce the debt burden through inflation, with a resulting currency depreciation, would be dispelled. This would give

monetary policy more flexibility in responding to the economic ups and downs that hit us from time to time.

Most governments in Canada took significant actions during 1995 to put their fiscal positions onto a more sustainable track. Clearly, we must continue resolutely with these fiscal adjustment efforts. Substantial progress was made last year; we must ensure that it continues.

How can the Bank of Canada help with this process? I believe that, in these uncertain times, the Bank's firm commitment to targets for inflation control offers an important degree of comfort to savers and investors who hold government debt. And the Bank's actions to meet these targets also provide support for sustained economic expansion. We need both comfort for investors and support for the economy while we keep working to resolve our fiscal problems.