Some current economic issues in Canada

Notes for remarks by
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Governor of the Bank of Canada

to the
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Every year, the Bank of Canada's Board of Directors has one of its meetings outside Ottawa, in a different part of the country. I am delighted that this year's meeting has brought us to London today, giving me the opportunity to speak to you about recent developments in the Canadian economy.

Among the economic issues frequently discussed in Canada these days are: the appropriateness of the Bank's continued commitment to price stability; the weakness of consumer confidence; and the sustainability of the present negative interest rate spreads with the United States.

Let me elaborate. With inflation in Canada being very low these days and expected to stay low, some people are wondering why the Bank of Canada insists on remaining focussed on price stability. Why not worry more about economic growth and job creation, they ask.

Others are wondering, if low inflation is good for the economy and if some of the other economic fundamentals are also more positive, why has the Canadian economy not been performing better? Why is the confidence of Canadians in their economy not stronger? People want to know the Bank's assessment of the prospects for a turnaround in consumer confidence.

What is the Bank doing to support consumer confidence? Interest rates are now lower in Canada than in the United States for maturities of up to 2 years. This is a rather new experience for many people. Not surprisingly, they are wondering if these negative spreads can be sustained.

I would like to use this opportunity to explain why we at the Bank of Canada believe that it is important to remain committed to our inflation-control targets. I will also tell you why I feel reasonably optimistic about the prospects for a recovery in consumer confidence. And I will conclude with a few remarks on what I see as the necessary conditions for interest rates in Canada to be lower than in the United States.

Why a policy of low inflation and why inflation-control targets?

The Bank of Canada is not preoccupied with low inflation because this is the flavour of the day in central banking, as some people still seem to think. Moreover, a low-inflation policy is not the end but rather the means through which monetary policy fundamentally contributes to good economic performance.

If our economy is to function well, Canadians need to have confidence that the money they use will retain its value over time. Money will hold its value only if it is not eroded by inflation -- that is, only if the general level of prices in the economy remains stable.

High inflation is very costly as we have learned from our experience of the 1970s and 1980s. It creates uncertainty about the future, complicates economic decision-making and diverts valuable resources away from productive investments into speculative activities, as people seek protection from the ravages of inflation. But not everyone is successful; and it is the less fortunate in society that often suffer the greatest losses.

To avoid these heavy costs, the Bank of Canada has made a commitment to Canadians to conduct policy in a way that provides confidence in the value of money.

To make this commitment more concrete and credible, and thus help reduce expectations of ongoing inflation, the government and the Bank of Canada have set specific targets for inflation control. The current target calls for inflation to be kept within a range of 1 to 3 per cent to the end of 1998. By then, a decision will be taken on a future target range consistent with an appropriate longer-term definition of price stability for Canada.

I believe that this low-inflation policy and our commitment to the targets not only avoids the costs of inflation but also provides the foundation for a more stable and productive economy.

By taking actions to hold inflation within the target range, monetary policy acts as a stabilizer for the economy. By this I mean that, when economic activity is expanding at an unsustainable pace and is pressing on the limits of production capacity, threatening to push the trend of inflation through the top of the target range, the Bank will act to tighten monetary conditions and cool things off. But the Bank will respond with equal concern, by relaxing monetary conditions, when the economy is weak and pointing to a trend of inflation below our target range. The easing in monetary conditions since last October is a case in point, and should allay fears that a monetary policy geared to price stability somehow will always be too restrictive.

Of course, monetary policy cannot 'fine-tune' the economy, aiming for any particular level of economic activity in the short run. Monetary policy actions have their effects on inflation with rather long lags of one to two years. This is why monetary policy has a medium-term orientation, with the focus on inflation control which supports a rate of growth of economic activity that is sustainable over time.

As well as acting to stabilize the level of economic activity, a policy geared towards price stability promotes the longer-term efficiency of the economy.

Some of these longer-term benefits are already coming through, contributing to an improvement in our economic fundamentals which holds the promise of greater future prosperity for all Canadians. I am talking in particular of the more effective cost control and enhanced competitiveness of Canadian businesses (which are important factors underlying our strong export performance of the past four years). I believe that low inflation has been instrumental in this regard, by providing a more stable environment, conducive to undertaking the sound investment and other restructuring initiatives that have contributed to these improvements.

Based on the record to date, I expect that many Canadians would agree that there are indeed important advantages for an economy where the authorities are committed to low inflation. And that whatever else we do, we must ensure that we do not jeopardize these hard-won gains and our budding reputation in financial markets as a low-inflation country, which has helped us to bring interest rates down.

We know that credibility takes a long time to establish and precious little time to undo once markets begin to doubt one's commitment to stated policy goals. While it is true that we have now had four years of good inflation performance, we also have a legacy of some 20 years of high inflation to put behind us. The only way we can achieve this is by providing market participants, both Canadian and foreign, with a strong sense of ***continuity*** in economic policy. This means a monetary policy focussed on low inflation but also a fiscal policy geared towards deficit reduction and a declining debt-to-GDP ratio.

For monetary policy, continuity requires that we remain committed to our inflation-control targets, striving to keep inflation inside those targets. Thus, the Bank has a responsibility to act promptly if there is evidence that the trend of inflation risks rising above ***or*** falling below the range.

Why are we also concerned about going ***below*** the range? The Bank's undertaking is to make monetary policy predictable and provide Canadians with greater certainty about future movements in the price level. For the economy to reap the full benefits of a low-inflation policy, we need to do our best to ensure that the expectations of Canadians in making their economic plans are consistent with our targets. At present, this means keeping to an inflation-control target of 1 to 3 per cent -- not above 3 per cent, not below 1 per cent.

Core inflation (that is the total CPI excluding food, energy and the effect of indirect taxes) has recently moved into the lower half of the target range. And with a significant margin of slack in the economy, reflecting the slow pace of expansion over the past year, core inflation is expected to remain under downward pressure for the balance of 1996. Essentially, this means that there is ample scope for the economy to grow at a rapid pace for some time without putting upward pressure on the trend of inflation.

Of course, the strength of the expansion in economic activity in Canada will depend crucially on how soon we get a turnaround in consumer confidence and how big that turnaround is. Let me turn to this subject now.

Consumer confidence: is there an early turnaround in the cards?

The Canadian economy has been going through a process of major restructuring in recent years. Basically, this is as a result of two major developments: first, initiatives by Canadian businesses to meet the challenges of technological advances and heightened international competition; second, recent concerted efforts by Canadian governments to address the serious fiscal debt and deficit problems accumulated over the 1970s and 1980s.

This restructuring was absolutely necessary and it is contributing to a strengthening of the foundations of the Canadian economy. However, the adjustment has been difficult and stressful. And it has contributed to increased uncertainty, weakened consumer confidence and a sluggish economic performance.

One of the reasons why restructuring has been a source of uncertainty is its effects on employment. For example, in the past year, we have had the ongoing restructuring and layoffs in certain areas of the private sector, as well as downsizing in the public sector, as part of fiscal restraint. Another source of uncertainty has been the upward spikes in interest rates in both 1994 and 1995 with the resulting increase in debt-service costs (especially given the already high levels of household debt relative to disposable income). Recent concerns about the future of public pension plans have also contributed to a heightened sense of financial insecurity among households.

The upshot is that more consumers have felt that it was not a good time for purchases, especially of big-ticket items such as homes, cars and furniture. With the largest part of economic activity in Canada revolving around household spending, it is not surprising that this led to a lacklustre overall economic performance over the past year. Thus, an early turnaround in consumer confidence is very important.

What are the prospects in this regard? Consumer confidence is notoriously difficult to predict. But I am encouraged by the recovery in household spending in the first quarter of this year. And when I look at the factors at play, I expect to see further improvement in the coming quarters.

Private sector employment has been rising strongly in the recent period, and indeed it has been more than offsetting ongoing cutbacks in the public sector. These net gains, if they continue, should reduce employment uncertainty and may help to sustain the recent growth in personal disposable income.

Another element in the more favourable outlook is that, although households have been postponing spending, at some point, more of them will feel that they can no longer avoid replacing the car, the lawn mower or the fridge.

Of course, the substantial decline in interest rates in Canada since October is also helping to improve the financial situation of many households and thus to bolster confidence.

Lower interest rates in Canada than in the United States?

This recent reduction in our interest rates has implied a marked narrowing of the spreads with U.S. rates across the maturity spectrum. Indeed, we now have lower interest rates in Canada than in the United States out to terms of 2 years. The last time we experienced negative spreads with the United States for any significant length of time was in the early 1970s. This explains why the sustainability of these spreads is viewed with a certain scepticism by some.

But how did the negative spreads come about?

I believe that these spreads are the payoff from the improvement in our economic fundamentals. From the point of view of the markets, what is required to justify lower interest rates in Canada than in the United States is that the Canadian dollar has some upside potential over time. In other words, investors will only accept lower interest rates here if there is also a possibility of compensating capital gains from a prospective rise in the value of the Canadian dollar.

What are the fundamentals lending support to, and indeed creating upside potential for, our currency? First, the favourable inflation differential with the United States. Second, the improving fiscal positions of Canadian governments and the likelihood that we are in for a period of declining debt-to-GDP ratios. Third, the strong competitiveness of our business sector, which underlies the recent sharp narrowing of the deficit in our international balance of payments. Other factors currently helping the Canadian dollar are: firm commodity prices, reflecting in part good prospects for a strengthening in world economic activity, and a lessening of market concerns regarding Quebec's political situation.

The same fundamentals (of lower inflation in Canada than in the United States, increased competitiveness and improving fiscal positions) that are underpinning our currency, are also working directly to reduce risk premiums in Canadian interest rates. This reduction in our risk premiums has also contributed to the movement to negative interest rate differentials for shorter maturities and explains the much narrower spreads for longer maturities than we have had for some years.

Evidently, financial markets are gradually becoming more accepting of Canada's new, improved economic circumstances.

Concluding remarks

As you may have gathered from my remarks today, the key for monetary policy is to provide a financial climate in which Canadians will be able to make their economic plans on the basis of sustained low inflation. In the end what matters, of course, is that the outlook for low inflation contributes to a more stable economy and a higher standard of living for Canadians. And that is why it is so important to hold to our present macroeconomic policies. From the point of view of monetary policy, this can only mean an ongoing firm commitment to our inflation-control targets.