Monetary policy and the Canadian economy in a changing world

The Dr. Harold Walter Siebens Lecture

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Governor of the Bank of Canada

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The performance of the Canadian economy is a popular topic these days. Canadians wonder why our economy seems to have been struggling recently, turning in a lacklustre performance that has left the unemployment rate high and a significant margin of our production capacity unused.

When people focus on the recent record of the Canadian economy, they point in particular to the contrast with the United States where the economy has been operating at close to full capacity over the past couple of years. The United States is by far our most important trading partner. And in the past, economic developments in Canada have tended to follow reasonably closely those in the United States. Naturally, people want to know what is different this time.

The fact that the Canadian economy has not been expanding at a strong pace is also worrying to governments trying, as they are, to address budgetary problems. They are concerned that fiscal cutbacks may weaken the economy further.

Of course in all of this, questions are also raised about the role of monetary policy. I would like to take this opportunity today to discuss the factors that have affected the recent performance of the Canadian economy, to explain the role that monetary policy has played, and to conclude with some comments on our future economic prospects.

The Canadian economy in a changing world environment

The world economy has been going through profound changes.

Many developing countries have embraced open markets and international trade as a means of accelerating their economic progress. Deregulation and privatization initiatives have been undertaken by both developing and industrial countries, typically as part of structural adjustment programs to improve economic performance.

Technological changes have reduced the cost of capital relative to labour, encouraging businesses to use more physical capital, in particular more computers and computer-based equipment. And there has been an accompanying shift in the demand for labour away from unskilled workers.

These technological innovations, along with reductions in transportation and communications costs, have also made possible a wider geographic dispersion of the production process -- not just nationally but internationally. And to ensure access to foreign markets, countries have been pursuing multilateral and regional trading arrangements.

As a result, all nations have been adjusting to the new reality of heightened international competition and to the accompanying substantial shifts in the location of production of many goods. Such shifts have not been limited merely to the diversion of the production of goods requiring unsophisticated techniques to the developing countries. Indeed, some developing nations, particularly in Asia, are establishing themselves as important suppliers of a wide range of internationally traded products, including high-technology manufactured goods. At the same time, industrial economies are moving more towards the export of services, as a result of improvements in communications and information technology.

All in all, these changes are to the good, in that they should result in expanding international trade, more rapid increases in productivity and, hence, improved living standards everywhere, but especially in developing countries. However, these ongoing globalization trends and adjustments to new technology do imply changes in the structure of national economies.

Canada and other industrial countries are having to cope with these changes. But change is never easy and is often stressful. Even in the large U.S. economy, there has been considerable concern over the uncertain job prospects, especially for unskilled workers, in light of the changes in technology, production and trade trends that I have just described. However, the process of adjustment in the United States to these developments began early, and their economy has been operating successfully at full capacity.

Why is it that in Canada we seem to have had a more difficult time of it? There are a number of reasons for this. But, in my view, one of the most important is the fact that in Canada we started adjusting later and, as a result, we were further behind. Why was that?

The depreciation of the Canadian dollar in the mid-1980s, by easing the pressure from foreign competition, blunted the urgency to adopt more efficient production processes. And through much of the second half of the 1980s, because many Canadians were still acting on expectations of accelerating inflation, we were devoting a good part of our energies and resources to speculative activities, rather than investing in improvements in productivity and competitiveness. Rising government deficits, which were absorbing increasing amounts of domestic savings, were not helping either. Thus, with poor productivity growth, rapidly rising wages and generally weak cost control, Canadian businesses and exporters found it increasingly difficult to compete, especially at the end of the 1980s, when the Canadian dollar had reversed its earlier depreciation.

For a nation that is highly dependent on foreign trade, Canada certainly was doing all the wrong things to get ready for the new world of changing technology and increasing global competition. It was not until the early 1990s that many Canadian businesses realized that they had to undertake major adjustments. They had to restructure, invest in new technology and implement tight cost control. And they had to do it quickly if they were going to position themselves to take advantage of the Free Trade Agreement with the United States, the subsequent North American Free Trade Agreement and then, more generally, the multilateral agreement on trade liberalization.

Adjustments of this magnitude are never easy. They are often disruptive and stressful, generating a great deal of uncertainty about the future for both individuals and businesses. But because the adjustment process was delayed in Canada, it ended up being more far-ranging and more intense than in the United States. For many businesses, restructuring has meant downsizing.

But the business sector has not been the only area of the Canadian economy in need of an overhaul. There has also been an urgent need for fiscal adjustment. Here again, that adjustment was late in coming. As a result, the cutbacks and downsizing necessary to restore fiscal health have been more sweeping and more disruptive than if action had been taken much earlier.

Thus, we have had two major structural adjustments vital to our economy taking place back to back. Indeed, over the past year, these adjustments have been overlapping, and that may continue for some time. And while a good deal of the restructuring in the private sector has already occurred, the adjustment in the public sector still has some way to go.

This restructuring has affected the unemployment rate as more people move between jobs, taking time to retrain and upgrade their skills. And the related uncertainty among workers has been reflected in low consumer confidence and an unwillingness to spend. As a result, the recovery of the Canadian economy has been 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 necessary, and it will have significant payoffs for the Canadian economy in terms of productivity gains, competitiveness and an improved standard of living.

The role of monetary policy

What has been the role of monetary policy in all of these developments? Should monetary policy have been following a different course to ease some of the difficulties that our economy has encountered?

During the last half of the 1980s, monetary policy sought to prevent excessive demand pressures from fuelling an accelerating trend of inflation. The intention was to put inflation on a gradual downward trend once the demand pressures subsided.

In February 1991, the Bank of Canada and the federal government made a formal commitment to price stability as the objective of monetary policy. To make the path to price stability more explicit, the Bank and the government agreed on specific targets for inflation control. The targets aimed at bringing inflation (as measured by the consumer price index) down from about 5 per cent at the end of 1990 to 2 per cent by the end of 1995.

Inflation decelerated sharply between 1991 and 1992 -- much more than the Bank had anticipated or indeed was aiming for. This was mainly the result of the sharper-than-expected downturn of the Canadian economy in 1990-1991 and the subsequent slow recovery. Our economy had to cope with both the economic distortions caused by past high inflation and with the large and overdue adjustment needed to respond to the changes in technology and the more open and competitive world markets that I have been describing.

When I reflect on the view expressed by the Bank's critics that the 1990-1991 recession, the slow recovery and the sharp deterioration in our fiscal situation were all caused by an excessively tight monetary policy in the late 1980s, I find it useful to ask what would have happened if monetary policy had in fact been less anti-inflationary in the late 1980s.

I believe that such a policy would have led to even greater inflation-related distortions in our economy, an even more pronounced recession afterwards and still greater problems for businesses trying to adjust to the new technology and the more competitive international environment. Moreover, higher inflation would have led to higher interest rates and more expensive debt-servicing costs for governments and other debtors. Indeed, with the benefit of hindsight, if there is a lesson in this experience, it is that the Bank should have pursued tighter monetary policy earlier in the second half of the 1980s. A tighter monetary policy earlier on might have moderated some of the speculative activity and debt accumulation that subsequently weighed so heavily on our economy.

The other lesson is that fiscal policy, too, should have been tighter during that period. With a tighter fiscal policy, some of the buildup of public debt that governments are now having to contend with would have been avoided. More fiscal restraint during the second half of the 1980s would also have moderated the excess spending demands on the economy, removing some of the upward pressure on interest rates and the Canadian dollar at the time.

Since the sharp deceleration of inflation in 1992, the role of monetary policy has been to keep inflation low. In doing so, monetary policy has provided Canadian businesses with a more stable, lower interest rate environment in which to undertake the investments and cost controls necessary to adjust to the new competitive reality I have described.

Looking to the future

So, where is the Canadian economy now, and what are the prospects for the future?

I believe that Canadian business has gone through a remarkable transformation in the last few years. There has been substantial investment in machinery and equipment, particularly in computer-based technology, to improve productivity. And strict cost control is now the norm. As a result, Canadian businesses have become much more competitive, both at home and internationally. The low Canadian dollar has, no doubt, also been helpful in this respect. But businesses are using the low exchange rate to help them get into new world markets and expand their market share rather than needing it to offset uncontrolled costs and poor productivity.

The benefits from this restructuring can already be seen in the success that Canadian businesses have had over the last few years in exporting their products and in competing with imports within Canada. Indeed, exports are likely to remain the main locomotive for economic expansion in the period ahead.

The restructuring process for the public sector is not that far advanced as yet. As I noted earlier, most governments in Canada took major steps last year to reduce their fiscal deficits. However, public debt levels remain high in relation to our total national income. Evidence of investor concerns about these debt levels, and about political uncertainty, can be seen in the persistence in Canada of medium- and longer-term interest rates that are high relative to similar rates in the United States. These high interest rates have the potential to discourage some of the investments that will be needed to keep the Canadian economy productive and competitive in the future. In order to reduce these interest rates, Canadian governments must stay the course of fiscal consolidation, and bring down the levels of public debt in relation to national income.

The largest part of economic activity in our country revolves around the spending by Canadian households on consumer goods of all kinds and on housing. This has been the area most affected by the stresses and uncertainty of the restructuring.

As I said before, a good deal of the restructuring in the private sector has already occurred. And private sector jobs have been increasing -- by 3.5 per cent in 1994 and 1.5 per cent in 1995. We now need to reduce some of the anxiety associated with public sector restructuring by getting on as quickly as possible with the fundamental decisions needed to put government programs and their funding on a sustainable basis.

As for monetary policy, our good inflation performance and the fiscal measures taken so far have given the Bank of Canada some room to ease monetary conditions in Canada. I believe there is now substantial monetary stimulus in the economy, which should help counteract some of the concerns that affect the confidence of Canadians, as we work our way through this crucial period of restructuring the Canadian economy.