BANK OF CANADA

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Notes for remarks by

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The Bank of Canada is a public institution that must be accountable to Canadians for its actions. That is why I and my colleagues at the Bank welcome opportunities to explain monetary policy and to talk with audiences all across Canada. I believe that our economy functions better, and monetary policy is more effective, if people know what their central bank is up to and why. But the Bank also needs to be well informed about the economy in all parts of the country and about the public's views and concerns regarding monetary policy. And when views differ, Canadians should expect us to explain the differences and respond to them.

Today, I propose to discuss some of the ideas you have probably heard about recently: that the Bank of Canada has worked too hard to reduce inflation and that we could use more inflation to grease the wheels of the economy. The suggestion is that the Bank, with its focus on bringing inflation down and keeping it down, is largely responsible for Canada's sluggish pace of economic expansion and stubbornly high unemployment rate during the 1990s, especially when compared with the United States. Moreover, in this view, a monetary policy that emphasizes price stability will somehow always be too tight to allow the economy to achieve its full potential in the future. The conclusion that follows is that Canada would be better off if the Bank relaxed its stand on inflation control and allowed the rate of inflation to rise above the current target range of 1 to 3 per cent.

You will not be surprised to hear that I do not agree with this one-dimensional explanation of the economic problems of the 1990s. And I certainly do not agree with the proposal to relax our inflation-control targets. This country has come a long way in restoring the credibility of its economic policies and improving its prospects for the future. I can think of no quicker way to undermine the progress we have made than to start backsliding on inflation control.

But before I address this issue further, I want to give you my understanding of economic developments during the first half of the 1990s and to explain why I see things shaping up rather well for Canada in a future with low inflation.

Explaining the 1990s

I believe that the reasons for the overall lacklustre performance of the Canadian economy in the first half of the 1990s are much more complex than the simple explanation that monetary policy has been too focussed on reducing inflation.

This explanation ignores some important economic realities that many Canadians have not been able to ignore in their daily lives. It certainly downplays the importance of the major transformation that our economy has been going through since the beginning of this decade. This transformation has caused a lot of stresses and strains among businesses and households. It has been the source of uncertainty about future job security and has led to an undermining of consumer confidence. But, as I will explain, these are temporary problems, and we are building the base for a more prosperous future.

The fact is that Canada had no real choice but to make these difficult yet very necessary economic adjustments. By the late 1980s, the Canadian economy was on a path that could not be sustained over time. Inflation was not under control, and expectations were that it would rise. Those expectations encouraged a surge of speculative activity, particularly in real estate. Many individuals and businesses were spending a great deal of their time and resources, and were accumulating debt, trying to maximize potential gains from inflation, rather than looking for ways to increase efficiency, productivity and competitiveness. Largely because of this, Canadian firms were slow in responding to the challenges of the technological changes and increasingly open and competitive markets that were transforming the world economy. U.S. firms began this process of change much earlier and were well advanced by the end of the 1980s.

The business sector was not the only area of the Canadian economy in need of an overhaul. Through the 1980s and into the early part of the 1990s, Canadian governments continued to run large deficits that were adding to our public debt at a faster rate than the economy was growing. The ratio of government debt relative to the size of our economy doubled between 1980 and 1990.

And because governments were absorbing such a large share of domestic savings, we as a nation were borrowing more and more from abroad. As a result, our foreign indebtedness was also rising rapidly.

Holders of Canadian debt, both foreigners and Canadians, began to worry about our ability to carry these large debts when the speculative bubble in Canada burst in 1990-91. With real estate and other asset prices falling and with productivity not expanding sufficiently to boost incomes, debt-service costs became very burdensome for many borrowers. And lenders started to demand that our interest rates include risk premiums to compensate for these concerns.

This situation was clearly untenable. If we delayed dealing with these problems, savers and investors placing their funds in financial markets would demand more and more protection against the risks involved in lending in Canada, in the form of higher interest rates. We had a taste of this in 1994 and early 1995. This kind of market response effectively leads to a decline in our living standards, since we end up paying an increasing share of our national income to service our debts.

In both the private and public sectors, the needed adjustments were late in coming. Because Canadian firms started later than their U.S. counterparts, the process of restructuring has been more intense and disruptive than in the United States. Needless to say, for many businesses, restructuring has meant layoffs. Similarly, in the public sector, the cutbacks necessary to restore fiscal health have been larger and more sweeping than if action had been taken earlier.

With these two major structural adjustments taking place back to back in the first half of the 1990s, the recovery of the Canadian economy has been slow. And the short-run disruption associated with these changes has naturally focussed attention on the costs of restructuring, which are direct and immediate, rather than on the underlying longer-term gains.

Where is the Canadian economy now?

I do not want to minimize the short-run costs to Canadians of this major restructuring we have been going through. But I believe it is important that we not lose sight of the benefits. So I now want to remind you how much we have already accomplished and to assure you that we are indeed beginning to see light at the end of the tunnel.

The response to the problems we were facing at the beginning of this decade has been remarkable -- a real success story. We have made some rather dramatic economic adjustments in this country. Canadian firms have invested in new technology. They have become more productive and more outward-looking. And with these improvements, they have been able to take advantage of a favourable exchange rate to break into new external markets and to expand their market share. Low inflation has contributed to this transformation by encouraging better cost control and providing a more stable environment for sound decision-making. While inflation came down rather more rapidly than the Bank had anticipated in the early 1990s, it has remained relatively stable, within a range of 1 1/2 to 2 per cent, for most of the past four years.

The restructuring of the public sector is also proceeding apace. Deficits are being brought down at both the federal and provincial levels. However, what investors really care about is the level of government debt outstanding relative to the size of our economy -- the ratio of debt to gross domestic product. Next year, this ratio should decline and, on the basis of federal and provincial budget plans, it should continue downwards in the future. This is important. Such a decline is needed to restore fully our financial health.

With the business sector's success in exporting and the reduced borrowing needs of Canadian governments, we have recently eliminated the persistent deficit in the current account of our international balance of payments. This means that, as a nation, we are no longer building up our indebtedness to foreigners.

As I said earlier, there is no doubt that the changes involved in these economic adjustments have meant a great deal of anxiety and uncertainty for Canadians. Jobs have changed, and many jobs have disappeared. There has not been much inclination among households to spend, especially on big-ticket items such as housing and cars, and this is understandable in the circumstances. In a sense, our economy has not been running on all cylinders -- it has been propelled largely by exports.

But because of the fundamental improvements in our economy that I have described, the risk premiums that had earlier raised our interest rates have been coming down, and our currency has been firm. In these circumstances, the Bank of Canada has been able to lower short-term interest rates. Most interest rates are now lower in Canada than in the United States -- from the short end all the way to terms of almost 10 years.

I believe that it is only a matter of time before this monetary easing encourages a resurgence in household spending. Indeed, some indicators of consumer and housing activity have a more positive tone to them. And the private sector continues to create new jobs, more than offsetting the ongoing cutbacks in public sector employment. While the improvements have been slow in coming, and our unemployment rate remains high, the economic outlook is favourable. We will soon see signs of the payoff for the difficult restructuring decisions taken in both the private and public sectors.

With this perspective on the economic events of the last six years, we may ask ourselves what would have happened during this period if the Bank of Canada had pursued a monetary policy that was more tolerant of inflation. Would economic progress have been greater? Would the costs of adjustment have been smaller? Absolutely not!

Inflation masks the need for adjustment. With more inflation, we would have ended up with greater economic uncertainty, higher interest rates and a slower process of adjustment in both the private and public sectors. And higher interest rates would have made it even more difficult to cope with our accumulated debts. All in all, we would not be looking at an economy with the sound foundations that ours has today -- that is, a strongly competitive business sector, markedly improved fiscal and external positions, and the lowest interest rates in over 30 years.

What about the future?

You may agree that monetary policy was correct in aiming to bring down inflation from the peak it reached at the beginning of the 1990s, but you may still worry about the future. Would the economy work better if monetary policy was less concerned with inflation control and more accepting of some ongoing inflation? There are at least two questions here. One is whether the Bank's focus on low inflation leads to a monetary policy that fails to support the growth of incomes and employment in our economy. Another question is whether, at very low levels of inflation, the economy is deprived of a lubricant that helps it run more flexibly and smoothly.

Let me respond first to the question of whether monetary policy is too narrowly focussed on price stability, at the expense of incomes and job creation. Not the way I see it. In fact, when the Bank takes actions to hold inflation inside the target range of 1 to 3 per cent, monetary policy operates as an important stabilizer that helps to maintain sustainable growth in the economy. When economic activity is expanding at an unsustainable pace, pressing on the limits of production capacity and threatening to push the trend of inflation through the top of the target range, the Bank will tighten monetary conditions to cool things off. But the Bank will respond with equal concern, by relaxing monetary conditions, when the economy is sluggish and there is a risk that the trend of inflation will fall below the target range. A case in point is the easing of monetary conditions in Canada over the past year. While there is always some lag in the impact of monetary policy on the economy, what this approach does is provide monetary support that, over time, will help economic activity and employment to grow at their potential.

This is a very important point. The potential for the economy to grow over time can change, depending on such things as investments in technology and increases in productivity. A monetary policy focussed on inflation-control targets ensures that the central bank will not inadvertently make systematic misjudgments about how fast our economy can grow. If the growth potential has improved, the resulting increase in the production capacity of the economy will tend to put downward pressure on inflation. This will encourage the Bank to ease monetary conditions to support faster growth in activity and employment and prevent inflation from falling below the bottom of the target range. The reverse is true if potential output is growing more slowly than we realize and inflation is tending to rise.

The second question I want to deal with is whether we need some inflation to grease the wheels of our economy. At any one time, there are usually some sectors of the economy that are having to adjust to difficult circumstances. The ability of firms in these sectors to make the needed adjustments will be improved if there is some flexibility in their labour costs. The argument for a moderate amount of ongoing inflation is that it presumably helps to provide that flexibility. Although employees may strongly resist rollbacks in their compensation, they will accept an effective decline in wages due to inflation, so the thesis goes. If labour costs cannot be reduced, employers will be forced to cut jobs instead. The conclusion drawn from all this is that without the lubricant of some inflation, our unemployment rate will be high and our economy will never perform as well as it should.

However, inflation will work as a lubricant only if it fools people into believing that they are better off than they really are. But our experience during 20 years of relatively high inflation in the 1970s and 1980s is that Canadians soon figured out the changes in the purchasing power of their wages and salaries, after accounting for inflation. Employees who were willing to accept an increase of only 2 per cent in their wages at a time when inflation was 4 per cent were well aware that this meant a cut of 2 per cent in their purchasing power. Why would they not be able to figure out just as easily that a wage cut of 2 per cent with no inflation amounts to the same thing? There is, in fact, every reason to expect that people's behaviour adapts to circumstances. In a low-inflation environment, employees are likely to come to understand the need for occasional downward adjustments in wages or benefits in struggling industries, just as they accepted less than full compensation for inflation in such industries at times over the past 20 years. To assume otherwise implies that people are permanently irrational. This strikes me as a poor premise on which to base monetary policy.

Our economy has shown remarkable flexibility in adjusting to the major transformations I described. There is no reason to think that we need to rely on the misperceptions and unfairness created by inflation to get the flexibility we will need to cope with future change.

Let us be clear. What our past experience teaches us is that inflation creates uncertainty and instability -- <u>not</u> the conditions for durable growth and job creation.

Concluding thoughts

In conclusion, let me say that I have heard no persuasive arguments for changing the economic policies that have helped to bring about the recent improvements in the foundation of our economy. Certainly any sign of a reversal in monetary policy could quickly undo some of these improvements.

I am convinced that the Canadian economy is on the right path. The benefits of the economic transformation we have undertaken are on the way. We just need to stay the course.