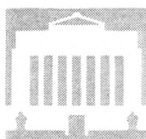

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Monetary policy and the prospects for a stronger Canadian economy

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Notes for remarks by

Gordon Thiessen
Governor of the Bank of Canada

to the

Canadian Association for Business Economics
and the Ottawa Economics Association
Ottawa, Ontario
21 March 1997

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Monetary Policy and the Prospects for a Stronger Canadian Economy

Anyone who has read our last *Monetary Policy Report*, the winter issue of the *Bank of Canada Review*, or our just-released *Annual Report* knows that the Bank has been positive about Canada's economic outlook. Basically, we are looking for a solid pickup in the pace of economic expansion in coming months, with inflation remaining low. And, with improvements in the basic foundation of our economy, we see the potential for sustained good economic performance over the medium term.

Not everyone is as upbeat as we are. Some analysts are rather sceptical, especially of the fairly strong recovery that we foresee in household spending. They see Canadian households carrying too much debt, a personal savings rate that is already too low, and an unemployment rate that is too high to sustain much of an increase in spending.

Others seem to have difficulty reconciling an optimistic outlook on the rate of economic expansion with a scenario of continued low inflation. In this group, some are afraid that the Bank will react too quickly to an acceleration of inflation, frustrating the economic recovery. Another camp is worried that the Bank will let inflation get away, with all the costs that that would entail.

Today, I would like to use this opportunity to address some of these issues. I believe that I can offer good reasons -- and monetary policy is one of them -- why we in Canada should be upbeat about our economic future.

Why is the Bank optimistic about an expanding economy?

The Canadian economy has been undergoing extensive transformation. And clearly we are not out of the restructuring woods yet. This restructuring has been spawned by rapid technological advancements, increasingly open and competitive world markets, the decline of inflation in Canada from the high levels of the past, and the need to reverse an unsustainable trend of debt accumulation, particularly by Canadian governments.

But over the last few years, Canada has made great strides in dealing with these issues. As a result, I believe that we now have a much more efficient and competitive private sector. We also have a fundamentally improved macroeconomic policy situation. Fiscal policy has been successful in reducing deficits, and governments have been moving towards less vulnerable debt positions. Inflation is low and relatively stable within the Bank's inflation-control target range.

Together, these improvements in our basic economic circumstances have facilitated the major decline that we have seen in domestic interest rates over the past year or so. Many interest rates in Canada are now at their lowest levels since the 1960s. And for maturities of up to 10 years, they are also below comparable U.S. rates by the widest margins we have seen in many years.

Some of the gloom about the economy during the past year had to do with the perception that the stimulus to economic activity from the decline in interest rates was taking a long time to have its effects on spending and employment. There are, of course, lags in the impact of monetary policy actions on the economy that are widely believed to be of the order of 12 to 18 months. However, what may not have been widely appreciated was that the reductions in short-term rates that began in the spring of 1995 initially just reversed the runup in rates that occurred after the Mexican currency crisis and before the 1995 federal budget. The real easing in monetary conditions relative to 1994 effectively started only in late 1995, following the Quebec referendum, and continued for one year to late 1996. Therefore, it is not surprising that signs of the response to that easing have only been apparent quite recently.

Because of the lags involved, the contribution of the easier monetary conditions to a stronger expansion in output and employment should continue for some time. Thus, we expect the

economy to expand at rates in excess of the growth in potential output through 1997 and 1998. In other words, we anticipate that the margin of unused capacity in our economy will shrink substantially over the next couple of years.

As I noted, there are those who view this outlook with scepticism. For them, it is not a question of lags. They argue that the current very low interest rates will not do enough to encourage additional household spending, given high debt levels, a low savings rate, and high unemployment.

I will not tell you that these factors cannot temper the response to low interest rates. Of course they can. But I do not believe they are sufficiently important to offset it. Let me take the arguments in turn.

First, household debt levels. Yes, they are high relative to personal disposable income -- over 90 per cent. But the burden of servicing this debt represents only 8 per cent of disposable income -- well down from the peak in 1990 -- and is expected to continue to fall as debt is rolled over, or new debt taken on, at lower interest rates. In addition, over three-quarters of household debt is in mortgages, which have financed the purchase of houses. Households have also been accumulating financial investments. In fact, the net worth of the household sector has been rising, although, of course, the assets and debts are not equally distributed across households. The important point I want to make is that, if you take the household sector as a whole, it is not buried under a mountain of debt, with high servicing costs, no assets, and no spending power.

Second, the personal savings rate. In this case, there are valid concerns that we have been underestimating savings by ignoring capital gains, particularly on investments in stocks, given the rise in the stock market. If we look at the conventional measure of personal savings, the savings rate of 3 1/4% in the fourth quarter of 1996 is indeed low. But this does not mean that it could not remain low for a time (or even go lower temporarily) while the economy is recovering. This is, in fact, what we would expect to happen if significant numbers of households decided to cash in some of their accumulated financial assets in order to spend.

Third, the high unemployment rate. This argument sounds like a "Catch 22": the high unemployment rate discourages people from spending, which keeps unemployment high, which discourages spending still more. I believe that this grim

picture overstates the problem, given that over 90 per cent of the workforce ***is*** employed. And yes, there are still cutbacks and layoffs, especially in the public sector. However, private sector employment continues to expand. Since the beginning of 1996, the private sector generated some 210,000 net new jobs, six times as many as were lost in the public sector. Undoubtedly, employment concerns remain, but the quickening of output growth that began in the second half of last year, should lead to sustained growth in private sector employment over the course of 1997, and to improved consumer confidence.

You can see that I did not find the arguments against a strong comeback in consumer spending persuasive. Moreover, these negative influences must be weighed against the size of the easing in interest rates that has taken place since late 1995. Short-term rates are down by about 3 percentage points, medium-term rates by 2 percentage points and longer-term rates by 1 1/2 percentage points. Another indicator of the extent of easing in monetary conditions is the growth of the narrowly-defined monetary aggregate, M1. This aggregate, which provides advance information on the near-term expansion of the real economy, has recently accelerated to a year-over-year growth rate of over 15 per cent.

But, of course, in the end, it is the recent evidence from the interest-sensitive sectors of the economy that is the most telling. As the economic results for the second half of 1996 show, and the more recent monthly indicators confirm, there have been substantial increases in spending on housing, motor vehicles and other consumer durables. Sales in these sectors have picked up in response to the lower interest rates, just as expected.

All things considered, I believe there are good reasons to expect solid economic expansion in coming months.

What are the risks that inflation will accelerate?

Let me now turn to the inflation implications of this scenario. If the economy grows at the above-potential rates that the Bank foresees, won't inflation accelerate? As I noted, this question seems to lead to two, quite opposite, concerns. One group of commentators fears that the Bank will respond, either too quickly or unnecessarily, to an acceleration of inflation and cut off the economic expansion. Another group worries that the

Bank will let inflation get away, resulting in another cycle of boom and bust.

There seems to be a certain confusion around this issue. Some people apparently assume that it is the ***speed*** at which the economy is growing that determines whether inflationary pressures will increase or decrease. While the rate of growth is not irrelevant, what really matters is the ***level*** of economic activity relative to the production capacity of the economy -- in other words, the margin of slack or the output gap in the economy. The size of the output gap, interacting with inflation expectations, is the principal force behind increased or decreased inflationary pressure.

Thus, one would expect inflation to start accelerating only after a period in which the level of aggregate demand had exceeded the economy's capacity to produce on a sustained basis. That is by no means the situation we face in Canada today. In fact, we have a fairly large margin of spare capacity. Even with the more rapid pace of expansion we experienced in the second half of 1996, we estimate that the level of real GDP was still, on average, about 3 per cent below the level of potential output.

This means that the Canadian economy should have room for strong, above-potential rates of growth in output and employment in coming quarters, without a resurgence of inflation.

But what about the current rapid rates of money growth? Are they not inflationary?

The 15 per cent year-over-year growth of the M1 aggregate that I mentioned a moment ago is certainly high, and if it persisted for very long, it would not be consistent with preserving low inflation. But there are currently some special factors in the picture which suggest that a temporary period of rapid M1 growth would ***not*** be inflationary. These are the recent changes in the nature of business chequing accounts and the need for an adjustment in the stock of money held for transactions purposes, in response to the low levels of interest rates and the move of the economy towards full capacity. Moreover, the recent evolution of the broader monetary aggregates continues to point to low inflation.

The important role of inflation-control targets

I believe that the role of inflation-control targets in the Bank's conduct of monetary policy provides additional credibility to this scenario of non-inflationary economic expansion.

First of all, with the success we have had in meeting these targets and their growing credibility, inflation expectations appear to have diminished. That makes our job easier these days. In the past, when inflation was high, any signs of demand or price shocks would worsen inflation expectations and add to upward pressures on inflation.

Inflation-control targets are also important in dealing with possible changes in the growth potential of the economy. Such changes can result, for example, from additions to the capital stock and increases in productivity. Potential output growth in Canada is expected to increase over the next few years, with the cyclical rebound in productivity and with improvements from ongoing restructuring and investments in technology. There is also a debate going on, particularly in the United States, as to whether there has been a structural change in the way an economy operates. Have more open and competitive international markets effectively increased the capacity of the economy to expand without generating inflation pressures?

The Bank tries to take all these considerations into account when forming a view about the inflation outlook. But estimates of potential output are difficult to make, and they have a wide margin of error around them. A monetary policy focussed on inflation-control targets ensures that the Bank will not inadvertently make systematic misjudgments over time about how fast the economy can grow. How does that work? An unforeseen improvement in potential will tend to put unexpected downward pressure on inflation. That will encourage the Bank to ease monetary conditions to support a faster expansion in output and employment and to prevent inflation from falling below the bottom of the target range. The reverse would be the case if potential was growing more slowly than we realized and inflation was tending to rise.

Moreover, by responding to the trend of inflation relative to the target range, as I have described, monetary policy will also act as an important stabilizer for the economy over the medium term in the face of cyclical fluctuations. The

targets effectively call for the Bank to tighten monetary conditions when demand in the economy approaches unsustainable levels, pressing against capacity. But they also call for easier monetary conditions when demand is weak, leaving slack in the economy.

Monetary policy targets focussed on inflation were initially developed to help reduce persistent high inflation in an orderly manner. But I believe that such targets continue to provide the best framework for the conduct of monetary policy, even at low rates of inflation.

Concluding comments

In recent years, Canada has made significant progress in restoring the credibility of its macroeconomic policies and making the adjustments necessary to lay the foundation for a more efficient, prosperous economy in the future. We are now beginning to see the payoffs from this economic transformation.

The best contribution the Bank of Canada can make to sustaining these positive trends is to foster a monetary environment of confidence and stability. And that is what we intend to deliver with our commitment to targets for inflation control.