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*** QUESTIONS-TEL. 782-8000 ***
R=013342 I=0072 C=002 G= DATE:97-10-08

to the

Vancouver Board of Trade
Vancouver, British Columbia
7 October 1997



Not for publication before 7 October 1997

1:00 p.m. Pacific daylight time

4:00 p.m. Eastern daylight time

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Governor of the Bank of Canada
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Challenges ahead for monetary policy

Today, I would like to talk about some of the important issues and challenges facing monetary policy in the period ahead and how the Bank of Canada proposes to deal with them.

This is not an unusual topic for me since the business of central banking is seldom without challenges. But what a difference the past two years have made to the challenges we face!

Let me remind you that it was in late 1995, when investors' concerns about Canada's fiscal and political problems finally began to recede, that the Bank of Canada was able to take action to provide substantial monetary support to the economy. This action, which continued over the next year or so, was designed to offset both the direct impact on the economy of fiscal restraint and the effects on consumer confidence of the difficulties and uncertainties arising from the major restructurings that were necessary in both the private and public sectors.

In response to the monetary stimulus, the economy has gathered momentum and finally seems to have pulled free from the difficulties associated with the restructuring. Indeed, economic activity has accelerated this year and has expanded by about 4 per cent over the course of the past 12 months.

With the economic momentum expected to continue at a solid pace in the period ahead, monetary policy now faces new challenges. Over the next year or two, as the remaining slack is absorbed and we move towards full use of the economy's capacity to produce, the issue for monetary policy will be to try to

ensure that this process goes smoothly and that inflationary pressures do not re-emerge.

Further down the road, we will also have to concern ourselves with the conduct of monetary policy as the economy operates under conditions of full capacity. With all the structural changes that have taken place in Canada and around the world in recent years, one important issue will be to gauge just how rapidly our economy can grow on a sustainable basis -- that is, without generating inflation pressures -- and what this implies for the employment picture in Canada. The challenge for monetary policy at that stage will be how best to deal with the uncertainty surrounding estimates of the economy's potential to produce.

The conduct of monetary policy through the economic upswing and then under conditions of full capacity are the two topics I would like to discuss with you today.

Returning to full capacity

Let me start with the immediate challenge for monetary policy -- to promote monetary conditions that will preserve Canada's good inflation performance through the current economic upswing, thereby helping to make this economic expansion a long-lasting one.

As I mentioned, monetary conditions in Canada have been very stimulative for over a year. With growing evidence that economic activity was expanding smartly, the Bank of Canada began reminding Canadians that, as slack in the economy is taken up, there would be a need to move to less-stimulative monetary conditions. We took a step in that direction last week when we raised our Bank Rate by 1/4 of a percentage point to 3 3/4 per cent.

This kind of action can set off alarm bells in the minds of some people. They may wonder why the Bank of Canada is "slamming on the brakes" when the economy has only just begun to pick up and the unemployment rate is still high. I would like to respond to any such concerns by explaining what Canadians can expect from their central bank in the period ahead and why.

But before I do so, I would like to remind you that, when we at the Bank talk about how stimulative monetary

conditions have been, we are not just looking at short-term interest rates (which are still near their lowest levels in decades and well below comparable U.S. rates). Monetary conditions also take into account the effects on the economy of changes in the exchange rate for the Canadian dollar. For example, the relatively low value of our dollar has been a major source of stimulus for Canada's export sector. So a proper assessment of the degree of monetary ease in the economy has to consider both our low interest rates and the relatively low Canadian dollar.

Now, what about the perception that any move by the Bank of Canada to less-stimulative monetary conditions means "slamming on the brakes" for our economy? Let me stay with the automobile analogy for a moment. To get the economy moving, the Bank has been pressing hard on the monetary accelerator. But once the economy picks up speed, just as with a car, you need to ease off gradually on the accelerator and steady your cruising speed at a safe level. If you press hard on the accelerator for too long, you will reach speeds that are unsafe. You risk losing control and getting into serious trouble. The same holds true for the economy. Too much monetary stimulus can lead to an exhilarating temporary burst of economic activity. But it will almost certainly also lead to inflation-related distortions that undermine both the expansion and the economy's efficiency over the longer term. The end result, as we know only too well from past experience, is high interest rates, punishing debt loads, recession, and higher unemployment.

A further complication is that it takes between a year to a year and a half for the economy to fully respond to changes in the degree of monetary stimulus. In this sense, the economy is like a car that doesn't respond immediately when you ease off on the accelerator but only a mile or so further down the road. With such a car, you want to be able to look a long way ahead to see what is coming, and you want to take action early to ensure that your speed is appropriate. This is why monetary policy must focus on the future, rather than the present, and why the Bank must act in a forward-looking, pre-emptive manner.

In other words, if we want our economy to reach full capacity relatively smoothly, without the risk of repeating the painful, inflation-related boom and bust cycles of the past, we must be ready to take timely action. If we wait to act until the economy is going flat out and pressing hard on the limits of its capacity to produce, we will have waited too long.

Thus, some combination of a further rise in short-term interest rates and an increase in the value of the Canadian dollar will likely be necessary in coming months. I hasten to add that such a rise in short-term rates is the best way to preserve medium- and long-term rates at low levels. And it is these longer-term rates that are so important for the investments in new technology and other initiatives to increase productivity that Canadian businesses need to stay competitive. Let me reassure you that we are not talking about anything like the short-term interest rate increases that we saw in the 1970s and 1980s, or even in 1995. In an environment of low inflation and improved fiscal health, interest rates should not have to get that high again.

You will not be surprised that I cannot give you in advance precise information about any further action the Bank may take to reduce the amount of monetary stimulus in the economy. What I can tell you is that it is the strength of the momentum of demand, and thus how quickly the economy approaches the limits of its capacity to meet that demand, that will determine the timing and extent of our response. Close monitoring of the strength of demand in the economy, and timely, measured steps in the right direction, will help us avoid the more substantial, and potentially more disruptive, tightening that would be required later on if monetary policy actions were unduly delayed. Moreover, the magnitude of the increase in short-term interest rates will be influenced by the extent of the exchange rate response.

I hope this makes it clear that what the Bank of Canada has in mind, and is aiming for, is a "gradual easing off on the accelerator" in the months ahead, so that there will be no need to "slam on the brakes" later on.

Making the most of the economy's production potential

Next, let me say a few words about the challenges that await us further down the road.

One of the more remarkable international economic developments of the past few years has been the performance of the U.S. economy. That economy has had six years of solid economic expansion, with high rates of job creation and low inflation.

In the late 1980s, when the U.S. unemployment rate dipped below 6 per cent, there were strong inflationary pressures. Compare this with the present situation: the U.S. economy has been expanding at an average rate of about 3 1/2 per cent for 8 quarters, current levels of demand are above most estimates of its capacity to produce, and the unemployment rate has been at or below 5 per cent for several months. Yet inflation has remained well behaved. What is happening? Are we operating in a different environment?

There are, of course, some temporary factors -- such as the appreciation of the U.S. dollar, the decline in energy prices, and the slack in overseas economies -- that are currently helping to suppress inflationary pressures in the United States. However, a number of observers are suggesting that other, more permanent factors may also be contributing. One possibility, which has been rather widely discussed recently, is that all the structural changes that have taken place in the United States have raised the production capacity of the economy and reduced the risk of inflation. I believe that another important factor in this success story has been the strong credibility of monetary policy in the United States. By persuading Americans that it is determined to maintain low inflation, the U.S. Federal Reserve has given itself room to test the potential of the economy without triggering the quick response in wages and prices from worried workers and businesses that we saw during the years of high inflation.

How does this U.S. experience relate to Canada? Can we also look forward to an improvement in the longer-term performance of our economy? Unfortunately, it is not possible to make that judgment in advance, given the complexity of the factors affecting economic performance. How rapid growth can be and still be sustainable, and how low our unemployment rate will go, will ultimately depend on the flexibility, efficiency, and productivity of Canadian enterprises. I am referring here to the effective use of new technology; the skills, training, and adaptability of our labour force; our ability to control costs; and the initiative and ability of Canadian businesses to find and develop new and expanded foreign markets for their products.

The contribution that monetary policy can make towards realizing this potential is to ensure that the pace of economic expansion remains sustainable. This essentially means encouraging monetary conditions that will allow the economy to test the limits of its capacity to expand, but without setting

off inflation and the costly boom and bust cycles of the past two decades.

As in the United States, the problem in Canada is that there is considerable uncertainty regarding the level of economic activity that can be accommodated by our capacity to produce and how rapidly this capacity will expand over time. This is where the Bank of Canada's inflation-control target should prove useful as we try to steer the economy along a sustainable growth path. That target is to hold inflation inside a range of 1 to 3 per cent.

One of the advantages of such an explicit target is that it provides a ready measure of the state of the economy by comparing the actual trend of inflation against the target range. If the trend of inflation looks as though it will be pushing through the top of the target range, this implies that demand in the economy has been unsustainably strong, and monetary conditions must be tightened. But if inflation is persistently lower than past history and the existing levels of demand would suggest, and it is tending to press the bottom of the range, chances are that there is more room for the economy to expand than previously thought, and monetary conditions can be easier.

However, if the Bank of Canada is going to respond to such signals, we must ensure that our inflation-control strategy is a credible one. It is by conducting monetary policy in a prudent manner during the economic upswing that the Bank can provide Canadians with assurance that inflation will remain under control when the economy begins to operate at levels that push against the limits of capacity. If businesses, individuals, and investors are persuaded that inflation will stay low, they will not respond immediately to signs of strong demand pressures by seeking to raise prices and wages and by pushing up interest rates. Such an environment provides the flexibility necessary for the economy to test the limits of growth and employment without immediately putting the economic expansion at risk.

Concluding remarks

In conclusion, let me just say that the period ahead will be an exciting one. At no time since the 1960s have we had in place the conditions that would permit the Canadian economy to fully realize its potential. With inflation under control and increasingly favourable fiscal positions, we now have an

opportunity to see what our economy is capable of delivering, in terms of sustained growth in output and employment and improving standards of living. The Bank of Canada's role is to make sure that monetary policy provides the right background -- a stable, low-inflation environment.