Remarks by Gordon Thiessen
Governor of the Bank of Canada
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The Canadian Economy: Finding the Right Balance

With the technological revolution that is currently sweeping the globe, dealing with change is a growing challenge for businesses these days. This revolution is erasing national frontiers, intensifying competition, and transforming economies everywhere. The rules of the game are constantly being rewritten, and the issues facing businesses are multiplying rapidly.

To survive and prosper in today's world, businesses need to keep abreast of global technological trends, be ready to innovate and apply new technologies to both their production processes and the development of new products and services for their clients.

From a broader perspective, in order to have a vibrant, dynamic economy, we count on the business community to take the initiatives that increase productivity and competitiveness so that we, as a nation, can benefit from rapidly changing technologies and increasingly open global markets.

What business people need, in turn, in order to go confidently about their affairs and take the innovative, and sometimes risky, initiatives we expect of them, is a supportive economic policy environment.

Today, I would like to talk about what monetary policy is doing to foster such an environment.

Low and Stable Inflation is Good for Business

Now, more than ever, businesses are operating in a changeable and uncertain world. The Bank of Canada has been doing what it can by removing one major cause of uncertainty—high and variable inflation.

Low and stable inflation is good for business, good for the consumer, and good for the economy as a whole.

This is not just a trendy central bank mantra. The emphasis that central banks are placing on price stability these days is neither fanciful nor unstudied. It is pragmatic. And it has to do with reducing uncertainty about the future, eliminating the inefficiencies caused by inflation, and minimizing economic ups and downs.

The future is always uncertain. But it is even more so when inflation is rising because the pace at which prices rise is rarely stable or predictable. This uncertainty distorts and confuses the information that consumers, entrepreneurs, savers, and investors rely on to make their economic decisions.

Not only that. Businesses and individuals end up spending more time and money either protecting themselves against inflation or trying to benefit from it. And interest rates rise to compensate savers and lenders for expected higher inflation and for the risks caused by uncertainty about future inflation. None of this encourages productive investment. In the high-inflation days of the 1970s and 1980s, a lot of economic resources were instead devoted to hedging and speculative purchases. And inflationary booms—here and elsewhere—inevitably turned into busts.

We must not let this happen again. That is why the Bank of Canada and the Government of Canada have agreed to an explicit target for inflation control. This target aims to hold inflation inside a range of 1 to 3 per cent.

Inflation-control targets also ensure that monetary policy works to moderate fluctuations in output, employment, and incomes. In the nine years since the targets were first adopted, not only has underlying inflation been lower than in the previous two decades, but economic growth has strengthened and has shown less short-term variability.

As we move ahead, we must ensure that this situation continues and that we avoid the boom-bust cycles of the past. Granted, we will not be able to wipe out fluctuations completely. External shocks will still buffet Canada’s very open economy every now and then.

And we will get economic surprises on the domestic front too. But in the past, our economic ups and downs were often amplified by outbreaks of inflation.

Keeping the Economy on an Even Keel

So how is the Canadian economy performing these days and what is the Bank of Canada doing to help keep it on an even keel?

Our economy has been expanding solidly for some time now—even through the Asian financial crisis of 1997-98—creating the conditions for the healthy gains in employment and incomes that we are now seeing.

Since mid-1999, the economy has outperformed expectations—growing in excess of 5 per cent at annual rates and with an underlying rate of inflation that, excluding fluctuations in energy prices, has remained in the bottom half of our 1 to 3 per cent target range. The Bank has raised its projection for growth in 2000 to a range of 4 to 4.5 per cent because of stronger demand for Canadian products from both domestic and foreign sources.

When it comes to foreign demand, this stronger momentum reflects faster-than-expected growth in several parts of the world, including Europe and the emerging-market economies that were in the eye of the Asian storm. Even in Japan, where the outlook continues to be uncertain, economic conditions should improve this year.

But by far the greatest source of this stronger external stimulus is the tremendous buoyancy of demand in the United States—a market that absorbs over 80 per cent of our exports. Demand in that country continues to steam ahead and to push hard against the limits of production capacity. And signs of price and wage pressures have become more visible. That is why the U.S. Federal Reserve has raised interest rates six times in the past 12 months to cool down the economy.

The Bank of Canada has also been concerned that the greater-than-expected U.S. demand for our exports, along with the strong momentum of spending by Canadians, could lead to undue pressure on our production capacity and consequently on future inflation in Canada. With U.S. monetary actions reinforcing our view about the risks of a buildup of demand and inflation pressures in that country—a buildup which could spill over into Canada—we have raised interest rates four times since last November.

In this connection, I would like to highlight a couple of important points that sometimes get lost in the public commentary.

Monetary policy actions aim at future inflation

First, monetary policy is concerned with *future* inflation pressures.

Monetary policy works with relatively long lags. It takes between18 and 24 months for a change in interest rates to work through the economy and have an effect on inflation. For this reason, any actions taken by the Bank of Canada today must be based largely on considerations about the economy and inflation 18 to 24 months down the road—*not* on what is happening now and *not* on the current rate of inflation (except to the extent that these factors colour our view of the future).

So, even though the underlying rate of inflation has been in the lower half of the 1 to 3 per cent target range, the Bank has to consider what is likely to happen to prices in the future.

Monetary policy actions are based on economic prospects here at home

The next point I would like to stress is that Canadian monetary policy decisions focus, first and foremost, on the economic outlook here in Canada.

So, the critical element is the Bank's assessment of the balance of forces at work in the Canadian economy, and what this means for future inflation. If domestic demand here in Canada was not particularly strong, greater-than-anticipated U.S. demand for our products would be a compensating element and hardly an issue. But if domestic demand was already rising rapidly, and the Canadian economy was operating at high levels, the spillover of strong U.S. demand would have the potential to strain our production capacity and lead to higher inflation in the future.

The important judgment that your central bank must make—every step of the way—is how these domestic and external forces add up.

When the Canadian economy is generally in sync with that of the United States, and interest rates in our two countries are moving in the same direction, I can appreciate that Canadian monetary policy may be difficult to interpret. Some people may be persuaded to think that the Bank of Canada never has any choice but to follow the U.S. Federal Reserve. Or, for that matter, that the Bank must have a target for the Canadian dollar that requires interest rates here to move in lock-step with U.S. rates.

But that is just not so.

When U.S. monetary authorities raise interest rates, the Bank of Canada has to look carefully at the reasons behind the move and decide what it means in terms of our ongoing

assessment of the prospects for total demand and inflation in Canada.

Developments in the U.S. economy will always be important to Canada. And moves in U.S. interest rates will always influence rates around the world, including ours. But that does not mean that we cannot have different interest rates in Canada and that the Bank always follows the Fed. Sometimes we do, and sometimes we don't. *It all depends on what we think is necessary to keep the Canadian economy on a non-inflationary, and thus sustainable, growth path.*

As I have already noted, in the past 12 months, we raised our interest rates four times while the Americans have raised theirs six times. On those four occasions, including the most recent increase in May, the Bank, after careful consideration, decided that the implications of U.S. developments for our economy justified higher rates here as well.

It is also important to remember that Canadian interest rates are still below comparable U.S. rates for all maturities—as they have been for the last few years. This basically reflects the fact that we have a lower rate of inflation than our U.S. neighbours and that our economy has not been pressing as hard against its capacity limits as theirs.

We need to keep demand and supply in balance

Through this discussion, I have talked mostly about total demand, but have not said much about our economy's ability to supply goods and services—except to suggest that a rapidly rising demand could lead to pressures on capacity and inflation.

For the most part, we can be reasonably confident about assessing the various sources and strength of demand in the economy. But estimates of the production potential of our economy, are much more uncertain these days because of major ongoing structural changes.

We know that in recent years, and especially since 1996, Canadian businesses have been investing heavily in machinery, equipment, and software, much of which embodies the latest technologies. This should raise productivity in Canada and allow our economy to grow faster than it otherwise would. But, at this point, it is difficult to tell by how much, whether some of the gains are already in, or whether most are still to come. So far, our statistics yield little direct evidence of a substantial pickup in productivity growth, although recent historical revisions to the National Accounts show somewhat larger gains than before.

Because of this uncertainty, the Bank is taking a cautious approach to projecting a permanently higher rate of growth in our economy's capacity to produce. But we certainly do not want to dismiss this possibility either. That is why we are following closely a wider-than-usual range of indicators that could tell us what is happening on the supply side and give us early-warning signs of pressure on capacity and prices. For example, we watch for unexpected

movements in the underlying trend of inflation and for changes in expectations of future inflation. We also look at commodity prices, wage settlements, reports of shortages in product and labour markets, the growth of money and credit, and information from the Bank’s business contacts across Canada.

Take, for instance, our best estimate of the trend of inflation—what we call core inflation. This is a measure that takes out of the consumer price index the fluctuations caused by the very volatile energy and food components and the effects of changes in indirect taxes. By this measure, inflation has been somewhat lower than we had expected since late last year. This very favourable price performance suggests that our economy has not been pressing as hard against capacity as we had thought. It gives us some more room to explore where the limits of that capacity really are. And this should give businesses a greater opportunity to exploit their new equipment and technology to the fullest.

Nonetheless, we must not be lulled into thinking that the threat of inflation has disappeared. Given the strong momentum and high levels of activity in our economy, and given the time that it takes for monetary policy actions to affect output and prices, the Bank must remain vigilant. Nothing will bring the present expansion to an abrupt halt more quickly than an outbreak of inflation.

Assessing the balance between total demand and supply in the economy and the implications for inflation will be an ongoing challenge for monetary policy. I can assure you that the Bank is fully committed to the task—because keeping inflation low and stable will help to provide an environment in which the Canadian economy can enjoy solid growth and achieve its full potential.