Remarks by Gordon Thiessen
Governor of the Bank of Canada
to the Calgary Chamber of Commerce
Calgary, Alberta
14 September 2000

The Outlook for the Canadian Economy and the Conduct of Monetary Policy

Today, I would like to bring you up to date on the Bank of Canada's views about the outlook for the Canadian economy. Prospects for the period ahead are generally very favourable. But, as is often the case, there are also uncertainties that the Bank will have to deal with as it pursues its objective of keeping the economy on a sustainable, non-inflationary track. Dealing with such uncertainties presents a constant challenge for the Bank in its job of conducting monetary policy.

Another part of our job involves always looking at ways to enhance the effectiveness of policy—by reducing uncertainty about our actions, by increasing transparency and accountability, and by broadening public awareness of how monetary policy works. Today, I want to outline some new procedures for announcing changes in official interest rates that we plan to introduce later this autumn. We believe that these procedures should help improve the effectiveness of monetary policy in Canada.

But first let me give you an update on the current economic situation.

Economic update

The Canadian economy has been expanding strongly for some time now, and particularly since mid-1999. Indeed, between mid-1999 and mid-2000, it grew by about 5¼ per cent.

Through much of that 12-month period, economic growth outstripped expectations. In part, this can be attributed to the spillover of greater-than-anticipated demand from the United States.

The rapid growth of the American economy has been confounding observers for quite some time now. And, as might be expected, buoyant U.S. demand has been pressing against that economy's capacity to produce. One safety valve that has helped to relieve the pressures on U.S. capacity has been the inflow of goods and services from abroad.

Canada's export industries have benefited greatly from this spillover of excess demand from the United States. Not only have these exports contributed directly to the rapid economic expansion in Canada, they have been a source of encouragement that has added to the surge in purchases of machinery and equipment by Canadian businesses. And, of course, the recent gains in employment and incomes in the export sector have strengthened the momentum of spending by Canadian households.

Together, buoyant exports, strong investment by domestic businesses, and robust household spending have led to a surprisingly strong demand for Canadian goods and services.

What is remarkable under the circumstances is that pressures on the *basic* trend of inflation in Canada have been minimal.

Now, I know that the 12-month rate of increase in the total consumer price index has risen to around 3 per cent because of the sharp rise in energy prices. Although these higher prices have boosted activity for Canada's energy producers, they are also raising living costs for most Canadians.

The Bank remains fully committed to preserving an environment of low and stable inflation. But monetary policy can control only the future trend of inflation—not the temporary ups and downs caused by movements in the prices of very volatile items such as energy and food. Of course, if there was evidence that higher energy prices were beginning to feed into prices of other goods and services, or into expectations about the future trend of inflation, that would be different. But so far, this has not been the case.

In order to get a better fix on the underlying trend of inflation, we should look at the Bank's core measure of inflation—the measure that excludes fluctuations in energy and food prices and the effects of changes in indirect taxes. This core measure has remained in the bottom half of the 1 to 3 per cent target range we have set for controlling inflation.

This is somewhat lower than we had expected. It suggests that total demand, although stronger than anticipated, may not have been putting as much pressure on our economy's production capacity as we had thought at the beginning of the year.

The economic outlook

Let me now shift to the Bank's view on the outlook for the economy.

When it comes to monetary policy, "looking ahead" is very important. Why?

Because the actions that your central bank takes today will not have their full effect on the economy and on prices for another 18 to 24 months. That is why the Bank must always base its decisions on a judgment about *future* economic growth and *future* inflation.

The Bank's latest projection for economic growth in 2000 (published in the August *Monetary Policy Report Update*) is within a range of 4 ¼ to 4 ¾ per cent—somewhat higher than we had expected in the spring. This projection assumes a slowing through the balance of the year from the very rapid pace of the first half. But, even then, output will probably be growing faster than production capacity; and so pressures on capacity are likely to increase. Because of this, we are predicting that the core measure of inflation will move up to 2 per cent—the centre of the Bank's 1 to 3 per cent target range—by early next year. At the same time, if world crude oil prices stabilize, we expect that the rate of increase in the total CPI will gradually come down and eventually converge with our core measure of inflation.

But, as I said before, there are a number of uncertainties attached to this projection. The most important uncertainties revolve around future developments in the U.S. economy. Will that economy slow to a more sustainable pace? Or will there be another surprising spillover of U.S. demand into our exports? Right now, it looks as if the growth of spending by U.S. households is moderating.

What if the American economy does not slow fast enough to prevent a rise in U.S. inflation? Will that have a significant adverse effect on expectations of inflation in Canada? This is where the Bank's commitment to keeping the trend of inflation within the target range really comes into play. Our role is to reassure Canadians, by seeing to it that inflation here remains low and stable even if U.S. inflation rises.

Another major area of uncertainty has to do with our economy's capacity to produce. As I said earlier, our remarkable inflation record to date suggests that there was probably still some excess capacity in the economy in the early part of this year. Although our projection assumes that pressures on capacity will contribute to an increase in the underlying trend of inflation—from around 1 ½ per cent now to 2 per cent next year—there is, in fact, a significant margin of uncertainty around these numbers.

It is possible that the investment boom we have witnessed in Canada since 1996 will increase productivity growth and capacity more quickly than we are allowing for. There is a good deal of anecdotal evidence that some of the American experience (burgeoning investments in technology leading to robust productivity gains) is being replicated in Canada. Until recently, there had been little evidence of this in our official, economy-wide productivity statistics. But there was a significant gain in productivity in the data for the second quarter of this year that were released recently. Of course, it remains to be seen whether this will continue.

Monetary policy response

How has monetary policy responded to all this? Because of the surprisingly strong momentum of demand in Canada since mid-1999, and because of the likelihood that this could lead to inflation pressures in the future, the Bank of Canada raised interest rates four times—by a total of 1 ¼ percentage points—between November 1999 and May 2000.

These four interest rate increases followed similar actions by the U.S. central bank. The Federal Reserve's assessment that interest rate increases were necessary because the growth of demand in that country continued to outstrip the growth of supply, was an important factor in our decision to match those moves. The reason was that this implied a continued spillover of U.S. demand into Canada, which would add to the already buoyant growth in spending by Canadian households and businesses.

This additional external demand for our products, at a time when domestic demand here was already brisk, essentially increased the risks that we would run into capacity constraints and pressures on inflation.

Clearly, U.S. economic and financial developments will always be relevant for Canada. After all, we do over 80 per cent of our foreign trade with that country. And U.S. financial markets have an important influence on interest rates worldwide, including ours. But that does not mean that the Bank of Canada must always follow the Federal Reserve, or that interest rate levels here and in the United States must be the same.

The job of Canadian monetary policy is to respond to trends in *our own* economy. Naturally, because of the close ties between Canada and the United States, economic trends in the two countries are often similar, and may require similar policy responses. But this is not always the case. Since mid-1999, the Americans have raised their interest rates on six occasions. We have raised ours four times. Moreover, Canadian interest rates continue to be below U.S. rates because inflation here has been lower and our economy has not been growing as quickly, or for as long, as theirs (so that the risks of pressures on capacity and inflation in Canada are not as intense).

Still, I can appreciate that, when our economies move together, people may find Canadian monetary policy difficult to interpret—particularly when the Bank has moved immediately to match increases in U.S. policy rates. On those occasions, there has been a tendency to conclude that either the Bank does not have much choice but to follow, or that it must have targets for the Canadian dollar that require interest rates here to move in lock-step with U.S. rates.

Neither of these assumptions is correct. When U.S. monetary authorities take a policy action, the Bank looks carefully at the reasons behind the move and at what it all means for our ongoing assessment of the outlook for total demand and inflation in Canada. Our job is to do what we think is necessary to keep *our* economy on a non-inflationary, and thus more sustainable, growth path.

New procedures for announcing monetary policy actions

I would now like to turn to another aspect of the way we conduct monetary policy in this country.

As I said at the outset, the Bank is constantly searching for ways to enhance the effectiveness of monetary policy.

Over the past couple of years, we have been looking at how other major central banks go about announcing changes in official interest rates, and we have been assessing whether our current arrangements could be improved. We have noted that most foreign central banks announce their decisions on interest rates only on certain dates that are set well in advance. In the United States, this has been the practice for some time. And now it is also the case in the other major economies (Japan, the euro zone, and the United Kingdom) as well as in a number of smaller industrial countries (e.g., Sweden, Australia, and New Zealand).

After carefully considering all the relevant issues, we have concluded that pre-set dates for announcing interest rate actions would improve the implementation and effectiveness of Canadian monetary policy.

We have decided that eight specified dates per year would be appropriate in the Canadian context. The scheduling of these eight dates would be based on the timing of the flows of economic information that the Bank relies on to gauge the economic situation in Canada, to make projections, and to assess the need for monetary policy action. Each of these eight dates would be separated from U.S. policy action dates by a week or more. In preparing to move to this new system, we will be consulting interested parties on the most appropriate day of the week and time of day for announcing interest rate changes.

The way we see it, this new approach has several advantages over the existing arrangements, advantages that should contribute to a more effective monetary policy. I would like to briefly highlight some of these benefits.

To begin with, the new arrangements should reduce uncertainty in financial markets about the timing of policy actions. Under the current system, the Bank can move interest rates on any business day (Monday to Friday), at 9:00 a.m. Because market participants are not sure exactly which day a change in interest rates may be announced, trading can slow in the early morning, for several days, when there is an expectation that the Bank may move. Removing this uncertainty should improve market efficiency and liquidity.

We also believe that the new system will help to focus public attention more closely on economic trends *here in Canada*, and on the appropriate monetary policy response based on those critical trends. Let me explain.

On each of the eight pre-set dates for interest rate action, the Bank would issue a press release that would give a brief assessment of the economic situation in Canada and explain why we chose either to change interest rates or to leave them unchanged. This would also give us an opportunity to link the latest developments more directly to the underlying economic trends in the medium term—the 18 to 24 months over which the effects of monetary policy actions are spread. Integrating the information in these eight press releases with our other key monetary policy statements throughout the year would provide a more regular, frequent, and continuous account of our views on the Canadian economy.

In the end, if the Bank does its job of keeping people well informed, we expect that economic analysts, market participants, and the public generally will be clearer about the factors that influence monetary policy and will be in a better position to anticipate the direction of policy. This has certainly proven to be the case in the United States, the euro zone, and the United Kingdom.

There could, of course, be extreme cases that might call for an immediate policy response from the Bank rather than waiting for the next scheduled announcement date. The new arrangements would not preclude such an option. It would be used very infrequently, however, and only under extraordinary circumstances.

Details of this new approach to announcing interest rate changes will be issued next Tuesday and will be posted on the Bank's Web site, along with an invitation for comments from the public. We plan to implement this system in the autumn, with the first date for interest rate action set for November 2000.

Concluding remarks

To conclude, let me return to my main points regarding our economic situation.

The Canadian economy has been performing very well in recent years and the

Bank expects that it will continue to do so. The task for monetary policy is to ensure that the economy stays on an expanding but non-inflationary path.

Monetary policy faces some challenges in the period ahead—challenges arising from several uncertainties surrounding the economic outlook. The key uncertainty is the future performance of the U.S. economy and the implications for Canada. From this perspective, what matters most is that the U.S. monetary authorities succeed in bringing their high-flying economy onto a more sustainable track.

Another important challenge for monetary policy will be to keep demand and supply here at home in balance at a time when the application of new technology may well be transforming Canada's economy and moving it onto a higher growth path. But we are not sure of that yet. While the recent productivity gains are encouraging, it is too early to tell if this is the beginning of a sustained improved performance on this front.

Because of this, the Bank will be closely watching all indicators that could provide early signs of such an occurrence. But we must be careful not to let our hopes run ahead of reality and take risks with inflation. A flare-up in inflation and the higher interest rates that would go with it would discourage investments, especially those in high-tech equipment and software, that enhance productivity and are so crucial to improved economic performance in the future.

The outlook for the Canadian economy is very promising. The best contribution the Bank can make to realizing this economic potential is to preserve the present environment of low and stable inflation. For this is what fosters sustained solid economic growth and improved standards of living over time. I can assure you that the Bank of Canada remains fully committed to the task.