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Canada's Economic Future: What Have We Learned from the 1990s?

It was to the Canadian Club of Toronto that I gave my first speech as Governor of the Bank of Canada seven years ago. It is only fitting that I should be here again today, for my final public presentation before I retire.

In early 1994, Canada's economic situation was not that favourable—our economy was facing some rather serious problems. Today, too, we face some challenges. But our overall economic and financial situation is much stronger now than it was seven years ago.

What I intend to do today is to look back at Canada's economic performance during the last decade of the twentieth century and, with the benefit of hindsight, look at the factors behind that performance. I would also like to talk about the changes that have taken place in our economy over this period, and what these changes mean as we look ahead.

The problems of the 1990s

Let me take you back to the early 1990s. That is when the gravity of the problems that would dominate the Canadian economic landscape for much of the decade became clear.

By 1990, the persistent inflation of the 1970s and 1980s had pushed the consumer price index (CPI) to a level nearly four times as high as in 1970. Inflation had come down through the first part of the 1980s, but, with an inflationary psychology still very much at work, it picked up again towards the late 1980s. During that whole inflationary period, many Canadians sought to protect themselves from the effects of inflation through indexed wage contracts and by investing in the housing market. Others saw an opportunity to benefit from high inflation by speculating in real estate or other assets. Since many of these transactions had been financed by borrowing, debt had risen to high levels.

When the Bank of Canada's anti-inflationary policy actions in the late 1980s finally convinced Canadians that inflation would be brought under control, the inflationary excesses that had built up contributed to a severe recession in 1990–91. Partly because inflationary pressures in Canada were greater than in the United States, and the inflation psychology was more deeply entrenched, the recession here was more severe than in the United States.

The effects of technological change, including a decline in communications costs, meant that, through the 1980s, national markets had become much more susceptible to international competition. In Canada, however, the relatively high inflation of the 1970s and 1980s had distracted Canadian firms: rather than focusing on product design and innovation, cost control, and productivity improvement, many of them had been looking for ways to take advantage of inflation. Thus, they had tended to postpone the adjustments needed to respond to a changing world economy.

Meanwhile, U.S. companies that had earlier found themselves in strong foreign competition, especially against Japanese firms, had already begun the process of adjusting to globalization during the mid- to late 1980s. So, by the beginning of the 1990s, they were better placed than most to respond to the intensifying forces of technological change and global competition.

By the early 1990s, the realities of the new world economic order were becoming clearer to Canadian companies too. Only at that time, they were also coping with the fallout from the high-inflation years, especially the sharp drop in the prices of speculative investments and the burden of servicing large debts, as well as with declining world commodity prices.

Working their way out of these difficulties was disruptive and painful for Canadian businesses. Defaults, restructurings, and downsizings became the order of the day. With all this, unemployment took a long time to recover from the 1990–91 recession and, in many instances, wages and salaries were frozen or reduced. But whatever else one may say, through this period, our businesses responded to the challenge and did a remarkable job of restructuring their operations and adjusting to the new economic realities.

Canada’s other major economic problem in the early 1990s was large budget deficits—federal and provincial. Because of these deficits, public debt was accumulating at an unsustainable rate, and foreign and domestic investors were becoming very nervous about holding Canadian government bonds. As a result, significant risk premiums were built into our interest rates.

By 1994, it had become clear that Canada could be facing a potentially very serious debt problem. If there was any doubt about that, it disappeared in early 1995, when Canada was sideswiped by the Mexican peso crisis. The Canadian dollar came under strong downward pressure, and interest rates rose sharply across all maturities as investors demanded even larger risk premiums.

Just as I believe that the restructuring in our private sector in the 1990s was impressive, I also think that Canadian governments (federal and provincial) responded forcefully and effectively in the mid-1990s to the need to cut fiscal deficits and slow down the accumulation of public sector debt. The overall government sector moved from a total deficit of close to $45 billion or 6 per cent of gross domestic product (GDP) in 1995, to a balanced position in 1997 and 1998, and to surpluses thereafter. Moreover, net public debt as a ratio of GDP fell from close to 104 per cent in the fiscal year 1995/96 to an estimated 80 per cent in 1999/2000. That is some adjustment!

This fiscal restructuring, although essential, was difficult and disruptive. Like the private sector, the public sector too had to undertake significant downsizing and salary restraint.

Overall, given the type and size of structural changes that had to be made, it is not surprising that, for much of the 1990s, unemployment rates in Canada remained high and incomes stagnated.

The turnaround

The economic problems of the 1990s that I have been recounting make for a rather sombre story.

The next chapter of that story, however, is rather more cheerful. Although Canada was late in dealing with past economic imbalances, once our private and public sectors realized the extent of the problems, their response was prompt and effective. And our economic performance has improved materially as a result. Let me highlight some of the major improvements.

I have already noted the influence of technology and globalization in changing the world economy during the 1990s. This influence continues and, if anything, is accelerating. Indeed, the world seems to be going through a real technological revolution—a revolution spawned by the increasing efficiency and declining costs of computers and fibre optics and their application to information processing and communications.

The United States has been at the forefront of this revolution. But, as far as we can tell, Canada is not that far behind.

Once Canadian businesses sorted out the required restructuring and reorientation of their activities in the first half of the 1990s, they quickly came to realize that they had to adopt and invest in the new technology to become more competitive. U.S. firms served both as a role model and a competitive prod in this regard. Investment in new machinery, equipment, and technology by Canadian businesses began to pick up in 1996 and, as a ratio of our GDP, has been rising continuously.

This pattern looks remarkably similar to the one in the United States—only with a lag of about four years. In the United States, the investment in equipment and technology, which had begun early in the 1990s, started paying off around 1996, with rather impressive gains in productivity. Over the past five years, U.S. productivity growth (measured as output per person-hour) has averaged 3 per cent.

Although it is still early days, there have been encouraging signs of a pickup in Canadian productivity growth this past year. I see no reason why Canada cannot benefit from a process similar to the one that has been at work in the United States. However, the extent of any future gains in our productivity is still difficult to gauge at this point.

There is, of course, more to the recent favourable economic news in Canada than just the early signs of a pickup in productivity growth. For example, there have also been substantial gains in employment. The unemployment rate, which had reached 11 per cent in the early 1990s, dropped to below 7 per cent in 2000—its lowest level in over 25 years. Incomes, too, have been rising. Adjusted for inflation, personal disposable income has increased by an average of almost 3 per cent per year over the past four years.

The fiscal restructuring has also figured importantly in our improved economic performance. The reduction in deficits and the subsequent move to surpluses, together with the declining debt levels of the government sector, have helped to eliminate the risk premiums in our interest rates that cost us so dearly in the early 1990s.

Indeed, for much of the period from mid-1996 to late 2000, Canadian interest rates were lower than comparable U.S. rates. This has, no doubt, been an important factor behind the surge in business investment in Canada since 1996, which is so important if we are to take advantage of new technology and enhance our ability to compete internationally. Low interest rates have also encouraged households to buy houses, cars, and other major consumer goods—purchases they had tended to postpone earlier in the decade.

The role of monetary policy

I have left a detailed discussion of the role of monetary policy (and of the Bank of Canada) for last.

To explain the role of monetary policy through the 1990s, I need to go back to the 1970s and 1980s. As I said before, this is when some of the serious economic policy problems in Canada, and elsewhere, really started.

In the late 1960s and early 1970s, the world economy was booming. And the large U.S. military expenditures during the Vietnam war amplified the boom. OPEC took advantage of strong world demand to restrict the supply of crude oil and push prices up. In the face of these pressures, inflation went up everywhere, including here in Canada. It took monetary authorities around the world a while to realize that rising inflation was not just the product of a series of temporary special factors. By the time most central banks reacted, inflation had become entrenched and proved very difficult to bring down.

The persistent inflation of the 1970s and 1980s undermined economic performance worldwide. Canada did not escape unscathed.

Because inflation creates uncertainty, it makes it much more difficult for households and businesses to judge future prices and to make sound economic decisions. High inflation encourages speculation rather than productive investments. It raises interest rates. And, in the end, it exacerbates both the booms and the busts.

Restrictive monetary policies in the United States and in Canada during the early 1980s finally brought inflation down from its double-digit levels. But fears of inflation lingered, encouraging continued debt-financed speculation in real estate and other assets. By the late 1980s, inflation pressures were on the rise again.

In Canada, those pressures, and the fears of ongoing inflation that had been undermining our economic performance, finally eased after the successful implementation of the inflation-reduction targets adopted in February 1991. Inflation promptly declined to around 2 per cent, and inflation-related hedging and speculation gradually disappeared.

I believe that the low-inflation environment that was firmly established in the first part of the 1990s contributed significantly to Canada’s improved economic performance later in the decade. Since the early 1990s, there has been greater certainty about future prices. Investment and savings horizons have, consequently, lengthened. Interest rates have come down. And, in contrast to our experience during the Mexican crisis, Canada rode out the impact of the Asian financial turbulence of 1997–98 with only a limited slowdown in output and employment growth.

The way ahead

Partly because of the difficulties we experienced in the 1990s, many Canadians remain sceptical about our economic future. They look at the extraordinary performance of the U.S. economy through much of the past decade, and Canada’s record looks lacklustre by comparison.

But I believe that there are considerable grounds for optimism. I say that primarily because of the improvements in our economic fundamentals that I have described.

Indeed, good economic performance starts with a foundation of prudent economic policies. In this regard, low and stable inflation, together with a declining public sector debt, now provides a stronger base for the Canadian economy than we have had in three decades. In addition, there is the shift in business attitudes towards greater focus on cost control, productivity, and international competitiveness.

How well we do in the future will depend on us getting a number of things right. Above all, we must ensure that we sustain and build on the progress made on the inflation, fiscal, and business fronts.

But other things are also important. We must find the level of taxation that offers scope for entrepreneurship and risk-taking, while also allowing a level of government services that gives Canadians the degree of social support that can help them accept, respond, and adjust to a rapidly changing world.

We must also think about the skills Canada needs to be able to exploit fully the benefits of rapid global economic change. This means strategic partnerships between employers and employees to promote on-the-job training, and partnerships between industries and educational institutions to improve skills and to develop new ones, suited to today's advanced technologies. This is very important if we are to avoid skill shortages that could constrain the expansion of our economy.

Conclusion

To conclude, our economy has been expanding robustly over the past five years, inflation has remained low, employment and incomes have been rising. And we are now seeing encouraging signs of a productivity payoff from the restructuring of the past decade—a payoff which, if sustained, would provide the basis for rising standards of living for all Canadians in the future.

Some of you may wonder if this conclusion is not overly optimistic in the face of a slowing U.S. economy. Since tomorrow is our next pre-set date for announcing changes in the Bank Rate, I hope you can appreciate that I cannot comment on the current economic situation. We will be doing that in tomorrow's press release.

What I can say is that the points I have been making here today are about the improvements we have seen in the fundamental, longer-term *trends* in our economy. Because of these improvements, our economy is now in a better shape than it has been for some time to deal with all kinds of external shocks—including fluctuations in U.S. demand for our products.

What I see ahead are challenges, but not the serious problems we were facing ten years ago. Today, we have an economy with sound foundations, well-placed to rise to these challenges and prosper.