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The Future Performance of the Canadian Economy

It can take anywhere from one to two years for monetary actions to have their full effect on the economy. Because of this, the conduct of monetary policy must be based on a view of what the economy will be like -- not tomorrow, not in a month -- but rather in one to two years' time.

That is why in speeches in Vancouver and Toronto last year I spoke about where the Canadian economy might be heading in the future; what this might imply for our economic performance over the medium term; and what should the contribution of monetary policy be. Understandably, these important issues can get pushed aside because of the public focus on the current economic situation and on recent movements in short-term interest rates and in the external value of the Canadian dollar.

Today, I would like to use this opportunity to revisit these medium-term issues. In doing so, I will be underlining the crucial role played by productivity improvements in our economic performance. The best place to start is with a brief review of the recent record.

Recent economic performance

As we approach the end of the decade, we can take satisfaction in the good economic performance of the past two years and in the notable improvements in our economic fundamentals. The Canadian economy has expanded at an average annual rate of 4 per cent since mid-1996 and, even with the dampening effects of the Asian crisis, it is expected to continue to grow at a healthy pace this year. This should contribute to further gains in employment and reduce the amount of unused capacity.

Inflation is low, and we are committed to keeping it low. Last month, together with the federal government, we announced that we would extend our target of holding inflation inside a range of 1 to 3 per cent to the end of 2001. Moreover, government deficits have virtually disappeared, and the ratio of public debt relative to the size of our economy is finally on a downward path -- for the first time in about 25 years. Low inflation and improved fiscal health represent major contributions towards the sounder economic fundamentals I mentioned a moment ago. They are no doubt the main reason why our interest rates have been below U.S. rates.

The other key area where there have been important improvements in recent years is in the private business sector. Since the early 1990s, Canadian businesses have taken up the challenge of structural adjustment, which their U.S. counterparts had started several years earlier, in response to the gathering momentum of technological change, globalization, and heightened competition.

With the benefit of low inflation and low interest rates, Canadian businesses have been investing in new technology and streamlining their operations to enhance productivity. Their success in doing so will be crucial to our future economic performance.

The importance of productivity growth

Why this emphasis on improving productivity? Whether viewed from the perspective of an individual firm or of the economy as a whole, it is almost impossible to overemphasize the importance of rising productivity for overall performance and prosperity.

Productivity growth is what allows firms to hand out real wage increases, while holding their production costs down and remaining profitable.

From a broader perspective, productivity growth is a key element that determines economic welfare and the general well-being of a society. At any point in time, our perception of how well we are doing economically is probably influenced by where we happen to be in the cyclical fluctuations that affect any economy. But over the longer term, the trend in productivity growth for the economy as a whole is the basis for growing incomes and rising standards of living.

Now, I know that for some people any discussion of the need to increase productivity can be rather unsettling. They tend to associate improvements in productivity in an individual company with downsizing and layoffs. And from there it is only a short step to the belief that strong economy-wide productivity gains can only mean a more difficult job market and higher unemployment.

But the history of industrial economies shows that growth in productivity has actually gone hand in hand with improved overall employment conditions. This is borne out by the experience of countries like Japan in the 1980s and, more recently, the United States and the United Kingdom. That was also our experience in Canada during the 1950s and 1960s.

Canada's productivity record

So how has Canada fared in the productivity department since the 1950s and 1960s? Not all that well, I'm afraid. After a relatively strong showing from the end of the Second World War to the early 1970s, our productivity performance became rather lacklustre. Productivity growth is estimated to have slowed from an average rate of about 2 per cent in the 1950s and 1960s to less than 1 per cent in the 1980s and 1990s, although it has picked up recently with the recovery in economic activity.

I should note that economists do not fully understand why productivity growth in Canada (and, indeed, in other industrial countries) has slowed so sharply since the mid-1970s. I do not propose to try to untangle this puzzle today. Nonetheless, there are a few points I would like to make with respect to the Canadian situation.

The sharp rise in the world price of oil in the 1970s no doubt dealt a major shock to Canadian industry. Because of our climate and because of the importance of primary commodity production in our economy, we are major users of energy. Adapting to higher energy costs certainly took considerable time.

In my view, two other important factors inhibited productivity improvements through much of the 1970s, 1980s, and early 1990s: large fiscal deficits and high inflation.

Government deficits through the 1980s and early 1990s tended to crowd out private sector investment by appropriating an ever-increasing share of Canadian savings. It was, of course, possible for businesses and governments to get foreign financing. But the accumulation of a large public sector debt and the rapid buildup of foreign indebtedness eventually resulted in appreciable premiums being built into our interest rates. High inflation through the 1970s and 1980s had a similar effect on interest rates. For these reasons, interest rates were high, even after adjusting for inflation. This discouraged some of the investment that would have contributed to gains in productivity.

Moreover, because high inflation increases uncertainty about the future, businesses and individuals seek protection from its ravages or try to profit from it. Either way, scarce economic resources were diverted from productive investments towards hedging and speculative investments.

I do not mean to suggest that the factors I have mentioned here explain all of our productivity problems. But they no doubt worked against the investment that was needed to help us adjust to both the oil price shocks of the 1970s and the global forces of the past two decades, and to make headway in terms of productivity growth.

Let me now turn to the question of what we can expect in terms of productivity in the future.

Future productivity trends and Canada's economic potential

Increases in productivity do not just happen. We need to work hard to achieve them. In a world of rapid technological change and intense international competition, there are opportunities and incentives for productivity gains -- provided we do what is necessary to take advantage of the possibilities.

Productivity comes from the interaction of business investment in new capital equipment, a skilled labour force, and the adoption of new technology. It takes entrepreneurship and innovation to pull it all together. Typically, this interaction works best when businesses operate in a stable, low-inflation economic environment and when markets are competitive. Producers are then under pressure to perform in terms of price, quality, and service.

With low inflation, a balanced fiscal position, and low interest rates, the economic policy environment is better now than it has been for over 25 years. This should provide the underpinnings for solid economic growth and increased savings and investment in the future.

With this support from improving economic policy conditions, business investment has indeed been buoyant, particularly since mid-1996, and notably in high-technology equipment such as computers. As well, more and more businesses, led by high-tech enterprises, are reported to have introduced new production technologies. Progress has also been made in learning new skills, removing labour market rigidities, and improving the adaptability, flexibility, and efficiency of our labour force. But more undoubtedly needs to be done in this area.

It is likely that these trends will continue in the future, and will spread to sectors that have been lagging behind. With ongoing technological change, deregulation, trade liberalization, and intensified global competition, the pressures and incentives are certainly there for further productivity gains.

Thus, the trends are positive, and the direction of our economy is clear. What is *not* clear is just how much our economic performance will improve. We cannot attach precise estimates to future growth in productivity. Neither can we judge the end results of the major structural changes that have taken place in the private sector of the Canadian economy. Because of this, we need to take a somewhat agnostic view about the production potential of the Canadian economy and about the lowest unemployment rate that can be sustained over time.

Monetary policy response -- making the most of the economy's production potential

What are the implications of all this for the conduct of monetary policy?

When we at the Bank look one to two years into the future to set a course for monetary policy, we must take into account changes in the trends that affect the potential of the economy to produce over time. At the same time, we must recognize that our ability to predict that potential is restricted by the many uncertainties involved.

In these circumstances, the best way for monetary policy to help the economy realize its potential is to focus on encouraging a sustained economic expansion over time. How do we do this? By keeping inflation low. As we move towards full capacity over the next year or so, it will be important to set monetary conditions at levels that forestall a resurgence of inflation and the painful boom and bust cycles that go with it.

A responsible, credible monetary policy will allow us to explore the limits of the economy's capacity to produce, to create jobs, and to support rising standards of living. The recent U.S. experience amply demonstrates the advantages and benefits of such a policy.

I believe that the recent extension of the inflation-control targets and the increasing credibility of those targets give monetary policy more scope to test the limits of our economic potential than at any time since the 1960s.

Now that I have discussed the rationale behind the Bank of Canada's medium-term strategy, let me explain our recent actions to raise the Bank Rate.

As I said earlier, the underlying momentum of the Canadian economy remains positive. Despite the problems in Asia, Canada's external environment is still favourable, given the strength in our major non-Asian trading partners, particularly the United States. In addition, the dampening effects on domestic demand from the fiscal consolidation efforts of the past four years are diminishing. And monetary conditions continue to support the economic expansion. Given these circumstances, the persistent decline in the external value of the Canadian dollar through December and January implied a further easing in monetary conditions that looked to us to be excessive. Moreover, the speed of the decline in the currency risked undermining investor confidence in Canadian dollar assets. That is why we took action.

Concluding thoughts

Let me conclude by summarizing my main points today.

For much of the period since the 1960s, we have not had conditions in place that would allow the Canadian economy to fully realize its potential. With low inflation and a sound fiscal position, we now have the foundation that should permit us to move towards full capacity and to explore what our economy can deliver in terms of sustained growth in output and employment and better standards of living.

Canada's private sector has been responding to the universal challenges of rapid technological change, globalization, and heightened competition by undertaking major restructuring initiatives to become more efficient, productive, and competitive. Although we do not know for sure just how much more productive we are going to be as a result of these initiatives, there is good reason for optimism.

The best contribution the Bank of Canada can make to this process is by continuing to provide a stable, low-inflation environment. With an eye to the medium term, this will require setting a course for monetary policy that will ensure that the Canadian economy reaches full capacity smoothly and then continues to grow over time at a non-inflationary and therefore sustainable pace. The longer economic growth is sustained, the more benefits we will see in terms of improved incomes and employment.