Remarks by Bernard Bonin
Senior Deputy Governor of the Bank of Canada
to The Canadian Association
of Financial Planners
Québec City, Québec
11 June 1998

The outlook for the Canadian economy and monetary policy

In mid-May we published our semi-annual *Report* on monetary policy, covering data up to April 24th. That means we now have new data available for the last two months. Furthermore, our report also pointed to a much greater-than-usual degree of uncertainty about the outlook for the Canadian economy. While recent weeks have not dispelled that uncertainty, they have provided us with more information about the impact of the shocks that have hit the Canadian economy over the last six to nine months. In my remarks today, I want to go over Canada's economic outlook with you, in light of these recent data, and discuss their consequences from the standpoint of formulating and conducting monetary policy.

Balancing the central bank's independence in monetary policy is its duty to account for its stewardship. The *Monetary Policy Report*, published twice a year, is one of the vehicles we use to give an account of our actions. It sets out the Bank of Canada's judgments on the economic situation in Canada, as well as in the rest of the world, and gives analysts like yourselves in both the private and public sectors the chance to compare their opinions with those of the central bank. Exchanges of view of this kind are very important indeed.

* * * * * *

Let me remind you what the objective of monetary policy is in Canada. The goal of monetary policy is to create a climate favourable to sustained growth in economic activity and in job creation as well as to rising standards of living for Canadians. How can monetary policy do that? By creating and maintaining conditions of low inflation. Hence, inflation control is not an end in itself, but rather the means whereby monetary policy contributes to solid economic performance. In a low-inflation climate, the economy works better. Low inflation helps businesses and individuals to make sound economic decisions and it helps moderate cyclical fluctuations in incomes and employment. That is why in February 1998, the government and the Bank of Canada jointly reaffirmed that Canada's monetary policy can best contribute to good economic performance by remaining focussed on inflation control. The 1 to 3 per cent target range for inflation was thus extended to the end of 2001.

Since adopting these targets back in 1991, Canada has seen considerable progress in the fight against inflation. Inflation has fallen and has remained at a low level. Economic decisions by businesses are now predicated on the continued existence of low inflation. Businesses are endeavouring to control costs and to improve productivity, the key factor in raising standards of living. Thanks to low inflation and the progress made in fiscal consolidation, interest rates are low. Indeed, medium-and long-term rates are now at or near their lowest levels in decades, thus contributing to the low cost of capital.

* * * * * *

Now let us take a look at how the Canadian economy has performed recently. Overall, 1997 was a very good year. The economy grew at a rate of 4.1% from the fourth quarter of 1996 to the fourth quarter of 1997. And the solid macroeconomic underpinnings of the Canadian economy have begun to show up in the labour market. The strength of economic activity has prompted a substantial rise in employment. For the year as a whole, more than 380,000 new jobs – mostly full time and in the private sector – were created far outweighing the loss of 13,000 jobs in the public sector. Strong employment gains have continued in the first five months of 1998, totalling about 165,000. In May 1998, the unemployment rate stood at 8.4%, its lowest level since 1990.

The pace of economic activity slowed in the fourth quarter of 1997 to 2.8%, compared to an average of 4.4% over the first three quarters of the year. The recently released National Accounts estimates indicate that growth in the first quarter of 1998 was about 3.7%. A key feature over the past six to nine months has been the number of unanticipated developments that have hit the Canadian economy. The Ontario teachers' strike and the postal workers' strike cut about one percentage point off the fourth quarter growth of last year. The January ice storm that hit eastern Ontario, Quebec and the Maritimes also had a negative impact in the first quarter of 1998, although reconstruction work due to take place later in the year and into 1999 will boost activity. Finally, the fallout from the Asian crisis and weaker commodity prices are also having a dampening effect on growth, particularly in British Columbia. Fortunately, the effects of these negative shocks have been significantly offset by the decline in medium-and long-term interest rates, by the amazing performance of the U.S. economy and better than expected economic conditions in Continental Europe. All these shocks have resulted in a higher-than-usual uncertainty and have complicated the conduct of monetary policy.

Declining interest rates have encouraged business spending on machinery and equipment and household spending on durable consumer goods, so that final domestic demand has been an important source of economic expansion in 1997 and early 1998, with investment alone rising sharply. With low interest rates and continued marked gains in good employment, household confidence has been high, leading to robust consumption expenditures.

What about the external sector? Thanks to the strength of the American economy, the volume of exports has also been rising sharply. There has also been a substantial increase in non-energy commodities exports in spite of declining prices. However, exports to Japan and other Asian countries, which account for about 8% of Canada’s total merchandise exports, declined in the second half of 1997 and early 1998. Overall, exports grew substantially over that period, but imports have also risen sharply so that the current account deficit widened in 1997. Amongst the factors responsible for the widening deficit, there was a sharp jump in domestic demand for products with a high import component notably machinery and equipment and other durable goods. In the first quarter, a notable improvement occurred with the current account deficit as a percentage of GDP falling back to less than 2%.

Before turning to the outlook, let us deal briefly with the factors affecting inflation. Wages have again risen at a moderate pace. With productivity improving, costs have been kept under control. Price inflation has been kept below 2% for the past six years now. Indeed, in late 1997 total CPI and core CPI (i.e. excluding the more volatile components of food and energy as well as the effect of changes in indirect taxes) fell below the target range of 1 to 3 per cent, reflecting the impact of temporary factors. More recently, core inflation has been at or slightly above the bottom of the range.

* * * * * *

Now let's look more closely at the Canadian outlook for 1998 and 1999. To do so, it is useful to examine prospects abroad and their impact on our economy. In the United States, economic activity was even stronger than anticipated during the first quarter of 1998. Growth should slow somewhat during the course of the year to a more sustainable pace in response to some expected loss of competitiveness and weak Asian demand, which became apparent in recent trade numbers. However, I must caution you that this slowing of the U.S. economy has been expected for a while, as the economy is really pressing against the limits of its capacity to produce. Yet, we keep being surprised by the strength of their economy. And for an economy that is deemed to be in excess demand, the United States has had remarkably good results with regard to inflation. In Europe, the outlook for 1998 is also somewhat brighter than two months ago.

What about Asia? This is the major source of concern for the world economy. While the financial situation in the countries that faced a crisis in the second half of 1997 and early 1998 now looks somewhat better, these countries still face considerable economic adjustment, and of course Indonesia has been going through a major political crisis. In Japan, conditions are quite uncertain notwithstanding important policy measures that have been taken. After contracting sharply in the second quarter of 1997, the Japanese economy showed little recovery during the second half of the year. Not much improvement is expected in 1998 given the aftermath of the Asian crisis, the fragility of the financial sector, and weak business and consumer confidence.

The outlook remains good for the Canadian economy in spite of the Asian difficulties and lower commodity prices. We are still expecting that our economy will grow at a 3.5% pace through the middle of 1999. This is somewhat weaker than what we were anticipating in the fall of 1997, but still robust growth. This would imply that the economy will achieve full capacity during the course of 1999. This assessment is based on the prospects of strong final domestic demand and assumes a modest recovery of the prices of commodities for which Canada is a major exporter. In spite of a modest pick up in inflation resulting from past depreciation of the Canadian dollar, inflation is expected to remain below 2%, that is well within the target range.

*   *   *   *   *   *

What are the consequences of this outlook for the conduct of monetary policy in Canada? In our May *Monetary Policy Report*, we acknowledged that the uncertainty surrounding the outlook is much greater than usual. However, the risks associated with it appear balanced. The main downside risks relate to developments in Asia and commodity prices. Offsetting these is evidence, particularly from the continuing strength of the U.S. economy and from the expansion of the money supply, narrowly defined, in Canada, that the underlying momentum of the economy might be stronger than we expect.

When all these factors are considered, it is the Bank's judgment (not commitment) that between now and the November report, monetary conditions in the recent range would be broadly appropriate <u>in the absence of further shocks</u>. This would be consistent with the above outlook of robust aggregate demand, the economy continuing to take up slack, and inflation inside the target range. Given the degree of uncertainty that is likely to persist over this period, monetary conditions — which refer to the effects of both short-term interest rates <u>and</u> the exchange rate on the economy and inflation — may continue to fluctuate over a relatively wide range. Subsequently, if the underlying momentum of activity remains as strong as is currently expected, less-stimulative monetary conditions would be called for as the economy approaches and achieves full capacity.

Over the past couple of months, we have seen no reason to fundamentally change these views. The economies of both the U.S. and Continental Europe appear a bit stronger while there is still a great deal of uncertainty in Japan, and commodity prices remain soft. The prospects for inflation in Canada — the objective of Canadian monetary policy — have also not changed. Overall, while there have been some signs of greater momentum in the economy, the outlook for the Canadian economy appears to be broadly in line with what we saw in the Monetary Policy Report.

<u>Conclusion</u>

To sum up, if we keep in mind that the objective of monetary policy in Canada, as has been reaffirmed recently, is to keep the annual inflation rate within a target range of 1 to 3 per cent, then the economic outlook facing us at present is compatible with that objective. 1997 was an exceptionally good year, despite the fact that the Canadian economy was hit by a series of shocks originating both at home and abroad. The pace of economic growth appears likely to be a little slower in 1998 and the first half of 1999. However, it should nevertheless allow further slack to be taken up, and thus bring output close to the economy's limit of capacity.

With the exception of Asia, where uncertainty continues to reign, international conditions are favourable to Canada. These include sound economic growth, weak inflation, and low interest rates. But the slowdown that has afflicted the more important Asian economies is certainly not unrelated to the weakness in prices for commodities, where Canada is still a major exporter.

While the most recent data suggest that Canada's economic outlook is somewhat more favourable than was anticipated a couple of months ago, the fact remains that this outlook carries with it a larger margin of uncertainty than normal. Therefore, more than ever, we must constantly be reviewing our judgments about the economic and financial situation. Nevertheless, we continue to believe that, between now and the publication of the next *Monetary Policy Report*, due in November, the appropriate course would be to keep monetary conditions within their recent range, provided there are no new shocks. This approach should be consistent with the expected strength of aggregate demand, the continued absorption of unused resources, and an inflation rate within our target range.

In closing, let me stress how important it is to make sure that our economy reaches its full capacity in a gradual and sustainable manner. We have learned over the past 25 years that, if we allow the economy to overheat and become inflationary, then we run the inevitable risk of plunging it into a severe recession. It is by keeping the economy on a track of non-inflationary and sustainable growth that we will achieve the greatest returns in terms of the income and employment that our economy is capable of generating.