
**Remarks by Malcolm Knight
Senior Deputy Governor of the Bank of Canada
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Price Stability and Canada's Economic Performance

Thank you for the introduction. It's a pleasure to be here. As many of you know, the Board of Directors of the Bank of Canada is meeting here in Calgary this week. Tomorrow, Governor Gordon Thiessen will be discussing the current state of the economy and what it means for monetary policy in the near term. So I thought it would be useful if I focussed today on something other than current economic developments. In particular, I'd like to talk to you about a subject that lies at the heart of the conduct of monetary policy: the establishment of inflation-control targets and the achievement of price stability.

But before turning to that subject, I can't resist saying just a few words about how well Canada's economy is doing right now. Here in Calgary, and throughout Alberta, you continue to have one of the strongest regional economies, with a strikingly low unemployment rate. Not only is the oil and gas industry booming, but Calgary also has a rapidly expanding high tech sector. One only has to look at the number of construction cranes that are in action around here to grasp how much activity is going on. And your provincial government recently announced its intention to eliminate Alberta's debt within two years. That, I must tell you, will be an impressive achievement.

But it's important to acknowledge that economic growth is strong all across Canada at present. Last month the Bank of Canada raised its projection for output growth this year, to a range of 4¼ to 4¾ per cent.

In fact, we have been enjoying buoyant economic growth for four years now, since 1996. In combination with this strong output growth, we have seen unemployment rates this year that have been at their lowest levels in over 25 years. Because of the surge in energy prices over the past year, inflation as measured by the overall Consumer Price Index rose to 3 per cent for the 12 month period to July. But despite this, the trend of core inflation—excluding volatile food and energy prices and the effects of changes in indirect taxes—has remained surprisingly subdued. In fact, the most notable feature of our current experience is that strong growth and low unemployment are being achieved in combination with low and stable core inflation—well within our 1 to 3 per cent inflation-control target range. In short, Canada's economy is in very good shape.

Today, I want to talk about the contribution that the achievement of low and stable inflation during the 1990s has made to the strong economic performance of recent years. We need to remember how different things were in the two decades before formal inflation-control targets were introduced almost a decade ago, back in 1991.

In the 1970s and 1980s, bouts of high inflation and the recessionary downturns that followed were part of the shifting and difficult economic landscape. Let me take you back and remind you what it was like. Over that 20-year period, inflation averaged 7 per cent a year, compared with an annual average rate of 1½ per cent over the past eight years. But these averages are misleading because inflation in the 1970s and 80s was not

only high on average but also variable and unpredictable. At its peaks in 1980-81, inflation climbed to an annual rate of more than 12 per cent.

Inflation causes uncertainty and poor economic performance

In an economy with pervasive inflation, uncertainty about the future leads savers and investors, households and businesses to make less well-informed economic decisions than they could make in an environment of price stability.

How does inflation complicate decision making? Let me give you some examples:

During inflation, price signals related to conditions of supply and demand for individual goods and services are difficult to read and interpret. This can lead to exaggerated expectations about the likely further increases in the prices of products that are already rising rapidly simply because of generalized inflation. One result is periodic bouts of over-investment in certain types of commodities. Good examples are the price surges we have all seen at various times in real estate, and precious metals, where prices typically respond the most sharply when markets begin to anticipate rising inflation. During the late 1980s, a number of Canadian cities experienced construction booms in condominiums and commercial buildings that fizzled with serious effects when inflation was followed by recession and the inevitable fall in asset values.

Inflation changes more than asset prices. For example, it often causes households and businesses to try to minimize their holdings of currency or chequing accounts. It also gives the financial industry an incentive to create instruments that are designed mainly to hedge against inflation and its volatility. As a result, considerable time, effort, energy, and expertise are devoted simply to trying to reduce the harmful effects of inflation.

These are valuable economic resources that would be more efficiently used in productive activities in a world of stable prices.

Another important cost from inflation is that the real returns on instruments such as deposits, loans and fixed-income securities are affected in unpredictable ways. Too many savers were caught unawares by the rise in inflation during the 1970s. And because savers—after they had experienced losses—became less willing to provide funds at fixed interest rates for extended periods of time, the supply of long-term fixed interest rate financing for housing and business fixed investment was adversely affected.

How can you make sensible economic decisions in such an environment? Think about what all that means because that is exactly the problem with high and unstable inflation—the uncertainty it creates. It undermines the value of money. And money can do its job in the economy only when it is a trustworthy standard that people can rely on.

Canada's experience with price stability

Back in 1991 when the Bank of Canada and the federal government first established inflation-control targets, the goal was to reduce inflation to the midpoint of a range of 1 to 3 per cent a year by the end of 1995. After that target was achieved ahead of schedule, in December 1993 it was agreed that this 1 to 3 per cent target range would continue to be achieved during a further period that extended to the end of 1998. Then in February 1998, the period was extended again to the end of 2001.

The inflation-control targets act as a guide for near-term policy decisions, but they also make it evident to financial markets that the long-run objective of monetary policy is

to sustain a low inflation rate. It is encouraging that under the inflation-control targets the average annual rate of inflation expected by market participants declined from about 5 per cent in 1990 to around 2 per cent by 1999. This is the mid-point of our target range and it appears that this has become an important anchor for expectations and for long-run corporate planning.

I want to emphasize that the reason for focussing on price stability—that is, to consistently achieve low and stable inflation—is that price stability is good for business and good for the consumer. And so it's good for the economy. It reduces the distortions and mistakes caused by inflation and inflation uncertainty. Price stability makes it much easier for households and business people to compare prices and costs and make better economic decisions.

This is not just a theory. Canada's underlying inflation is lower now than it was in the 1970s and 1980s, while economic growth is strong. If we compare the past five years with the period from 1975-95, we'll find that since 1996 we've had:

- S a lower average unemployment rate
- S lower interest rates
- S a higher real growth rate
- S fewer days lost to strikes
- S a lengthening of the average term of home mortgages

I think this is impressive evidence of how our environment of low inflation has improved the performance of the real economy.

Now, I would like to emphasize that monetary policy certainly did not accomplish these good things all by itself. Canada's strong economic performance over the past four

years is the result of several factors. Low inflation certainly is one of them. But another fundamental factor is the major fiscal adjustment that has taken place at both the federal and provincial levels since the mid-1990s.

In this respect, Canada has accomplished a major feat in virtually eliminating government deficits and putting the high level of public debt relative to the size of our economy (as measured by the ratio of public debt to GDP) on a downward trend.

In fact, it was only after 1995, with improved credibility on the fiscal front, that the Bank of Canada was able to achieve a durable reduction in short-term interest rates to levels consistent with the improved inflation performance that we had already been enjoying for some time. As the credibility of both monetary and fiscal policy improved, Canadian interest rates across the maturity spectrum—from short-term to 30 years—moved to levels below comparable interest rates in the United States. And, except for a short period in late 1998-early 1999, they have remained there. The combination of fiscal adjustment and low inflation permitted lower interest rates, and lower interest rates, in turn, helped domestic demand in Canada to recover. As a result, a strong expansion was set in motion, beginning in mid-1996 that has continued to the present.

There is also a third very important factor that has contributed to our current economic prosperity. That is the major restructuring of Canadian businesses that occurred during the 1990s in response to stronger global competition, the free trade agreements signed in 1989 and 1994, technological change, and the increased need to focus on improving cost efficiency in the new environment of low and stable inflation.

The issue of productivity growth

The recent experience of the United States in achieving spectacular productivity growth bears watching because our economies are closely linked. The amazing strength of U.S. productivity gains in recent years appears to have been set in motion by the strong rise in business investment that began in 1992, especially in machinery and equipment.

Productivity growth south of the border began to pick up in the mid-1990s. Now, after nine years of economic expansion, productivity gains in the United States have remained very strong, rather than falling off as usually happens at this stage of the business cycle. High levels of economic activity and tight labour markets seem to have encouraged the continued record level of investment in that country and more efficient use of technology than before. In Canada too, we are hopeful that we will see a similar payoff from the adoption of new technology and a comparable improvement in productivity.

Since 1996, business investment in Canada has been rising smartly and more firms have been adopting new production technologies. Indeed, investment in machinery, equipment, and technology has risen from 6 per cent of GDP in 1996 to 9 per cent of GDP in 1999—which brings us to about where the United States was four years earlier.

Until recently, there had been little evidence of larger productivity gains in our official, economy-wide statistics. But the data for the second quarter of this year do show significant productivity growth. Another indication that productivity may finally be rising more strongly is the unexpectedly low trend of core inflation, despite the stronger-than-anticipated momentum of total demand in Canada.

Is this the beginning of a trend? If so, how can we best foster it? At the Bank of Canada, we believe that we must ensure that the trend of inflation remains low, and that we do not approach the economy's capacity limits too rapidly if we want to sustain strong output and employment growth, strong investment, and durable productivity gains for the Canadian economy.

Current work on price stability

Looking ahead, by the end of next year—2001—the government and the Bank of Canada are committed to reconsidering the current inflation-control targets and determining a long-run objective for monetary policy that is consistent with price stability.

In preparation for this work, the Bank of Canada has been conducting a good deal of research. We held conferences on price stability in 1993 and 1997. And again last June we sponsored a one-day conference on the subject with the participation of prominent academic and policy economists. The research papers presented at the conference are now available on the Bank's Web site.

And that is where things stand at the moment. Building on the success of the current inflation-control targets, our challenge now as we move forward is to continue to deliver a stable, low-inflation environment.

I believe that the achievement of low and stable inflation in Canada has been an important contributor to the strong economic performance that we are seeing today. It has delivered results. We are seeing increased growth and lower unemployment. It is this solid economic performance that is the ultimate justification for Canada's inflation-

control targets. We at the Bank of Canada believe that low inflation is a cornerstone of Canada's continued strong economic performance.