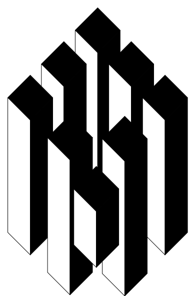

PRESIDENT'S DIGEST

BY TOM KIERANS

November 1996

Well, well, well! Monetary policy is back in the news again! And this, despite the Bank of Canada's unquestioned success in managing inflation down to below the midpoint of the federal government's agreed-on target range. The Bank's credibility in domestic and international capital markets has never been higher. That has translated into a yield curve with rates across the spectrum from lower than, to as low as, US interest rates. And, for the time being, the Canadian dollar remains well below its purchasing price parity level with the US dollar — a significant competitive advantage. As well, the volatility of interest rates is easing, despite the enormous debt burdens that still haunt federal and provincial governments. (Admittedly, this is not all the Bank's doing. In part, it is also because the capital markets have bought into Finance Minister Paul Martin's far-reaching, if languid, 1995 fiscal reforms.)

What more can monetary policy do? If Canadian consumers are immobilized by huge household debts and fears of job loss, it would seem that low interest rates should help *a lot*. But over the longer term, the key lesson of much economic research and practical experience is that monetary policy's long-term impact is almost exclusively on prices. Basically, I don't buy into extravagant claims about the Bank's ability to raise the long-term growth rate or to alleviate governments' fiscal struggles. Maybe we should look elsewhere for job creation and buoyed consumer confidence, perhaps by starting with the regulated and government enterprise components of the consumer price index and their impacts on discretionary consumer spending, or with policy-induced obstructions in the labor markets.

So, why the eruption of renewed controversy? In part, it is due to the pain retired seniors are experiencing as interest rates on investments decline. Their lobbyists recommend reflation. But you can't have your capital and consume it too; nor is this a viable option, given the costs incurred to achieve the benefits *already* accruing from the goal of price stability.

But mainly, it's about the current inflation control target, a 1–3 percent band for year-over-year increases in the CPI. This arrangement between the Bank and the federal government is due to expire by the end of 1998. Since there is a long lead/lag relationship between monetary conditions and price levels (two years, give or take), the debate is properly beginning now. Also, a federal election will intervene and the current arrangement may well become an issue.

A Follow-Through Agenda

So, what to recommend? There are three schools of thought (excluding the reflationists). According to the first, the target range should be raised to, say, 2–4 percent. The thinking here is that, within that range, real wage cuts can be im-

plemented surreptitiously; otherwise, so the hypothesis goes, worker resistance and layoffs keep unemployment unnecessarily and perpetually higher. I have two problems with this hypothesis. One, it is not consistent with my observations about labor market behavior in the truly private sector. And two, for inflation to vanish as an influence in decisionmaking, it must stay low and stable for an extended period. I think this approach takes the wrong direction.

The second school would continue the current 1–3 percent target band on the grounds that it is familiar, demonstrably achievable, thus far credible, and therefore effective. But this is a double-barreled proposition. That band also appeals to those who believe that monetary conditions can be even easier, since inflation is currently below the midpoint of the band and can therefore be allowed to rise. To the first, I say: maybe. To the second, I worry about expunging inflationary expectations.

Which brings me to the third school and to my own bias: Canada should *follow through* on progress made to date and lower the target to $^1/_2$–$2^1/_2$ percent. This would bury inflationary expectations for some time to come, enhancing even further the Bank of Canada's credibility and securing (all other things being equal) the beachhead for the goal of price stability, with concomitant low interest rates.

Sooner or later, a political decision must, and will, be made in the context of, or in the aftermath of, an election. I, for one, do not believe that in a democracy the central bank should be mandated to take this decision of its own accord. The prospect of an election debate may be unsettling, but it can also be salutary. How better to ensure that the voting population really focuses on the key issues: what can monetary policy really deliver? What rate of inflation, if any, do we really want? And who is responsible for achieving it?

The 1996 Benefactors Lecture: Growth through Innovation

Speaking of focusing on the right stuff, I was recently in Vancouver to chair the Institute's prestigious annual Benefactors Lecture. For more than an hour over lunch at the Waterfront Centre Hotel, I, along with about a hundred Institute members and guests, sat spellbound as renowned economist Richard G. Lipsey detailed exactly where we *should* be looking for growth: in technological innovation — it's as simple and complex as that. If we want jobs created, if we want greater longevity, better educational levels, and a cleaner environment, we must foster innovation and technological progress, Lipsey argued. Over and over again throughout history, technological change has caused giant leaps forward in living standards, whether it was the discovery of mechanical printing or electricity. But technological advances also bring social and economic turbulence. As new technologies displace old ones, some workers find that their skills have become obsolete. Pushed by the wayside by the forces of change, these workers pay a high price so that their children and grandchildren can benefit from new discoveries, processes, and machinery. Terrified by the temporary transitional effects of the technological transformation, many try to stop it, seeing it as an evil that undermines society's cohesion.

Don't Stop Progress

Does this sound familiar? It should. Lipsey, a Fellow of the Canadian Institute for Advanced Research and Professor of Economics at Simon Fraser University, argued that since the early 1970s the industrialized countries have been in the midst of an economic upheaval because of the introduction of major changes in information and communication technology. As in the past, such a pervasive technological change is wreaking havoc. People are frightened about losing their

jobs. They worry about whether their children will ever again see "the good old days" of high-paying, stable jobs. But if the past is any guide, Lipsey said, this period of change and economic realignment should soon pay off — with a period of sustained boom within a more stable economic structure, beginning around the start of the next millennium and lasting for decades.

Lipsey made an impassioned plea to that Vancouver audience: Don't stop progress. Help those who pay the price of future benefits, but don't try to stop a better future from unfolding. And don't take for granted the growth that has made us richer than our ancestors could ever have dreamed of. Since 1896, relative purchasing power has increased tenfold. That increased value of consumption has come about not by producing ten times as many products and services as the late-Victorian economy did, but by the introduction of wholly new commodities with technologies that were unknown a century ago.

But in the same way that other civilizations have lost their scientific and technological edge, we too could lose the things that make progress and growth possible. According to Lipsey, the necessary ingredients for growth and innovation include: the freedom to innovate; market, rather than political, decisionmaking applied to technological change; market-applied rewards and penalties for innovators; a pluralistic society; free scientific enquiry; and the rule of law. (I would add: An environment of negligible inflation does no harm to the ability of markets to cope with technological change.) Change those ingredients and you risk losing the potential to keep on growing, Lipsey warned.

Lipsey concluded with a timely reminder to governments:

> The Canadian political rhetoric is "jobs, jobs, jobs." Yet it is not government that creates jobs in normal times, although it may reallocate them by spending tax money in ways that differ from private spending. Anyone who fosters the myth that government can create jobs is urging the public to ignore the real issue, which is how to create the circumstances under which private sector firms can create jobs (instead of fleeing to more industry-friendly jurisdictions) and the labor force can fill them. *Creating* more jobs requires an environment of reasonable taxes, regulations, and labor laws. *Filling* jobs is something government could do more about — by education, education, education.

I am proud of the Institute's Benefactors Lecture series. Over the five years we have sponsored these lectures, scholars have tackled issues as diverse as the flexibility of the Canadian federation to the benefits of fixed exchange rates. Each year, one of the Institute's valued supporters makes the lecture possible. This year, it was the Hongkong Bank of Canada, whose President and CEO, William R.P. Dalton, is a director of the Institute and a strong supporter of reasoned public policy debate.

I was especially happy to see so many new supporters of the Institute at the luncheon in Vancouver. To Lipsey's list of the ingredients that are necessary to make our children's lives better than our own, I would venture to add: a business community that understands the importance of ideas.

Don't Overreact to Short-Term Jitters

It is hard to keep a focus on long-term growth when short-term growth still looks shaky. October's unemployment figure, which reached a double-digit 10 percent, was a reminder of why Canadians still feel vulnerable despite evident gains in other parts of the economy. But the near-term prospects are not as bad as is often made out. The Quebec economy is still a cause for worry, but the rest of the country is looking pretty good. The reason we have seen such a patchy growth performance over the past year or so is because back

in late 1994 and early 1995 the Bank of Canada reacted to weakness in the dollar as though it were just a hiccup in foreign exchange markets that needed offsetting with higher short-term interest rates. Instead, as a *C.D. Howe Institute Commentary* by Ken Boessenkool, David Laidler, and Bill Robson pointed out earlier this year, the lackluster dollar was a sign of bad fundamentals (uncertainty over Quebec; overindebtedness; and a weakening economy, to name the most obvious culprits).

Since early 1996, however, the Bank of Canada has had the money taps open wide. We are now seeing early signs of the sort of economic acceleration one would expect with that kind of stimulus. With 42,000 new jobs in October, job growth over the past three months has reached an annual rate of almost 3 percent. From Ottawa's point of view (or from the point of view of a lot of people in Ottawa), the problem with the latest job figures is that lots of job seekers have been entering the now more buoyant market, raising the measured jobless rate. Ten percent is an ugly number, not only for what it says about still-frustrated job seekers, but for the kind of short-term "fixes" it prompts politicians to look for. Especially in the runup to an election, and with Ottawa ahead of its deficit targets, a new surge of pork-barrel-type spending and subsidies is a real threat.

If Finance Minister Martin must give in to this lobby, his best bet is to cut employment insurance (EI) premiums. The cumulative surplus that is building in the EI Account is far beyond what reasonable projections for a slowdown can justify: EI premiums have become a deficit-reduction payroll tax. The worst problems in the job market are faced by younger, less-skilled job seekers — the kind of people a cut in EI premiums would help the most. Ottawa's determination to keep EI premiums high is preventing badly needed reform of the Canada Pension Plan, with several provinces unwilling to see higher CPP premiums without EI cuts. And by putting the measured deficit more closely in line with the federal government's fundamental position, removing the padding of excess EI premiums might strengthen Mr. Martin's hand in facing down the spending lobby.

The C.D. Howe Institute is a private, independent, nonprofit research and educational institution. For further information, contact:
C.D. Howe Institute, 125 Adelaide St. East, Toronto, Ontario M5C 1L7; (416) 865-1904; fax (416) 865-1866; e-mail: cdhowe@cdhowe.org
or visit the Institute's Internet web site at: http://www.cdhowe.org