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Smooth Sailing?

We've had year after year of prosperity. Can it last forever?

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"Let the good times roll" could be the theme song for the Canadian economy over the past several years. Output and employment have been growing, inflation has remained low, and the fiscal dividend has now kicked in with a vengeance. Many people are wondering when these good times are going to end. Is Canada's next recession just around the corner, or is there reason to be more optimistic?

Let me come clean right away. Even macroeconomists who spend their time studying business cycles can't tell when the next recession is coming, or what its cause will be — there are still lots of mysteries in economics. Despite this uncertainty, however, some simple lessons about Canada's last two recessions point in the direction of optimism.

The recessions of 1982 and 1990-91 were caused largely by the Bank of Canada's efforts to reduce inflation. Recessions are, after all, the only known way of squeezing sustained inflation out of the economy. They accomplish this because sufficient excess supply in the economy stops workers pushing for high rates of wage growth and stops firms pushing for high rates of price increases. There are, however, some key differences between the inflations that preceded these two recessions, and herein lies our lessons for the future.

In 1981, inflation in Canada and the United States was above 12% and had been high for a decade. The main cause of this inflation was the OPEC oil shocks of 1973 and 1979, each of which tripled the world price of oil. These negative supply shocks, as economists now call them because they increase firms' costs and reduce the supply of goods, led to "stagflation" — the combination of slow growth and high inflation. The problem for policymakers at the time was that such supply shocks were completely unknown — they didn't even exist in the arcane scribbles of academic economists. Central banks around the world didn't know how to respond. Only with hindsight did it become clear that the inflation that started from higher oil prices became entrenched in expectations and was being sustained by high rates of money growth. The only way to reduce this inflation was to clamp down on the rate of money growth, which both the U.S. Federal Reserve and the Bank of Canada did. The deep 1982 recession followed, and the significant slack in the economy drove inflation down to 4% within a year.

The Canadian economy recovered strongly after 1983 and grew steadily for 7 years. No significant supply shocks occurred to drive up inflation. But by 1989, inflation had risen to 6% and showed signs of increasing further. The cause, this time, was the combination of a quickly growing economy and the absence of an "anchor" for monetary policy. The Bank of Canada had abandoned explicit monetary targeting several years earlier and monetary policy was left to drift, with nothing but the Bank's discretion to keep money from growing too quickly. Discretion may be the better part of valour, but it is usually a problem for central banks, leading to a gradual increase in inflation. The Bank's eventual response was the much debated policy of "price stability", introduced in January of 1988. By the time the policy was fully implemented a year or so later, Canadian interest rates had risen to over 5 percentage points above U.S. rates and the next Canadian recession was well underway.

Does today's economy look anything like the economy in 1981 or in 1989? Not really. Inflation in the developed economies is low and stable and has been that way for several years. Here at home, the Bank of Canada now has a very effective monetary anchor — explicit inflation targets. The Bank's current objective is to keep the "core" rate of inflation (which excludes volatile food and energy prices) between 1% and 3%. Moreover, it has clearly shown both its willingness and ability to achieve this objective. The Bank of Canada has unquestionably established its low-inflation credibility.

Inflation targets matter because they act as a powerful "automatic stabilizer" for the economy, reducing the likelihood of a future recession. With very strong economic growth during the past four years, why hasn't inflation increased as it did during the late 1980s? Part of the credit goes to the Fed's commitment to low inflation in the United States. But more important for understanding Canadian inflation is the Bank of Canada's inflation targets. Whenever it appears that the Canadian economy is beginning to overheat and push up inflation, the Bank raises interest rates and gently slows the economy, thus reducing the inflationary pressure. If the Bank continues to be vigilant during the current period of healthy growth, inflation will remain within the official target band. And if that happens, there will be no need in the future to engineer a recession to reduce inflation. In other words, as long as the Bank continues to use its monetary anchor we will avoid the boom-bust cycle that, in the future, has always ended so painfully.

How about the rising price of oil? Couldn’t this lead to the same problems we had in the late 1970s? Probably not, for two reasons. First, with the ongoing shift in economic activity away from manufacturing and toward high technology and services, the Canadian economy relies less on oil now than it did in the 1970s. Second, and more important, policymakers have spent two decades learning about supply shocks, and about how to respond, or not respond, to them. Inflation targets are an important result of this learning experience. Any significant external shock that threatens to create a Canadian recession will lead the Bank of Canada — if it’s really serious about its inflation targets — to reduce interest rates and provide the necessary monetary stimulus for the Canadian economy.

The upshot of the story is that, while we don’t know what types of shocks are lying in wait for the Canadian economy, we do know two things. First, we now have an effective monetary anchor that will prevent a growing economy from pushing up inflation, thus eliminating the need for a costly future recession to reduce inflation. Second, that same monetary anchor automatically provides us with a powerful tool to offset the effects of external shocks. The Bank of Canada’s commitment to inflation targets therefore provides us with a good reason to believe that today’s booming economy will not soon be followed by tomorrow’s bust.