000000466 31JUL1993 920 002

S. ROBINSON
SEC
8
WEST

BANK OF CANADA

Monetary policy and financial markets

Notes for remarks by
Gordon G. Thiessen
Governor of the Bank of Canada

NAME/NOM FI ADDRESS/ADRESSE
FILES - FIB-280

FOR YOUR RETENTION:
A CONSERVER:

BANK OF CANADA.
(SPEECHES): GOVERNOR.

*** QUESTIONS-TEL. 782-8000 ***
R= 013342 I= 0048 C= 002 G= DATE: 941012

to the
Halifax Board of Trade
Halifax, Nova Scotia
12 October 1994

Not for publication before 12 October 1994 at
1:10 p.m. Atlantic daylight time
12:10 p.m. eastern daylight time

Notes for remarks by Gordon G. Thiessen
Governor of the Bank of Canada
to the Halifax Board of Trade
Halifax, Nova Scotia
October 12, 1994

Monetary Policy and Financial Markets

I am pleased to have been invited to Halifax to speak to you today. I plan to talk about what we at the Bank of Canada are trying to achieve with monetary policy and why we think that this is good for the Canadian economy, including for the Atlantic provinces. I will also spend some time on why interest rates have been higher for much of this year and the impact this is having on the Canadian economy.

While the Bank of Canada has a number of functions, our main responsibility is monetary policy. Monetary policy has to do with controlling the amount of money in circulation and the speed at which it grows. The expansion of money has an influence on interest rates and the Canadian dollar, and these in turn affect savings, investment, demand and production. But the main result of monetary policy over time shows up in prices -- specifically in the rate at which prices increase, in other words, in the rate of inflation.

Our objective is to protect the value of money from being eroded by inflation. We want Canadians to be able to have confidence that the money they hold will retain its value in terms of the goods and services it can buy. The term we use for this objective is "price stability."

This goal is the objective for monetary policy because our economy functions better with price stability. Investors and savers can make better decisions and the economy is more efficient. As a result, we can produce more, thereby helping to raise our standard of living.

It is interesting to note that price stability has become the objective of monetary policy not just here in Canada, but in most other major countries as well. And indeed, because of declining inflation, interest rates have come down significantly from their levels at the beginning of the decade in all of these countries. I will return later to the interruption of this trend that we have seen this year.

The achievement of price stability means that there should be no increase on average over time in what we pay for the goods and services we consume. However, it does not mean that individual prices will not change. Some prices will go up, while others will come down. There were also relative movements in prices when inflation was high -- some prices rising more rapidly or slowly than others -- but these relative movements look more dramatic when the price level on average is not changing much. Indeed, it is one of the benefits of price stability that relative price movements are more clearly identifiable.

Relative movements in individual prices are important in a market economy because they signal where more resources are needed to produce the goods and services being demanded and provide incentives for resources to move. So we are not worried by relative movements in prices. What we want to avoid are generalized price pressures.

In recent months, the year-over-year increase in the consumer price index has been close to zero. However, this measure has been influenced by the cut in tobacco tax rates earlier this year, which has had a one-time effect on prices. To get a better idea of the underlying momentum of prices, we at the Bank of Canada look at the consumer price index excluding indirect taxes and the more volatile food and energy components. This alternative measure indicates that underlying inflation has been running at about 1 1/2 to 2 per cent. Our goal has been to hold inflation within a range of 1 1/2 to 3 1/2 per cent as of mid-1994 with the inflation-control target band moving down to a range of 1 to 3 per cent for the period 1995 to 1998. As you can see, underlying inflation has been in the lower part of our range. And we believe that inflation in the months to come will remain by and large in the lower part of the target band.

This low rate of inflation and the Bank's commitment to price stability have contributed to the recent improvement in the performance of our economy. The more certain outlook provided by low inflation has encouraged investment and productivity improvements. As well, the policy of bringing inflation down has enabled businesses to get their costs under better control. With the improvement in productivity, labour costs per unit of production have actually fallen over the last year. This good record in cost control has helped businesses to take full advantage of the depreciation of the Canadian dollar that has occurred over the last few years to improve their international competitiveness -- the evidence is in our recent export figures.

Helped by this impetus, the economy has been expanding at a pace of close to 5 per cent on average so far this year. And growth has become increasingly based on a broad recovery of demand -- not just in exports, but also in investment and consumer spending. Employment has also been strong in recent months. This has helped to reinforce confidence, both of

consumers and business, that the economy will continue to strengthen.

However, the economic situation in some areas of the country has been improving rather slowly -- and the Atlantic region is one such area. The sluggish recovery in the prices of commodities produced in this area provides part of the explanation -- although in recent months, some prices, such as for pulp, have been showing signs of improvement. The Atlantic provinces also have been hard hit by the closure of part of the fishery, which has eliminated many jobs.

These developments underline a fact of life we have all been learning to cope with over the last few years -- the need to adjust to rapidly changing economic conditions, such as the exhaustion of a previously plentiful resource like fish, or costs that are out of line in more competitive world markets or the arrival of new technology. The process of adjustment is not pleasant: long-established companies either make major changes in the way they do business or go out of business altogether and people lose their jobs and must suddenly acquire new skills. However we are beginning to see some of the benefits of restructuring -- in the improving productivity I referred to earlier and here in the Atlantic provinces in the more diversified economy that has resulted from the recent development of the service sector.

What can monetary policy do to help along this difficult process of adjustment? People have sometimes criticized monetary policy for not taking sufficient account of the economically weaker parts of the country. Let me emphasize that the Bank closely follows developments in all regions of Canada. However, there can be only one monetary policy in Canada and it has to be based on an assessment of what is appropriate for the country as a whole.

What monetary policy can do to help the adjustment process in Atlantic Canada is to provide a backdrop of price stability. Such an environment helps people make better economic decisions and results in an improved investment climate. Inflation only obscures the need for adjustment and retards the process, making the overall situation more difficult.

* * *

A common difficulty that all regions of Canada have faced this year is turbulence in financial markets and the higher interest rates that such turbulence has brought in its wake. These higher interest rates are having an impact on some kinds of spending, in particular, big-ticket consumer items like houses and cars.

However, it is important to realize that, despite the higher interest rates, the economy still has considerable momentum. The effects of higher interest rates have been offset to an important extent by the lower dollar and its contribution to the buoyancy of the export sector. To gauge properly the effect on the economy of financial developments, you have to take into account both interest rates and the exchange rate. At the Bank, we call this combined influence "monetary conditions." This way of looking at financial ease or restrictiveness suggests that monetary policy continues to provide a lot of support for economic expansion in Canada.

Even so, the increase in interest rates is troubling because of its effect on the economy over the longer run. Over time, higher interest rates have the effect of discouraging investment that could increase productivity and incomes in the years ahead. As well, higher interest rates mean that consumers, businesses and governments must pay more to service their debts.

Is there something monetary policy can do about this situation? How are these higher interest rates consistent with the proposition that lower inflation is supposed to lead to lower interest rates?

In looking for the reasons why interest rates rose in Canada this year despite our good inflation performance, it is important to recognize that the increase was not purely a Canadian phenomenon and to a considerable extent reflected developments abroad. The United States economy is operating very close to full capacity, and to prevent the resurgence of inflationary pressures there, the Federal Reserve started to tighten the stance of monetary policy last February. As a result, interest rates, both short- and long-term, rose in the United States. And these higher interest rates spread to financial markets in other countries, including Canada.

With these pressures coming out of the United States, investors everywhere reassessed the risks of various types of investments, in particular looking at the risks associated with investments in different countries. It is interesting to note that while long-term interest rates in some countries, for example in Japan, have gone up by less than those in the United States, long-term interest rates in Italy, Sweden, the United Kingdom, Australia and Canada have risen by significantly more. In some of these latter countries, there were also increases in short-term rates and the exchange rate came under pressure. What these five countries have in common is a recent history of relatively high inflation, high budget deficits and weak currencies; in some cases political uncertainty has also been a factor. The larger increases in interest rates in these countries therefore appear to reflect risk premiums that investors require to protect themselves against all these uncertainties.

To get back to the question of what monetary policy can do about these higher rates, you may ask why we at the Bank of Canada -- and the central banks in the other countries I mentioned -- did not just print more money to keep interest rates down. The answer is that this would not have helped us. The Bank of Canada has considerable direct influence over very short-term rates. Beyond that, however, our influence is much more indirect. And when it comes to long-term rates, our influence stems almost entirely from the effect of our actions on people's expectations about what inflation will be in the future. If we tried to keep interest rates down by pumping more money into the financial system, we would cause doubts to arise about the maintenance of low inflation and our commitment to the goal of price stability. And interest rates beyond the very short-term would likely rise rather than fall as a result.

Thus, printing money is not a way to insulate our interest rates from influences coming from abroad or from the demands of investors to protect themselves against risks they see in Canada.

What can be done, however, is to deal with the problem that has made us especially vulnerable to the kinds of pressures on interest rates that we have experienced this year.

As I noted above, the industrial countries experiencing the largest increases in interest rates in the recent period all have had large budget deficits. Large deficits, and the accumulation of debt which results, can cause nervousness in financial markets because in the past countries have frequently tried to reduce the burden of their debts by inflating the problem away. So to protect themselves against this risk, investors require higher interest rates.

Once investors have become worried about a country because of its large fiscal deficit and debt, the country becomes more vulnerable. With a large amount of debt outstanding, upward movements in interest rates then translate into large increases in debt-service costs and in the deficit. And this widening of the deficit causes investors to assess once again the risk premiums and the interest rates they demand -- resulting in higher rates and yet another deterioration of deficit and debt positions.

There is no doubt that investors in financial markets are looking for efforts by governments at all levels in Canada to reduce budget deficits and put them on a more sustainable footing. This would reduce fears of inflation, help to lower interest rates and make us less vulnerable when interest rates rise because of external reasons or because of political developments here.

I would note, however, that contrary to a notion that sometimes circulates in financial markets, monetary policy is not dependent on fiscal restraint to attain the goal of price stability. The Bank of Canada could sustain an anti-inflationary policy quite apart from fiscal policy. Our commitment to our inflation-control targets is without reservation.

What fiscal restraint can do is to ease the task of the monetary authorities in controlling inflation and achieving price stability, particularly at times of expanding private demand. Put another way, without fiscal restraint the resulting mix of policies may not be very pleasant because interest rates would be much higher than otherwise. But the situation would be much worse if monetary policy were to ratify whatever higher rate of inflation resulted from pressures arising from the government spending and borrowing at a time of rapidly expanding private sector demands on the economy. There are too many benefits from price stability for the Bank to take any risks in letting inflation get away on us again.

In summary, the objective of monetary policy in Canada continues to be to control inflation, and over time to reach price stability. And we have had a good measure of success in bringing inflation down over the last few years -- the underlying rate of inflation is now less than 2 per cent. However, interest rates remain high. While the increase in interest rates this year has in part reflected the unavoidable influence of international markets, it has also been due to domestic fiscal and political concerns. But despite higher interest rates, the economy continues to have considerable momentum and prospects for future growth in output and employment are good. To an important extent that is because of the strong economic foundation built by the movement to price stability over the last few years.