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Notes for a Luncheon Address by

John W. Crow

Governor of the Bank of Canada

to

The Calgary Chamber of Commerce

Calgary, Alberta

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I want to thank the Calgary Chamber of Commerce for the invitation to address you today. I welcome the opportunity to give you my perspective on some of the economic developments affecting Canada and to explain the response of monetary policy to those developments. And I also welcome the occasion it provides to visit Western Canada. I am well aware that economic conditions in Canada look distinctly less rosy the further one gets from Central Canada. It always helps to get away from the office and see conditions at first hand -- even if the Bank staff and the members of the Bank's Board of Directors are a good source of information about what is going on across the country.

My remarks today will focus mainly on international issues -- in particular, on how recent international economic developments have affected Canada and on the importance of international considerations in the conduct of monetary policy. At first glance it might seem strange that I have come here to give such a speech. But of course it is not strange at all. Canada is heavily influenced by international developments, and no part of the country feels that influence more strongly than the West. And Calgary knows better than almost any other city the extent to which international forces have contributed in recent years to good, and not so good, times in our economy.

In contrast to the relative stability of the 1950s and 1960s, ever since the early 1970s the international economic environment has been volatile and troubled. This was largely a result of bad economic policy. Policymakers worldwide allowed a sharp run-up of inflation during the early 1970s, and it is no exaggeration to say that the whole period since then has been spent trying to undo the resulting damage.

Getting back to more stable prices after high inflation is never easy. But the difficulties have been made worse by the uneven balance of fiscal and monetary policies followed in the major industrial countries. In particular, years of highly expansionary fiscal policy in the United States resulted in unusually high levels for world interest rates over a long period of time. This in turn led to large swings in exchange rates, budgetary and trade imbalances, and additional pressure on already burdensome debt positions in the global economy. These developments pose a persisting threat to the pace of economic expansion.

The painful process set in train over fifteen years ago has not yet ended. No one imagined that it would take so long and be so disruptive. This should persuade us never to let the inflation spiral get started again.

Its lingering effects are nowhere more evident than in the markets for primary commodities. Measured in U.S. dollars, the prices of industrial materials are not much above their recent low point, while the prices of energy and many agricultural products are well below levels prevailing just over a year ago. This has occurred despite the fall in the U.S. dollar against other currencies, and despite five years in a row of world economic growth. It has been particularly painful for the Canadian West.

Why has this happened?

In part, low commodity prices are a product of special circumstances -- for example, the effect on agricultural prices of massive subsidies in both Europe and the United States and a fight for market share. In this regard, we must all welcome the armistice announced last week at the OECD in Paris and look forward to the follow-up.

But there is a more fundamental reason for low commodity prices today. They are in large part the by-product of the exaggerated expectations fostered by the rapid rise of prices during the 1970s. These price increases stimulated expansion in productive capacity worldwide at the same time as they encouraged users to reduce their reliance on these commodities. Both responses acted inevitably to bring prices down again, and to levels lower in terms of purchasing power than before the inflationary spiral began.

What are the prospects for these commodity markets? There have recently been some encouraging signs, but the outcome will depend in large part on the pace at which the world recovery in economic activity continues. Here, we face some major uncertainties.

As I have already noted, the expansion of the world economy since the recession of 1981-82 has been very unbalanced so far. The recovery of demand was generally much stronger in the United States than in other countries. This demand was spurred in the United States by large budgetary deficits, and elsewhere by the strong appreciation of the U.S. dollar in the first half of the 1980s. The end result has been a U.S. trade deficit of unprecedented size and counterpart trade surpluses in Germany and Japan.

Such a state of affairs was not sustainable. Governments and countries, like individuals, cannot live beyond their means for long periods without inviting awkward consequences. And the longer they put off adjustment, the more disruptive and prolonged the eventual, and inevitable, sorting out becomes.

The U.S. economy is now responding to these imbalances. The federal government is beginning to reduce its budget deficit. The value of the U.S. dollar has fallen in response to the large and persistent trade gap. And domestic demand, after being so strong for so long, is beginning to slow. What remains uncertain is how abrupt this slowdown will be. It is also uncertain whether, in the face of the need for large changes in trade performance, there will be a big enough increase in demand in other countries to take up the slack in the world economy.

These are pressing issues. They affect the prospects for commodity prices and for trade more generally. They could add further impetus to the forces of protectionism, already strong in many countries, that threaten to undermine the world trading system. I repeat, these are pressing issues for the world, for Canada and for Western Canada.

It is going to take an unusually strong degree of understanding and cooperation to deal satisfactorily with them. At the same time, some constructive developments have begun to make themselves felt. European and Japanese consumers and investors now have appreciably greater purchasing power than they had a year ago -- a product of their strong currencies as well as the decline in the price of oil -- and that is bound to lead to an increase in their spending. Moreover, there is now widespread recognition of what needs to be done to sustain growth, and a commitment on the part of all the major industrial nations to cooperate to do it. At recent meetings of the Group of Seven industrial countries in Paris and Washington, Ministers of Finance affirmed their commitment to lower government deficits in North America, to fiscal stimulus in countries having the leeway to do so, and to lower interest rates in situations where this would not risk a resurgence of inflation.

Canada as a major trading nation has a great stake in all of this. Our best route to continued prosperity is within a framework of free and open trade in a growing world economy. We must continue to promote this outcome in every way we can.

I have focussed until now on international economic developments affecting economic activity in Canada. I dare say that many of the points I have made are already well recognized by this audience. But what I suspect is less well understood is how international forces, particularly in the markets for foreign exchange, impinge on the conduct of monetary policy in Canada. So let me say a few words about our recent monetary policy actions.

I am often asked why the Bank pays so much attention to the exchange value of the Canadian currency. The answer is simple. Domestic price stability is the primary contribution that monetary policy can make to good economic performance. And the most important single price in the Canadian economy is the price of the Canadian dollar. A decline in the dollar relative to other currencies directly raises the price of our imports and the domestic price of all those Canadian made goods which compete against imports or may be exported. These price increases can lead to concerns about inflation and can feed back into wages and other prices. The risk that this will undermine confidence in the currency cannot be ignored by a central bank in the way it conducts monetary policy. Just over a year ago the Bank had to react very strongly to what was evidently a severe erosion of confidence in the Canadian dollar. That is part of our job.

There can of course be circumstances quite apart from problems of confidence in which the external value of the Canadian dollar might be subject to downward pressure. For example, the weakness in the prices of Canadian resource exports relative to the prices of imports into Canada over the last few years has implied that other Canadian industries must become more competitive if we are to maintain a reasonable balance in our external trade and payments.

What I do not accept is the argument that this increased competitiveness can be provided automatically, effortlessly, by encouraging currency depreciation. It is true that the dollar has on balance fallen over the last three years or so. But the Bank has had to lean against that decline to ensure that the resulting upward pressure on domestic prices did not endanger progress in reducing domestic inflation. It is inherently dangerous to rely on currency depreciation to improve international competitiveness. If depreciation sets off a spiral of price and wage increases, we wind up less rather than more competitive. That is the chief lesson I draw from our history of currency depreciation since the mid-1970s. The only sure way to bring about a sustainable improvement in competitiveness is by keeping our domestic costs and prices down. That should be the principal focus of monetary policy.

The problems we have seen in our exchange markets in recent months have not been ones of persistent depreciation but rather ones of unusual volatility. As is well known, the Canadian dollar strengthened markedly against the U.S. dollar in the first several weeks of the year before retreating in April. And within this broad up and down pattern, day-to-day movements have been quite sharp in both directions.

Evidently, the driving force behind these fluctuations has been large international flows of capital. These flows themselves have been the product of major uncertainties among investors as to the direction of financial policies in a number of countries -- principally the United States, Japan and Germany -- in the face of the massive imbalances in their international trade that I referred to earlier.

International investors, seeking to protect the value of their investments in this uncertain atmosphere, have been quick to shift their funds from one market to another and from one currency to another. In the face of this volatility in capital flows there have been large fluctuations in exchange rates for major currencies, including the Canadian dollar.

These currency fluctuations also affect our domestic interest rates. As investors buy or sell investments denominated in Canadian dollars in response to their expectations of a rise or fall in the Canadian dollar, Canadian interest rates will change as well. They can change without any specific action by the Bank of Canada. Indeed, the change in the value of the currency and the change in interest rates are really just two aspects of the same phenomenon -- a change in the willingness of investors in a world market to accumulate Canadian financial assets. In short, more volatile currency markets will necessarily bring in train more volatile interest rates. While no one welcomes this development, it is the reality we must contend with.

The basic aim of the Bank of Canada in this unsettled environment has been to adjust its operations in supplying funds to the domestic financial system so as to act as a counterweight to extreme movements. Put another way, we have been leaning against the wind, and shifting our weight as the wind has changed.

Thus, as the exchange rate was running up in the first weeks of this year, our policies accommodated the market dynamic that was leading to an easing of short-term interest rates. But at the same time, we aimed to ensure that the decline in interest rates was not so precipitous as to overshoot reasonable levels in relation to what was happening with domestic inflation. More recently, with the weakening in the Canadian dollar against the

U.S. dollar, our monetary operations have endeavoured to ensure that the market reaction in pushing up interest rates did not lead to an upward spiral. It may be helpful to give you a concrete, although still partial, indication of what we have done on this occasion. In the earlier period, when the Canadian dollar was appreciating, we were net sellers of Treasury Bills to an eager market, whereas in subsequent weeks we were net buyers at the margin as investors found Treasury Bills less attractive to hold.

In telling you this, I should stress that I am by no means suggesting that it would have been good policy to have tried to suppress this recent interest rate reaction entirely. Such an attempt would have been both futile and profoundly destabilizing.

It is no more feasible to turn off the tap on these volatile developments in Canada than it is in the United States, to cite an example close at hand. What we can expect to do is cope with them constructively, seeking to mitigate rather than encourage extreme effects for both exchange rates and interest rates.

On a broader and more fundamental plane, we have to continue to do what we can to encourage the efforts underway among the major industrial countries to solve fiscal and trade imbalances in a way that puts less strain on exchange rates. This means that countries have to recognize more acutely the need to adjust domestic policies in a way that is consistent with easing trade deficits for the United States and trade surpluses for Japan and Germany.

Such a cooperative effort is demonstrably not easy, but the stakes are extremely high -- for world economic expansion, coping with debt problems, and warding off the threat to international trade.

Within Canada we can cope best with the prevailing uncertainties by keeping our own financial and economic house in order. For monetary policy, this means a flexible response to volatile international conditions. We want to ensure that any effects on Canada are not magnified, while continuing to preserve and improve on our own movement towards stability in prices and therefore confidence in the value of money. That is the best, and most important, contribution that monetary policy can make to economic progress in Canada.