
NOT FOR PUBLICATION BEFORE NOVEMBER 3, 1987 AT
1:00 P.M. EASTERN STANDARD TIME

Luncheon Address by
John W. Crow
Governor of the Bank of Canada
to La Chambre de commerce de Montréal
in Montreal, Quebec
November 3, 1987

Notes for a Luncheon Address by
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THE ECONOMY AND CANADIAN MONETARY POLICY

Although I have come to Montreal quite often since becoming Governor last February, this is the first time that I have had the opportunity to talk to such a large group. I thank La Chambre de commerce for providing me with the occasion.

Evidently, 1987 has been a good year for the economies of Montreal and of the province of Quebec generally. Not only has the pace of economic expansion picked up markedly in the past year or so, but the economic performance of different sectors and regions of the province has become somewhat better balanced. Something that also stands out, and which must be gratifying to more than just this audience, is the confidence and vigour shown by the private sector across the province. This pattern of strong expansion mirrors the performance of the Canadian economy in the aggregate -- although admittedly the strong expansion of the Canadian economy as a whole is not yet equally shared by all of its parts.

We are not yet at the end of 1987, and a good distance from the end in terms of the statistics currently available. However, we can already be sure that the record will show that overall the Canadian economy has turned in a very impressive performance. This is true whether judged by our own record or in comparison with our major trading partners. In the first half of the year, output in Canada expanded at an annual rate of over 6 per cent. This was a faster pace than for any other major industrial country and better than our own good record since the end of the recession in 1982. Moreover, the available data give every indication that the expansion remained brisk in the third quarter of the year as well.

This strength is remarkable, bearing in mind that this is the fifth consecutive year of economic expansion. Behind it has been a further upswing of consumer and business confidence. Consumer confidence shows up in the volume of spending on durable consumer goods, which was up over 9 per cent year-over-year in the second quarter, as well as in housing construction and renovation, which rose nearly 17 per cent. The strength of business confidence may be gauged from new spending on plant and equipment. This was more than 6 per cent higher in volume terms for the same period.

In this climate, jobs have been created at a rapid pace. As a result, we have seen significant declines in unemployment rates in virtually all parts of the country this year. I might also add that the share of the population employed is now the highest it has been in our history.

One of the most encouraging aspects of our economic performance this year is that regional differences have narrowed. There is evidence of this in the fairly steady shrinkage of differences in regional unemployment rates since the spring. However, they are still too large. It is therefore also encouraging to see that investment spending outside central Canada has begun to increase again after last year's declines. Unquestionably, a good part of the improvement in the performance and prospects of regions outside central Canada is attributable to the recovery in world prices of a number of the commodities that we produce. An important contribution has also been provided by spillover effects from the strong performance of the economies of Ontario and Quebec.

The record is a good one. But we can all readily agree that sustained economic improvement is not assured. Of course, as a nation heavily dependent on international trade, economic conditions in the rest of the world, and the extent to which international economic cooperation bears fruit, will have a considerable influence on our scope for sustained economic expansion. However, what is at least as crucial, and certainly more crucial over time, is how well we manage our affairs at home. In this vein, the theme of the rest of my remarks is how the Bank of Canada is managing its prime responsibility -- the formulation and execution of monetary policy.

The event on the economic and financial landscape that has been at or close to the centre of everyone's attention for the past couple of weeks has of course been the extreme turbulence in the stock market -- in stock markets practically everywhere.

In the face of the sharp slide in share prices over a matter of days, even hours, it was vital to act promptly and decisively to maintain underlying confidence in financial markets generally. It was important to ensure, at a time of greatly heightened financial uncertainty giving rise to an expanded demand for liquidity, that the stock market problem was not aggravated by a financing problem. The Bank of Canada has acted to ensure the availability of sufficient liquidity in the financial system to meet fully the increased demand. It was natural that very short-term interest rates would decline somewhat because of our actions. This easing has no doubt been reinforced by changed financial market expectations regarding interest rates beyond the very short term.

I might add here that one side-effect of the Bank's actions has been a vastly expanded interest in the precise nature of our day-to-day operations. People are curious as to how exactly we "add liquidity". On this occasion, let me just say that our recent actions do not represent a radically different kind of central banking operation. The fact is that we add or subtract liquidity all the time, and what we have done recently is different in degree rather than in kind. I might also add that while these operations have their technical aspects, we have been happy to explain the details in response to enquiries because there is no reason why they should seem a mystery.

The need for our liquidity-augmenting operations to help stabilize financial markets appears to be well understood. However, there is apparently a question in some people's minds whether monetary policy might because of recent stock market developments be different in the future from what they have perceived it to be in the recent past. I shall address that question in the rest of my remarks.

The Bank of Canada's ongoing actions, and similar actions taken elsewhere, will continue effectively to mitigate any pressures in domestic financial markets arising from these stock market developments. However, there still are potential consequences of an economic nature stretching beyond the purely financial market effects that we have been coping with in the past couple of weeks. The fall in share values makes the holders, individuals and institutions, abruptly less well-off. This could well affect future spending. Issuing stock to raise capital for investment will not be so attractive, also affecting plans and economic demand generally.

This is the kind of potential economic change that has received most attention, and against which I want to look at monetary policy more closely.

The essential point to emphasize about monetary policy in Canada is that its fundamental objectives certainly have not changed. It is a policy that has been, and continues to be, aimed at promoting and sustaining price stability. The way we do this is by seeking to maintain over time moderate rates of monetary expansion. This kind of policy is the best contribution monetary policy can make to the goal of sustaining durable economic expansion -- an objective to which we all surely subscribe. As regards interest rates, their evolution will largely depend on the degree of inflationary pressure in the economy at any point in time, besides any impact from international financial conditions and from the level of government budget deficits. The level of interest rates will also depend upon the confidence of the public at large in the likelihood that price stability will be achieved. Sustaining that confidence is a central concern of the Bank of Canada.

I believe that the stance of the Bank of Canada in financial markets in the course of 1987 has been fully attuned to that concern.

The first part of this year was characterized by sharp increases in money and credit, an extremely rapid advance in total spending in the Canadian economy, and indications that inflation pressures were beginning to revive after several years of progress towards lower inflation. In these circumstances it should not really have been surprising that short-term interest rates in Canada tended to rise. It should not have been surprising even apart from the fact that interest rates were tending to rise abroad and the fact that there appeared to be some increased expectation in Canada that inflation would accelerate in the next year or so. Indeed, the increases in our short-term interest rates earlier this year were one outcome of a responsible and timely monetary policy seeking more moderate rates of expansion in money, credit and spending. And these increases in interest rates should be seen as an assurance that the Bank of Canada remains firmly committed to resisting inflationary tendencies in our economy.

As I indicated earlier, in less inflationary circumstances a monetary policy aimed at a steady expansion of money and spending in the economy tends to exert less upward pressure on short-term interest rates. One question, then, is to what degree might the economy turn out to be less inflationary as a result of the developments of the past couple of weeks?

The Bank of Canada, like quite a few other bodies in Canada and around the world, is, and will continue to be, engaged in assessing the kinds of broad economic effects occasioned by the stock market drop. What I want to emphasize at this point is that there is an evident danger in overreacting. While the direction of the effects I sketched earlier is clear, this is not a basis for concluding that the result will be an economy suffering from weak demand. Such a conclusion is questionable for a number of reasons. In the first place, as I have already stated, prompt and vigorous steps have been taken to head off any cumulative effects that might arise in uncertain and illiquid financial markets. These effects from financial dislocation, besides possibly affecting the economy directly themselves, could of course also feed back on the stock market if not guarded against. They are being guarded against. Secondly, the underlying situation of the Canadian economy is strong, as we have seen in our economic performance this year. This strength has been apparent in the United States as well as in Canada. Finally, the stock market drop, which it is very much worth noting followed an earlier surge, is one of a whole range of different economic shifts that are going on in our economy and in other economies all the time. It is one, albeit particularly dramatic, part of a much larger moving economic picture. That picture has to be seen as a whole.

In concluding my remarks today I want to spend a moment looking at one facet of that larger economic picture.

While it is true that the stock market, like other financial markets, will inevitably be subject to swings and volatility, the abruptness of the recent shift is extremely unusual. I think that it reflects to a very important extent continuing uncertainties in financial markets about the imbalances in the world economy. We have confronted that uncertainty in exchange markets as well. In my view, the various kinds of domestic policies for the countries of the G-7 group spelled out in the Louvre Accord in February and reviewed and reiterated in subsequent G-7 communiqués this year are clearly the right medicine. I must conclude therefore that market uncertainties are hardly likely to be over the direction of the policies already agreed upon since these policies are clearly aimed at resolving the imbalances in the world economy. They would more likely be a message of concern over the extent or the speed with which these agreed policies are being implemented. The message from financial markets is a very important one.

As the Managing Director of the International Monetary Fund observed just a month ago at this year's Annual Meetings of the Fund and World Bank in Washington: "Each must do more and must do it better".