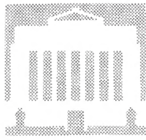
F1B-280



BANK OF CANADA

Notes for a luncheon address by John W. Crow Governor of the Bank of Canada

On the occasion of a

Meeting of the Board of Directors
in St. John's, Newfoundland
28 June 1988

Not for publication before 28 June 1988 at
1:30 p.m. - Newfoundland double daylight savings time
11:00 a.m. - eastern daylight saving time

Notes for a luncheon address
by John W. Crow
Governor of the Bank of Canada
on the occasion of a
Meeting of the Board of Directors
in St. John's, Newfoundland
June 28, 1988

We Canadians are fortunate to live in such a large and diverse country. And, living nearer to Europe than to British Columbia, Newfoundlanders are perhaps even more aware of Canada's huge distances than most other Canadians -- especially when the mainland is cut off by fog. Such distances and diversity make it important as well as pleasurable for the Board of Directors of the Bank of Canada to meet from time to time in cities across the country. Visits, like this one to St. John's, offer the Board and the Bank's senior management a tremendous opportunity to meet the province's government, business and community leaders, as well as to see and discuss financial and economic developments and concerns in the region. They also give the Bank the chance to express its views on monetary policy issues affecting all Canadians.

Since the depths of the recession in 1982, the Canadian economy has experienced a particularly long and vigorous expansion. But that recovery has by no means been spread evenly across the country. Large differences in unemployment rates and incomes continue to exist among Canada's regions. For this reason, signs in the past year or so of somewhat better balance in the pace of economic activity across our regions have been especially welcome. And nowhere is it more pleasing to see marked increases in employment and signs of strengthened consumer and business confidence than here in Newfoundland and, indeed, throughout

the Atlantic region. But I scarcely need to tell a Newfoundland audience that there is still a long way to go before anyone can begin to be satisfied.

The crucial task of economic policy, whatever aspect we are dealing with -- whether it is trade policy, budgetary policy, competition policy, or monetary policy -- is to promote conditions favourable to economic growth and rising incomes. Therefore in my remarks today, besides sharing with you my thoughts on the course of the Canadian economy in the midst of its sixth year of expansion, I also want to spend some time focussing on the kind of contribution that monetary policy can make to Canada's economic well-being.

In view of the great importance of international influences on the Canadian economy generally, and on the economy of the Atlantic region in particular, I will begin my comments on the economic situation by looking at the international scene.

The big event last year was the stock market crash in October. It affected Canada directly, but the really striking feature was the way that the stock market slide, starting in the United States, became global. As a result, many observers of the economic scene expected a pronounced slowdown in the world economy. Those expectations have not been borne out -- far from it. Instead, the economies of the major industrial countries have advanced vigorously in the past seven to eight months. Statistics coming in month by month not only have belied the fears of pessimists, of whom there seemed to be very many, but also have tended to exceed the expectations of even quite optimistic observers.

In the United States, our most important market by far, the expansion in industrial production, spurred most recently by an export boom and strong business investment, has been running at an annual rate of 6 per cent. In Japan, the pace of activity has been even more remarkable with industrial output increasing at a rate of well over 10 per cent annually. And among our four European partners in the G-7 group, output since the autumn of 1987 has been rising at an annual rate of over 2 per cent. While this is by no means an exceptionally fast pace, it has nevertheless exceeded most observers' expectations. Furthermore, it has been achieved despite a squeeze on European exports as a result of the sharp rise in these countries' currencies against the U.S. dollar.

I might also note that as fears of a marked slowing in the world economy have faded, there has been a consequential increase in inflation concerns in the major countries. In the United States in particular, fears of a revival of inflationary pressures have been kindled by a pace of spending that presses ever harder against the limits of the productive capacity of the U.S. economy. The gradual but fairly persistent upward push in U.S. long-term interest rates this year reflects such concerns on the part of investors. The more recent increases that have been seen in U.S. short-term rates are a reflection not only of market pressures and expectations, but also of the measures taken by the U.S. Federal Reserve to resist increased inflation.

Among the major industrial countries overseas, concerns about a revival of inflation stem less from current pressures within individual economies than from a rapid expansion of money and credit and from the fact that the collective strength of demand in the major industrial

countries is exerting upward pressure on the prices of a wide variety of basic products. This is not to deny that events affecting supply, such as the drought conditions currently affecting the Prairie provinces and some parts of the United States, can add to price pressures, but the fact remains that the bulk of upward pressure on commodity prices now evident stems from strong demand. In this respect the situation today has certain parallels with that of the early 1970s. Then, the simultaneous rapid expansion of demand in the major countries provided a major impetus to a commodity price boom and, when it was not checked sufficiently quickly, fed into a decade-long inflationary spiral.

So, as we look at the prospects for the Canadian economy, an important factor to keep in mind is the strength of demand abroad. And indeed, Canada's exports have been boosting output, employment and incomes across the country. Moreover, the increases in the prices for a wide range of the basic commodities we export have also been an important source of the strength seen in the Canadian dollar. But let me also note that although the appreciation of our currency has tended to temper the rise of such prices when measured in Canadian dollar terms, Canadian dollar prices have nevertheless risen to relatively high levels by historical standards. The prices of such important Newfoundland exports as fish and forest products provide good instances of this pattern.

Profits in many sectors of the economy have also been very buoyant. This buoyancy is partly a result of the developments in regard to our export commodities to which I just referred. It is also partly attributable to good levels of activity in other areas of the Canadian economy. In this climate, it is gratifying to see investment spending

pick up since this will translate into increased capacity, enhanced competitiveness in world markets, and more new jobs in the years ahead. It is also helpful, and very welcome for better balance in the Canadian economy, that a healthier share of planned investment this year is taking place outside central Canada.

Within this context of strong investment and export performance, some evidence earlier this year of a more moderate pace in consumer spending was not unwelcome. In any event, it was unlikely that the surge in consumer outlays, and corresponding decline in household savings rates seen in 1987, could have been sustained for very long. Nevertheless, household confidence has evidently remained high through the first half of 1988 and may be picking up again. So, for example, while housing activity has come off its earlier peak, the rate of housing construction is still very strong in many parts of the country.

The main threat to sustaining the expansion of the Canadian economy is the piling on of excessive demand pressures leading to a revival of inflation. And such pressures have become increasingly evident in many areas across the Canadian economy. Over the past year a lengthy list of industries -- of all types and in all regions -- have reached and exceeded normal rates of capacity utilization, and in such circumstances profits to producers, costs to producers, and prices to consumers, tend to rise more quickly. In the same vein, as unemployment rates have fallen across the country, labour markets have gradually tightened and wage demands have become less restrained.

Against this background, the thrust of monetary policy through the first half of 1988 has been to try to

encourage spending in the economy to rise at a more sustainable pace -- one that is more consistent with the economy's ability to supply additional goods and services in a non-inflationary manner.

In going about the business of monetary policy, we naturally focus on a variety of indicators and harbingers of spending trends and inflation pressures. The broad monetary aggregates, M2 and M2+, for example, have been growing at annual rates of close to 10 per cent so far this year. This is too high a rate of monetary expansion. Total credit expansion in Canada has also been strong, especially for households. Moreover, our progress in reducing consumer price inflation has stalled at a year over year rate of around 4 per cent since the beginning of the year. And even this has only been achieved because weakness in food and energy prices has temporarily offset a speed-up in most other categories. I also note that wage increases have in general been moving upwards over the past year.

The point is often made that wage and price pressures have been more readily apparent in central Canada than elsewhere. This is true, but it is not a good reason to be complacent about circumstances in the country as a whole. Higher wage costs and prices for goods produced in central Canada, which constitutes close to two-thirds of our economy, will naturally tend to contribute to increased prices and costs in all areas of the country. Furthermore, the rest of the country has not been wholly immune to such pressures, given the boom conditions in a number of industries that operate outside central Canada.

In aiming monetary policy squarely at restraining inflationary demand pressures, I am well aware that the Bank

of Canada has been viewed in some quarters as gearing policy to the needs of particular parts of the country, such as central Canada or, even more narrowly, southern Ontario, rather than towards the needs of other parts of the country. The criticism that a national institution -- which the Bank of Canada most assuredly is -- shows a regional bias in its policies is a serious charge. Let me examine this criticism.

The Bank of Canada is well aware of the differences in the economic performance of Canada's regions. Our staff analysis, our Board of Directors, and visits such as this all serve to keep us closely informed. Nevertheless, the plain, unavoidable fact is that monetary policy operates through financial markets that are national in scope. As a result, monetary policy cannot be differentiated in order to alleviate in any direct way the symptoms, much less the root causes, of imbalances in economic performance among Canada's regions. We have to look across the whole picture, add everything up, and make our decisions on that basis. That is to say, we ultimately make our decisions from a national perspective. The Bank of Canada would be remiss if it did otherwise. Just as it would be unfair or irresponsible for us to give excessive consideration to the economic circumstances of central Canada, so too it would be inappropriate to give that region -- or indeed any other region -- an unduly small consideration in our decision-making.

Insofar as the causes of regional economic differences are concerned, I might note that some of the widening and narrowing of disparities seen over the years has been a reflection of substantial cyclical variation in world demand and prices for the major primary products on which much of Canadian export performance depends. Movements in

the demand for and prices of such commodities as oil, wheat, fish, forest products and a variety of minerals are bound to affect Canada's different regions differently. The decline in these prices helps account for the widening in regional disparities in the 1980s. The more recent firming of world prices for many of our commodity exports has helped to narrow differences in regional economic performance and is therefore a welcome development. But it should be clear that such movements, originating in world markets, are not something that can be controlled or manipulated by Canadian policy actions.

Other sources of regional differences in economic performance may be more aptly described as structural in character in that they are more deeply rooted in our history and reflect persisting problems of market inflexibility and market structure more generally. Over the years, these problems have been the subject of numerous studies and have generated a web of government programs to help deal with them.

Those in charge of the budgetary levers, taxes and spending, at both the federal and provincial levels have a broadly-recognized role to play in mitigating the worst effects of both structurally and cyclically based imbalances. But it has become increasingly evident in recent years that the margin of manoeuvre for fiscal action has become seriously constrained -- especially in dealing with the effects of cyclical difficulties -- by the burden of accumulating public debt. An additional problem, clearly and eloquently highlighted in the Report of the Newfoundland Royal Commission on Employment and Unemployment, is that fiscal programs aimed at alleviating the symptoms or consequences of regional economic disparities can, at times,

help to entrench the problems that they are trying to relieve.

Monetary policy does not have the means to grapple with these problems; it is not an industrial policy nor is it a regional development policy. However, monetary policy can make a crucial contribution to our national economic well-being by promoting an environment of general price stability. In such an environment, markets will work more effectively and investors and savers will have the confidence in the future that financial stability can provide. Some will no doubt argue that to achieve what I have just indicated is not very much. Let me just point, then, to the inflationary turmoil of the 1970s and the real economic pain that accompanied it. The aim of monetary policy is to do what it can to avoid a repetition of that distress. This surely is worthwhile.

In concluding my remarks today, I want to make some comments on what can be done to communicate and to explain what monetary policy is doing and should be doing. This is a question which we at the Bank of Canada, whether at the staff level or at the level of our Board, regard as being of paramount importance.

This is why we have gone to some lengths to supply a great deal of material on our actions, whether through the regular release of our Board minutes, through speeches, through press releases, or through meetings, such as we are having here in St. John's, with interested groups and with the press.

The operation of monetary policy gives rise to many complex and subtle issues related to financial markets and

the economy, and we have tried to explain such issues as fully and as clearly as we can to both the general public and more specialized groups. But the basic guiding issue that we always try to return to, and that is behind all the technical issues, is the goal of underlying monetary stability -- in other words a Canadian money that Canadians can justifiably have confidence in. This is what we must work towards and measure our actions against if we are to make a lasting contribution through monetary policy to sustained and sustainable national prosperity.

To put the message in negative form, monetary policy does not do its job if it underwrites inflation and actions that promote inflation. Indeed, our past experience with the ravages of inflation in Canada should make it clear why monetary policy has to work consistently against inflation. The positive message that I want to leave with you is that we have come a long way in Canada in the past several years towards achieving a climate of price stability. By avoiding inflationary excesses, the expansion of the economy has continued for a good deal longer than many observers thought possible. Increasingly, consumers and businesses in all parts of the country are benefiting from this progress. It is the task of monetary policy to help prolong the expansion by making further progress towards price stability so that all Canadians will benefit in the future as well.