BANK OF CANADA

Notes for remarks by
John W. Crow
Governor of the Bank of Canada

to the
Winnipeg Chamber of Commerce
Winnipeg, Manitoba
14 December 1989

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It is a pleasure to be here today. This is not my first visit to Winnipeg since I became Governor, but it is the first time that I have given a public speech here.

As the end of the decade draws near, this is an excellent opportunity to reflect on past events -- what we have learned from them, and, especially, how they have influenced monetary policy. Certainly monetary policy, interest rates and the exchange rate get a lot of attention in Manitoba, as they do elsewhere in the country. Recognizing this, my main purpose is to explain to you what we are doing. In particular, I want to review why we believe it is the right monetary policy; that is, one that works for the benefit of all Canadians.

The historical record

Canada has seen a tremendous rise in living standards in the postwar period. Although this increase has been fairly continuous, many people probably reminisce with a certain fondness of the 1950s and 1960s. In both those decades, the economy grew by 5 per cent a year on average.

Inflation was also low at that time -- from the Korean War until the mid-1960s averaging under 2 per cent annually. Then it began clearly to move up, with each acceleration building on the one before.

It is worth pointing out that a popular view back then was that inflation, far from damaging the economy, on balance could be helpful. Inflation, while perhaps an irritant, was thought to help maintain a buoyant economy and keep unemployment low. In fact, this was an odd idea. Essentially, it hinged on people behaving as if inflation did not really exist.

In any event, this idea was implicit in persistently stimulative policies designed to squeeze more and more output and jobs out of the economy in the near term. But of course people began to see which way the wind was blowing and took defensive action to protect themselves against the erosion of their incomes and savings from inflation. And attempts to coax more economic activity increasingly induced more inflation.

This was the situation on to which were loaded the inflation shocks of the 1970s. You will certainly recall, for example, the OPEC-inspired oil price increases that occurred. Given the domestic inflationary climate that had built up in the way I have just outlined, we were in poor shape to deal with those shocks. And indeed, the shocks themselves were magnified by the generally inflationary situation.

Inflation leapt upward in the early 1970s, soon reaching double-digit rates, and the economy ground to a halt. The economy did recover for a while. But the higher inflation rate did not turn out to be temporary. Indeed, if we look at the decade beginning with 1973, yearly increases in consumer prices averaged almost 10 per cent. Let me also emphasize that there was tremendous uncertainty, even fear, about where inflation was headed.

Policymakers certainly took action aimed at bringing inflation down during that period. Monetary policy was tightened, and temporary wage and price controls were introduced in the latter part of 1975.

Inflation receded somewhat, but certainly not to the rates that had prevailed earlier. Even this mild improvement could not be sustained, and inflation started to speed up strongly again in the latter 1970s. In retrospect, monetary policy was not tightened enough to bring about a permanent decline in inflation. Fiscal policy stayed on balance expansionary.

And on top of this, people had come to expect high rates of inflation. Their expectations propelled increases in prices and wages. Those increases fed each other. Monetary policy did move further to resist the mounting inflationary spiral in the late seventies, but the degree of restraint initially proved inadequate to the task. Inflation accelerated further, finally peaking at close to 13 per cent in 1981.

You are all probably well aware of what followed. This country was hit by the worst economic setback of the postwar period. Between mid-1981 and the end of 1982, both output and employment fell by 5 per cent. Unemployment rose to levels that would scarcely have been thought believable beforehand.

Before looking at the remainder of the 1980s, let me point to some lessons from the events just described.

The most important is that failure to control inflation -- in other words, trying to "live with" inflation

-- damages the economy. And the longer policy action is delayed, the more severe the damage is likely to be. I will return later to some of the implications this has for what we should be doing today.

Another lesson is that successfully resisting inflation requires the strong commitment of monetary policy. Other policies can certainly help, but monetary policy is the essential element in ensuring that Canadians have a money that they can trust.

Expansion in the eighties

Coming back to the economy, by the end of 1983 output had returned to the level it had reached before the recession. Since then, our economy has undergone a long expansion. Canada has in fact been one of the top performers among the industrialized countries. In the five years to the end of 1988, the increase in output averaged 4 1/2 per cent annually. Employment growth averaged over 300,000 jobs annually. Inflation hovered around the 4 per cent mark.

Looking at total dollar spending, the pace of advance gained renewed vigour after slowing somewhat in 1986. From the beginning of 1987 through the first months of 1989, spending rose at an average annual rate of 10 per cent. This is a very large number.

Since the spring, it has become apparent that spending is rising less rapidly. The year-to-year pace of increase has recently been more like 7 per cent.

But the level of demand pressures remains strong. This can be seen by the buoyancy of financial activity across the economy. The monetary aggregate M2 (the measure of money we look at most closely), and business and household credit, have all been growing at a double-digit pace through 1989. I will also note in passing that these increases are appreciably higher than those recorded in the United States, for example. And the Canadian labour market remains very tight, particularly the market for skilled workers.

As tends to be the case, developments in Manitoba's economy have broadly reflected the national experience. Dollar spending in the province has risen strongly. Output here expanded at a rate near the national average, although this increase was concentrated more in the first years of the expansion than it was generally for the nation as a whole.

Manitoba has also been a source of the continued strength in Canada this year. Economic activity in this province is expected to increase in 1989 at a rate well above the national average. This can be attributed not only to a recovery in agriculture, but also to a surge in private investment.

Now, focussing again on the national economy, and recalling to you my earlier account of how the Canadian economy got into inflationary trouble in the late 1960s and the early 1970s, you will appreciate why I underline the serious risks that the Canadian economy has been running with the pace of spending that developed in 1987 and 1988.

We are now seeing the results of those demand pressures show up in Canadian costs and prices. Tightened labour markets have contributed to a marked jump in wage settlements. The year-to-year rate of inflation rose above 5 per cent in June and has since stayed there.

The role and response of monetary policy

The response of monetary policy to these developments is guided by its responsibilities. So let me describe what the Bank of Canada is trying to accomplish.

The goal of the Bank is to provide, through monetary policy, the strongest support it can to a growing economy, and, as I indicated earlier, what monetary policy can do is provide a sound monetary climate. This means that the Bank can best help by achieving and maintaining broad stability in domestic prices -- by keeping the pace of monetary expansion in line with the capacity of our economy to grow.

Of course, monetary, or price, stability is not a cure-all. But why should we add incessant inflation to the other economic challenges we face? Inflation undermines the monetary standard on which our economy rests. It keeps our economy from operating as well as it should. Those fortunate enough, or strong enough, to be effectively shielded from inflation, or even to profit from it, may not be greatly concerned about this. But we must consider the well-being of all Canadians, that is, the best interests of the economy as a whole.

A concern still voiced by some people is that a monetary policy that fights inflation hurts rather than helps the economy. But the record shows that what is really costly to the economy is the failure to control inflation. This is the same as letting inflation and inflationary behaviour control us. The most recent example is, of course, the early eighties. The impact of this economic downturn was devastating. For example, here in Manitoba, despite the resilience of the economy, the unemployment rate quickly doubled from the beginning of 1981 to the end of 1982. None of us wants to see this happen again, and we believe that monetary policy has to be directed at avoiding it.

In what I have just said I have aimed to make clear why the Bank of Canada has been seeking in recent years to limit the pace of monetary and credit expansion -- to bring it into line with the conceivable expansion of the underlying economy. Given the strength of spending, this policy of aiming to hold money and credit to a relatively moderate pace of advance has certainly meant upward pressure on short-term interest rates. They are now roughly 4 1/2 percentage points higher than in the first half of 1987. However difficult this is to accept in some quarters, bringing inflation under control is necessary to place economic expansion on a solid footing.

At the same time, because of the persistence of inflationary pressures some contend that monetary policy is "not working". Indeed, there are those who believe that monetary restraint, because of its effect on short-term interest rates in a climate of strong demand adds to inflation rather than combats it.

Let me respond by observing that for monetary policy the alternative to what we have done would have been to pump more liquidity into the system in an effort to keep interest rates down, notwithstanding the strong advance in dollar spending. But what is difficult to figure out is how such a policy would have helped to hold down inflation; we haven't figured it out at the Bank of Canada.

In reality, trying to reduce interest rates with easy credit in the face of inflationary pressures would be self-defeating. Such a misguided policy would intensify fears of inflation, and in fact savers and borrowers themselves would respond by driving interest rates up. The only sure way to lower interest rates is to bring inflation down in a convincing manner, and this needs a firm anti-inflationary policy. As I indicated earlier, total spending in the economy is now expanding less rapidly than before. This represents important progress for an easing of inflation pressures and interest rates. But sustained progress is necessary. If we are to turn inflation around, it is critical to persevere on the current path.

Let me comment on some other issues.

The monetary policy conducted by the Bank of Canada is a national monetary policy. But it is often argued that the impact on spending should be alleviated for parts of the country where the expansion has, at least in the past, been less strong. In terms of monetary policy, this has to mean different interest rates for different regions or different industries.

However, to be brief, before deciding whether we <u>should</u> operate a system of differentiated interest rates, we have to ask the question whether we <u>could</u> operate such a system. The answer is that we cannot, given the welcome reality in Canada of a highly efficient financial market, with freedom to save, lend and invest across the country.

Another point raised is that, during the present expansion, the increase in wages in terms of their purchasing power has seemed low by some measures. Does not the effort to fight inflation hinder gains by wage earners?

In fact, I would say that the reverse is true. Monetary stability contributes to a more productive economy, and it is gains in productivity that are necessary to increase living standards in Canada.

Finally, while I underlined earlier the critical importance of monetary policy being oriented in an anti-inflationary way, how hard monetary policy has to work is affected by the stance of other policies. Fiscal policy can also work in the direction of reducing demand pressures in the economy. The channels through which monetary and fiscal policy exert their influence are different -- monetary policy works through the money and exchange markets, while fiscal policy's effect is more direct -- but there is an "overlap" between the two policies in terms of the impact on total spending in the economy. Thus, actions taken to restrain demand at the budgetary level -- on government spending, revenues and deficits -- go in the direction of easing pressures on monetary conditions -- on interest rates and exchange rates. A substantial effort is being made to bring down the federal fiscal deficit, and this can only help in bringing about a better policy balance.

Conclusion

Let me conclude by emphasizing that the Bank of Canada is a national institution, dedicated to the economic well-being of the whole country. We know, from the reports of our directors across the country, from the reports of our representatives in various cities, and from our staff visits (of which there are many) what developments are taking place.

Our country is a large one. Economic developments can shift significantly from area to area and year to year. But no part of this country will be helped if we backtrack on inflation and repeat the boom and bust cycle of times past. The route to low interest rates requires that we bring inflationary pressures under control. If we don't do that, if we orient monetary policy in an inflationary way, we would compromise the Bank's role in sustaining the good economic performance, year in year out, that Canada can achieve.