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The economy and financial markets

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

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luncheon given by the
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Traditionally, the start of a new year is a time for looking at where we are and how we got there. It is also a time for considering the challenges that lie ahead. I propose to do some of this in these remarks. I only hope that it is not already too late, because after all spring, for you, is just around the corner.

Let me begin with the international scene. On that score, perhaps the most striking feature of 1988 was the impressive advance in economic activity among the major industrial economies. As a group, the economies of the G-7 countries expanded by about 4 per cent. This was hardly what was expected at the start of last year. Following five years or so of marked increases in activity, and a particularly vigorous performance in 1987, most forecasters were predicting some slowing for 1988. Such predictions came even before the stock market crash of October 1987. That crash led many to scale back their forecasts even further.

Why did a slowing fail to appear? There seem to be a number of factors. So far as the stock market is concerned, one reason -- one that I find quite appealing -- is that central banks in the major countries acted promptly and vigorously in the wake of the stock market slide to avoid the direst consequences for financial markets generally. Another reason, linked in part to the first, is that the consumer and business confidence that fueled the earlier expansion did not evaporate after the crash. And that spending momentum, so widely underestimated at the time, clearly carried on right through 1988.

Still, we may justifiably ask, why such persistent momentum in consumer and, above all, business spending among so many of the industrial countries? This resilience may well owe something to the softness in commodity prices generally, and especially in oil prices, for most of the 1980s. Western Canadians will of course be familiar with the adverse effects this has had on the real incomes of producers of such commodities. But by contrast, consumers of such commodities, who predominate among the industrial countries as a group, have experienced a favourable impact on their real incomes. And overall, it may fairly be argued, we have been experiencing some reversal of the cost raising supply shocks that we heard so much about during the 1970s. Those 1970s shocks were universally viewed as being adverse for the world economy, if not for every single part of it.

Supply conditions may have improved in yet another, more systematic, way. In virtually all countries there is now much greater attention to structural policies such as deregulation or privatization that aim to enhance the capability of a given economy to deliver the goods, and the services, demanded. The strength of investment in Europe suggests that those countries are sloughing off their so-called "Eurosclerosis" of the 1970s and early 1980s. The U.S. economy has shown an impressive degree of labour flexibility in generating production in response to its investment and export upsurge. The Japanese "miracle" has continued in high gear, even while the driving power has been shifted in part from exports to domestic markets.

But, to develop the motoring analogy, even if our economies conceivably are getting a tune-up, have larger engines and enjoy better roads, this does not mean at all that they are safe at any speed. Even less, of course, does it mean that we should drive carelessly. I will in this regard note that the expansion of demand in practically all the major economies has outstripped potential supply. This has happened even though that potential supply may have been, or is being, enhanced. As a result, broadly based inflationary pressures have begun to re-emerge, not just as a threat but as a reality, and not just in North America.

The international scene also continues to be clouded by the deeper-seated problems that have been with us for some years. Fiscal imbalances in various countries, and in the United States especially, remain worrisome, most obviously in regard to the stability of international financial markets. So too are the persistently large trade and current account imbalances of the major countries. Some progress was registered last year in stabilizing or reducing those imbalances, but not enough to lessen concerns very much. As regards the international debt problem, the situation today may in some respects be better than it was -- certainly, many of the main creditor banks, including Canadian banks, are now somewhat better provisioned against loan losses -- but the problem persists and continues to need very careful management in the interests of debtors, creditors and the world financial system.

Since these problems of debt and disequilibria were, at best, only partly, mitigated in the past year, they continue to receive a good deal of attention from many angles. Such attention is very fitting. They have the potential for serious trouble. We cannot afford any slackening of efforts to cope with them and also to search for avenues of progress, just because comprehensive solutions, in the sense of quick and complete solutions, are elusive.

Let me now turn to developments closer to home.

Canada experienced another year of rapid expansion in economic activity. Indeed, I will emphasize, spending continued to expand very strongly right through 1988. In these circumstances, the squeeze on productive capacity in many sectors intensified progressively. Rates of capacity utilization in most manufacturing industries, which by the end of 1987 were already above average, rose further last year.

Labour markets also tightened further as employment demand outpaced expansion of the labour force. This tightening was not limited to southern Ontario, although conditions in that region, which accounts for about 30 per cent of Canada's economic activity, are still under the most pressure.

As is of course well known in British Columbia, a sharp recovery over the past couple of years in the Canadian dollar prices of a range of the commodities that we export has contributed importantly to the lessening of regional imbalances. We seem to have been blessed with a relatively large number of the industrial commodities whose prices have improved recently worldwide, especially when measured in U.S. or Canadian dollars.

While economic conditions differ among regions, the broad picture of the evolution of the Canadian economy over the past year has nonetheless been one of continued rapid expansion of demand, tightening supply conditions and, consequently, mounting inflationary pressures. The strength of consumer and investment spending and world demand for certain commodities nourished price increases, contributing to a widening of profit margins in many industries. This buoyancy, together with the tighter labour market conditions in many areas, led to increasing wage demands. As regards wage settlements, there was a distinct upward drift, towards annual increases amounting to 5 per cent.

Consumer prices have not been pushed up by these developments to the degree that might have been expected. The stability, even declines, in the prices of imported goods provided an important offset to home grown cost pressures. This benefit on the import side was importantly a result of the appreciation of the Canadian dollar over the past year. The earlier easing of world oil prices also had a dampening effect, offsetting roughly the impact of the drought on food prices.

In the light of the crosscurrents I have just sketched, you will probably not be surprised to learn that I find the frequent reference by commentators to the "stability" in our rate of inflation to be a less than adequate description of what has been going on. What has been going on poses risks for soundly based, therefore sustainable, economic expansion in Canada. Inflationary pressures take time to develop and, initially, the process of wages and prices leapfrogging each other is commonly mistaken for prosperity. But the foundations are suspect and the process is of course anything but stable.

One notable feature of the present conjuncture is the commentary to the effect that wage increases are overtaking consumer price increases. And one inference seems to be that more inflation is acceptable in those circumstances. I will simply note here that gains in real wages, or in real incomes in general are of course very welcome, but that they do not depend on faster inflation. They depend fundamentally on the extent to which good economic performance can be sustained. A lasting good economic performance requires enterprise, hard work, and a well-managed economy. Such an economy is, among other things, non-inflationary. Putting the same point differently, inflation will damage rather than enhance the prospects for gains in real incomes.

Having raised the issue of economic management, let me now review briefly how monetary policy has responded to developments in the Canadian economy over the past year.

I emphasized earlier that a sharp slowdown in activity did not in fact follow the stock market slide in late 1987. As the strong momentum of spending in the economy reflected itself in continuing rapid expansion of monetary and credit aggregates, the Bank of Canada moved more firmly in the direction of restraint. Indeed, right through the past year, we have had to adjust our sights continually as demand pressed against supply and signs of inflationary pressures increased. We have by all accounts been seen as acting promptly. We have been anxious to explain our actions. We have sought above all to forestall the damage that would come from tolerating through monetary policy an inflationary spiral and the re-entrenchment of inflationary expectations.

This brings me to interest rates and the exchange rate. I will not on this occasion present a chronicle of what has happened in this area. For one thing, it seems to me that Canadian interest rate and exchange rate developments have received a lot of publicity in recent months. Furthermore, a period-by-period description and analysis of interest rate and exchange rate developments can be found, for example, in our regular publications of Bank of Canada Board minutes. Rather, what I want to emphasize is an aspect of these developments that is generally ignored in commentary but that is of prime importance in understanding monetary policy.

The Bank, in its discussions of monetary policy, is very careful to make a distinction between the underlying goals of monetary policy and the movement of particular financial market prices. In this regard, I have in mind such prices as interest rates, the exchange rate or, indeed (to cite a particular variant that is often taken, mistakenly, to summarize Canadian monetary policy) the spread between interest rates in Canada and those in the United States. I should also emphasize that to say that interest rates or the exchange rate are not goals of monetary policy is not at all to suggest that these financial market prices are unimportant. We know perfectly well how important they are for all sectors of the economy, not just for financial markets. But, I repeat, they should not be regarded in any fundamental sense as targets or goals of monetary policy.

The objective of monetary policy is to be viewed more accurately as providing for a moderate rate of monetary expansion and thereby helping to create a non-inflationary as opposed to inflationary economy. Over time, our economy will work better that way. Also, I can add in passing, in a non-inflationary climate interest rates will tend to be lower than they would be otherwise. In other words, over time, high inflation brings high interest rates, and low inflation, low interest rates.

Let me conclude by looking ahead. The world economy in 1989 faces many of the same challenges as it did a year ago. While 1988 was a better economic year than many feared, as I indicated earlier, the problems generally seen at the beginning of the year have not gone away. In particular, budgetary policy in both the United States and Canada will be the subject of keen scrutiny. Efforts to reduce fiscal deficits have a great deal to commend them. This is the case whether they are viewed as a way of controlling the rise of government debt, improving national savings, or easing pressure on financial markets, real interest rates, or demand in general.

What should be expected from Canadian monetary policy? In the most basic sense it should be business as usual, that is to say, the improvement of our inflation performance and, therefore, our underlying economic performance. Thus, the degree of pressure on monetary conditions would depend on the pressure arising from inflation, and expectations and fears of inflation. Clearly, those pressures, expectations and fears have not been dissipated, but I am hopeful that they have been at least contained. What in any event I know is that the progress made in the past year in resisting inflation will pay off in 1989 and the years beyond. It will pay off because it means a better overall economic performance for Canada than if monetary policy had been less forehanded than it has in fact been.