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

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to the
Edmonton Chamber of Commerce
Edmonton, Alberta
27 June 1989

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Notes for remarks by
John W. Crow
Governor of the Bank of Canada
to the Edmonton Chamber of Commerce
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27 June 1989

I am glad to be back in Edmonton. Early last year I had the privilege of presenting the Eric J. Hanson Memorial Lecture at the University of Alberta. At that time, I discussed in some detail the objectives of monetary policy and the tools available to the Bank of Canada. This speech is not a lecture, but it is about monetary policy -- the Bank of Canada's business and the business of all Canadians.

Since my earlier visit to Alberta, short-term interest rates in Canada have risen considerably, and monetary policy has attracted a lot of attention. Canadians across the country have been asking, quite understandably, if this increase in short-term interest rates has really been necessary, particularly in light of the differences in the level of economic activity in different parts of the country. I would like to speak to those concerns today. In doing so I shall highlight the key considerations behind the Bank's monetary policy approach. I shall complete my remarks by briefly reviewing recent economic developments and what they mean for monetary policy.

Let me begin by outlining what monetary policy aims at. Put simply, its goal is to do what it can to promote a strong economy -- one that provides a rising standard of living for Canadians. Since our economy is based on money, the most solid contribution the Bank of Canada can make towards a strong economy is to guide monetary policy so that the value of money in Canada is maintained. Ultimately, this

means keeping the pace of monetary expansion in line with the capacity of our economy to grow. If we succeed, Canadians can be assured of a stable price level. If we fail, inflation is the inevitable result.

Why is stability in our price level, and therefore stability in the value of our money, so important? The basic reason is that for money to play fully its central economic role, people must have confidence in its value. Admittedly, monetary stability is not an economic cure-all; there are many different kinds of economic and financial problems to cope with in this world. But why should we aim to compound them with the further burden of chronic inflation? The negative aspects of inflation are certainly apparent to people on fixed incomes; to wage earners who are concerned that the real value of their income is declining; to businesses that must decide if an investment made today will be profitable in the years ahead; to anyone who has entered into a contract only to find that price changes have put them at an unexpected disadvantage. The essential point is that inflation hurts many and benefits few. It certainly does not benefit the economy as a whole. That is why monetary policy needs to address it.

Why, then, does a monetary policy aimed at working towards and maintaining price stability for Canadians seem to attract so much controversy? Well, perhaps the most common objection one hears today is that monetary policy, with its effects through interest rates and the exchange rate, is somehow pressing too hard. Some would contend that monetary policy is addressing an inflation problem that does not exist, or at least is not sufficiently serious to warrant the actions taken. Others argue that in fighting inflation there is a cost to economic performance rather than a benefit. In

other words, monetary policy is working against the goal of fostering a strong national economy.

Let me respond to these criticisms.

The first point I will make is that if monetary policy is not firmly anti-inflationary, inflation cannot be beaten. Other policies can certainly be helpful in moderating cost and price pressures, but they cannot by themselves sustain price stability. Over time, broad movements in prices in Canada reflect the rate of monetary expansion permitted by the Bank of Canada. If the Bank encourages a rapid expansion of money, inflation will flourish no matter what other policies are in place.

Secondly, monetary policy can only restrain inflation by bringing about a moderate rate of monetary expansion. And in an environment of surging spending and credit demands, as has existed in Canada for the past couple of years, a policy aimed at ensuring moderate monetary expansion will induce upward pressure on short-term interest rates, and in turn on the Canadian dollar. However, keep in mind that as the pressures from strong borrowing and spending come to lessen, as inflationary forces and fears subside, so do the pressures on interest rates.

Now let me turn to the criticisms that inflation is not a serious problem, and that the Bank of Canada's anti-inflationary stance is harmful to the Canadian economy.

Canada's current inflation rate is about 5 per cent. Even if it were to remain constant at this level, in less than 15 years the domestic purchasing power of our currency would be cut in half. For those on fixed incomes,

that would be devastating. Moreover, there has been substantial pressure in the direction of still higher inflation. Total dollar spending in the Canadian economy has risen by some 20 per cent in the last two years alone. That is way above the ability of our economy to expand its production of goods and services. Therefore, the pressures on our prices and costs have been cumulating, and monetary policy has been seeking to moderate those spending demands to prevent an outbreak of higher inflation.

But just to contain current inflation pressures is not enough. We need to ensure that monetary policy is directed at progress over time towards broad price stability. Unless the monetary authorities are steadfast in this objective, what assurance is there that Canadians can count on the money they use retaining its value?

Inflation creates a momentum in the way people think about prices and what, as income earners or consumers, savers or investors, they expect in the future. And we certainly know from the experience of the 1970s that pessimism about the outlook for inflation makes it more difficult to prevent inflation from rising further. Furthermore, as savers and investors respond defensively to inflation fears, market pressures push interest rates up. Indeed, trying to live with inflation is a recipe for higher interest rates, not lower ones. Interest rates can be brought down in a way that makes sure they stay down only if inflation is controlled and Canadians are convinced that it will not be allowed to reemerge. This, like most good things, is better done early than late, and done consistently rather than sporadically.

Let me also emphasize that ignoring inflation is not a recipe for sustained economic expansion. Every economic downturn in our recent history has been preceded by an outburst of cost and price pressures. Those episodes clearly show that such a pattern must be avoided. By acting early and with determination, the thrust of our policy in recent years has been to avoid a cycle of high inflation and economic bust. That is why monetary policy has been shaped the way it has.

Finally at this point, a comment on the argument that even if we have the right general objective, monetary stability, we are hitting the wrong target. This is the contention that the Bank of Canada, in its effort to contain inflation, is essentially responding to a problem that is concentrated in certain regions of the country. Southern Ontario, where spending pressures have been particularly intense, is always cited in this context. The argument continues that a policy which appears appropriate for some parts of Canada may not fit other regions. That is to say, monetary policy is too "tight" for regions where inflation pressures are not so evident.

The basic point to be made here is that the Bank of Canada conducts a _national_ monetary policy, on the basis of _national_ levels of economic activity and inflation. While economic conditions may diverge among regions, decisions about monetary policy must necessarily be taken from a national perspective. We must neither ignore what is happening in southern Ontario nor developments elsewhere in Canada. Let me review with you the arguments for this.

First, we have a unified financial system in Canada. This is beneficial. It allows savers and borrowers

to gain from the broadest range of opportunities and from wide competition among financial institutions and instruments. This helps all of us. However, it also means that interest rates will to all practical intents be the same in all parts of the country. Consequently, there is no useful sense in which we can have a monetary policy that is differentiated by regions.

Since there can be only one monetary policy, the only alternative to taking a broad national view would be to orient policy towards a specific region. We could, for example, focus it exclusively on the region with the most intense demand pressures, but that is not what we do. Neither do we do the opposite. If we were to focus on the region experiencing the weakest demand pressures, the stance of monetary policy would not be right for Canada as a whole. It would be inflationary for the entire country -- reflecting the fact that with our common currency, and institutions and markets in common, price and cost pressures are transmitted all across the country. For example, when inflation leads to rising prices for cars and other consumer goods produced in one part of Canada, Canadians in all parts of the country find themselves facing higher prices. Indeed, the evidence is that our current inflation problems have become more widespread across the country.

There will, realistically, always be regional differences in economic performance. Those differences mirror the diversity of our economy. One particularly important factor has been the influence that changes in international prices for food, energy, and other primary commodities have had on the economic fortunes of the regions where these commodities are produced. I would note that in the run-up to the bout of high inflation in the late 1970s

and early 1980s, the expansion of spending in Alberta was substantially faster than the national average. However, the basic point is that no part of the country would be made permanently better off if the Bank of Canada followed inflationary policies. In fact, the reverse is true.

Turning to general economic developments, the Canadian economy has undergone a long and well-sustained expansion since 1982 -- not at the same pace everywhere, but the benefits have been felt everywhere. The distribution across the country of economic activity was more even in 1988 than in earlier years, reflecting primarily the income gains over the past couple of years stemming from the sharp rise in the prices of many of the commodities that Canada produces for the world market.

Indeed, a number of Alberta's industries have benefited from the increase in primary commodity prices. This province's economy expanded at an impressive rate in 1988, well above the national average. The rising level of activity was reflected in substantial increases in business investment, employment and incomes in most of the province. Following a relatively low rate of inflation in Alberta for 1988, consumer prices have recently been increasing more rapidly.

I indicated earlier that monetary policy has been seeking to moderate the extremely high levels of total spending in the Canadian economy that accumulated during 1987 and 1988 and that have threatened to push us into escalating inflation. More recently, there have been some signs of such a moderation.

A more truly sustainable pace of expansion in spending is to be welcomed. At the same time, the demands placed on much of Canada's resources remain high, as do pressures on costs and prices. The trend of money and credit expansion remains strong. The monetary aggregate M2, the measure of money we look at most closely, has increased at an annual rate of over 10 per cent since December. Total business credit continues to expand at more than 10 per cent, while growth in household credit is higher, at 15 per cent. Evidently, the Bank of Canada has to remain watchful.

As I have emphasized in these remarks, the Bank of Canada's policies will continue to be aimed at controlling and moderating inflation. But let me reemphasize that our policy is not, in itself, a high interest rate policy. As the growth of spending moderates, as confidence grows in a good inflation performance as opposed to a bad one, then clearly the climate is being created for lower interest rates. In this regard, I should point out that medium and longer-term interest rates are currently much lower than shorter-term ones. You will have seen in the press, or perhaps know from direct experience, that mortgage rates have eased back. Why is that? This easing is evidence that the basic confidence of savers and investors, of borrowers and lenders, in what monetary policy is aiming to achieve remains strong. We aim to keep it that way.

Some concern has been expressed regarding the potential impact on inflation of various indirect tax increases announced in the recent federal and provincial government budgets. Those increases are of course meant to transfer purchasing power to government channels. If these transfers generate only a one-time increase in the price level, they need not be of great concern. This is because

they would not have any impact on the underlying inflation process in Canada. The trouble would come if they were to provoke a leapfrog of demands for compensating increases in income. This would be both self-defeating and inflationary. It is important to be aware of this risk and to recognize that there is no justification for monetary policy to finance such an inflationary surge. I trust that with public awareness we can avoid such problems.

In summing up, let me say that I am well aware that the scale and diversity of the Canadian economy presents a challenge to public economic policy. For monetary policy, one challenge is the need to follow and interpret accurately economic developments in all regions. Our Board of Directors, made up of Canadians from all regions of the country, and visits such as this, help to ensure that we are very well informed.

I look forward to occasions such as this for another reason as well. They give us the chance to keep Canadians informed directly of what the Bank of Canada is doing and why. We readily concede that there are many problems about which monetary policy can do very little directly. But what is not beyond our scope is to provide for all Canadians, year in and year out, a monetary policy that sustains their confidence in the money they use. Our national economy, year in and year out, will work better that way. That is surely what we all want.