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The Economy and Monetary Policy in Canada

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

On the occasion of a
luncheon hosted by
the Rotary Club of Kitchener
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It is a great pleasure to be here in Kitchener. I must say that in my travels across the country, how southern Ontario is doing is a continual topic of interest. Indeed it is often suggested, with feeling, that the Bank of Canada pays perhaps overmuch attention to how this region is faring economically. Still, that should not deter me from coming to this part of Canada, thanks to the generous invitation of the Rotary Club.

Occasions such as this provide important opportunities for explaining directly to Canadians what monetary policy is about. My colleagues at the Bank of Canada and I in fact do a great deal of this, to large and small groups. And nowadays interest in monetary policy issues seems to be so great that it is often difficult to keep small groups small.

Of course, the widespread interest in what is happening in southern Ontario stems from the fact that this part of the country has been experiencing a tremendous boom in demand, not only in absolute terms but also relative to most other areas of the country.

Where has this exceptional demand pressure come from? There seem to have been a number of important sources. As is well known, the Ontario economy depends heavily on export markets and has therefore benefited substantially from the continued buoyancy of demand among our major industrial trading partners, especially the United States. The weakness of oil prices in recent years has played an important part in sustaining the vigour of demand abroad, through its favourable impact on the real incomes of consumers. Ontario, as a net consumer of oil and gas, has also gained directly from the softness of energy prices, even while some other parts of Canada, as net energy producers, suffered a weakening of real incomes from this source. Southern Ontario, as a major producer of machinery and equipment, has benefited greatly from the general boom in investment. A further factor contributing to the more rapid pace of spending in Ontario than elsewhere in Canada is that provincial government outlays have increased more quickly in Ontario than in other jurisdictions in recent years.

These developments, reinforcing each other, have brought high levels of economic activity to southern Ontario. They have also led to acute market pressures. Not surprisingly, the strength of spending has tended to bid up the prices of a wide range of goods and services. Especially affected have been the prices of those items, notably housing services and other services, which essentially cannot be imported from outside the region. Such prices went up in southern Ontario by about 7 per cent during 1988, compared with 5 per cent for Canada as a whole.

It is certainly true that the force of consumer, business and government spending has induced some expansion of supply. For example, the steep rise in job vacancies in southern Ontario has encouraged many additional people to enter the workforce, and the proportion of the population of working age that has a job has risen to record levels, not only in southern Ontario but also, I might add, in the rest of Canada as well. The job market tightness in southern

Ontario has been alleviated to some extent by immigration from other parts of the country and from abroad. More than a third of the rise in southern Ontario's workforce in the past couple of years has evidently been made up of people coming from outside the province. As regards additions to the supply of plant and equipment, investment expenditures in Ontario as a whole increased by 7 per cent in 1987 and by a further 17 per cent last year.

The fact remains, however, that the expansion of demand has far outstripped these increases in supply. As a result, labour markets in southern Ontario are bursting and most industries in this part of the country have been running to the limits of capacity. In such circumstances it is scarcely surprising to observe escalating increases in wages and salaries. Indeed, while wage increases have accelerated across the country, wage rises in southern Ontario have been leading the nation, and increases in earnings were typically in the range of 6 per cent in 1988.

In focussing my initial remarks on the economy of southern Ontario, I aim to give due measure (not too much, not too little) to its importance in the nation's economy and, therefore, to monetary policy. My comments reflect the fact that the Bank of Canada keeps itself very closely informed on developments in all regions and industries of the nation.

What lessons then does all this information hold for monetary policy?

A good place to begin is by noting that it is frequently contended that the kinds of demand pressures evident in southern Ontario may, perhaps, constitute a regional problem, but hardly a problem for Canada as a whole. Therefore, it is also suggested, in responding to these demand pressures monetary policy is being misdirected. Today I will take the opportunity to discuss these contentions.

However, before tackling the specifics, there is a very general point that needs to be kept clearly in mind when discussing the relationship between differences in regional economic conditions and monetary policy in general. This point is that monetary policy has inevitably to be conducted on a national basis.

We have an efficient and unified financial system in Canada, because there are no barriers to the movement of funds across the country. That is a good thing. Savers benefit from the opportunity to place their funds in diverse, competitive markets, and investors can spread risk efficiently. Borrowers benefit from access to a much larger pool of funds at more competitive rates than would otherwise be available. Having unified and efficient money and capital markets in Canada means that interest rates will to all intents be the same in all parts of the country. And of course the exchange rate will in any event be the same for all Canadians. Consequently, there is no useful sense in which we can have a monetary policy that is differentiated by regions. At times we may wish we could, but that does not make it possible.

Since the scope and impact of monetary policy is bound to be national, decisions regarding monetary policy must also be taken from a national perspective. In other words, the Bank of Canada gears its actions to the needs and circumstances of the country as a whole.

Let me now move to more specific comments.

The first point I will make is that the southern Ontario economy, while admittedly regional, is also extremely large. The fact is that this region, not a large space by Canadian standards, and not even a whole province, nonetheless generates fully one third of Canada's total income and economic activity. To play down developments in this region would therefore be at least as unrealistic, for example, as to disregard developments in all of Quebec or all of western Canada. It would also be irresponsible.

A second point I will emphasize is that the kinds of spending and cost pressures besetting the southern Ontario economy are not without parallels in other regions. It is true that they have been most intense in these parts, but demand, price and cost pressures are increasingly evident in a number of other areas of the country as well, even though there remain parts that are still weak. Not only have spending demands spilled over from southern Ontario and other areas of central Canada to other regions, but incomes and economic activity in those regions have also been spurred by the sharp increases over the past couple of years in the prices of quite a few of the commodities that Canada exports. Led by sharp gains in the prices of a whole range of base metals and of wood pulp, the Canadian dollar prices of all commodities, excluding energy products, jumped by an average of close to 10 per cent a year in both 1987 and 1988.

Demand and inflation pressures are, therefore, more than just a small problem, and they are not sealed off in one region of the country. Indeed, economic and financial information at the national level -- that is, information which takes in every part of the country -- demonstrates this very clearly. To cite a broad national number, total dollar spending on Canadian goods and services went up by over 8 per cent last year, following a rise of nearly 11 per cent during 1987. This is a pace far in excess of the rate at which the Canadian economy can generate sustained annual increases in the physical supply of goods and services of all kinds. So long as this sort of gap persists, our economy will remain an inflationary one, and the greater will be the momentum that inflation acquires.

Indicators of national monetary and credit expansion, the kind of information that is particularly relevant to monetary policy, are also revealing. Monetary expansion in Canada, as reflected in the rise in the public's holdings of currency, demand and savings deposits (M2), has been running consistently at a pace above 10 per cent. The rise in credit extended to Canadians has also been very rapid and well sustained through 1988 and, I might add, into 1989. For consumers and homeowners, the credit expansion over the past year has been some 17 per cent. The increase has not been quite so rapid in the past few months, as the expansion in consumer credit (made up of such items as car loans, credit card and personal loans) has slowed from about 16 per cent to a less dramatic, though still vigorous, rate of close to 10 per cent. However, with the sustained strength in housing demand and mortgage lending, the recent expansion of credit to households overall has still been some 15 per cent at an annual rate -- not much below the almost 20 per cent pace we saw during the summer. As for Canadian businesses, their borrowing has also been rising rapidly, at a pace that has been sustained at around 10 per cent. At the same time, profits have continued to move up.

In summary, these kinds of information indicate the continued strength of demand pressures at the national level. And if monetary policy is to do its job, it must respond to such pressures. It would, of course, be preferable to see still more evenness in the pace and level of economic activity across the country. But the undeniable reality has been a situation of strong spending and increasing pressures on inflation at the national level at which monetary policy operates.

The challenge for monetary policy has been to do what it can to support the prospects for sustained good economic performance by resisting firmly the surge in spending pressures and thereby curbing inflation. But when demand restraint is exercised mainly through monetary policy, this is bound to be reflected importantly in money markets and the exchange market. And I am well aware that the increases in short-term interest rates and the exchange rate over the past year or so have seized the attention of Canadians.

Therefore, a question that arises, and indeed is quite often posed, is whether the pressures from, or perhaps on, monetary policy can or should be alleviated.

Let me just note in passing that one thought that crops up in my correspondence from time to time is the idea that there is some kind of short-cut available through the imposition of control measures of various kinds -- credit controls, price controls, wage controls. In this regard, the fundamental point to be made is that the expansion of spending in the economy still has to be brought more into line with the economy's capacity to add over time to the supply of goods and services demanded from it. Controls cannot do this, and as a result such measures not only would be futile but also would generate serious distortions in the economy. So this controls approach, then, is more a diversion than a solution to the issue of excessive total spending.

A similar comment may be made in regard to arguments that curbing inflation should be tackled not so much through limiting demand as through increasing supply. In this regard, let me note that measures to enhance our productivity performance in Canada are to be welcomed in their own right. They make us better off by increasing the goods and services available to us all for the same amount of effort. But in any event, the rhythm of the advance in spending has to be one that stays in touch with potential supply. In other words, spending has to be maintained at a pace which, unlike the situation in the past couple of years, does not run far ahead of the rate at which the economy is capable of generating new output.

The role of fiscal policy is broad and complex. Internationally, the U.S. federal debt and deficit is a central issue in U.S. economic management and international economic co-ordination. In Canada these same questions have been getting more attention in recent years. This attention to fiscal performance is to be welcomed because good fiscal performance is important for achieving good economic performance.

In any event, you will not anticipate that I will be saying a great deal about fiscal policy in Canada at this particular juncture. Still, this is a good occasion to note one aspect. This is the aspect where fiscal policy relates to demand and, to that extent, to spending pressures in

Canada and the pressures on monetary policy.

Both monetary and fiscal policies are, broadly speaking, demand policies. Fiscal policy, at least in its broad budgetary impact through taxes, spending and deficits, is, like monetary policy, a policy that has its primary economic impact on demand.

However, because the channels through which monetary and fiscal policy exert their influence are different, it can be readily appreciated that there exists in a general way scope for some counterbalancing between the impacts of each kind of policy on total spending in the economy. Thus, actions undertaken to reduce fiscal deficits go in the direction of restraining demand, which in turn go in the direction of easing pressures on monetary policy and monetary conditions. These questions of "mix" or overlap pose of course a number of very real complexities in relation to the timing and the ultimate effects of policy actions. Furthermore, shifts in the level of demand affecting the economy do not come about solely because of fiscal or monetary actions. Still, the relevant point here is that there is an overlap.

Many challenges face us in 1989. One important role of public economic policy is to provide the kinds of economic stability that allow well-founded decisions to be made. Let me therefore re-emphasize that the Bank of Canada will continue to act responsibly in the conduct of monetary policy. Ours is a monetary economy, and Canadians should expect to enjoy strong confidence in the money they use. Our economy will function better if this confidence continues to be assured through a monetary policy oriented towards price stability.