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

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to the

Chambre de commerce de la Rive-Sud
Brossard, Quebec
4 April 1990

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Notes for Remarks to the
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I have visited the Montreal area often, but this will be the first occasion on which I will give a speech south of the river. Economic and financial events have been in ample supply recently. So I am glad to have this opportunity today to discuss what some of these developments mean from the viewpoint of monetary policy.

But before turning to these events, it is important to have firmly in one's mind what monetary policy is about. So let me start there. Of course the Bank of Canada should conduct monetary policy so that it makes the best contribution it can to the healthy functioning of the Canadian economy. That is not the issue. The issue, one that concerns us all, is how it can best do this.

What monetary policy can uniquely do to help ensure a good economic performance is to provide Canadians with a Canadian money they can trust. This is terribly important, so I make no bones about emphasizing it. Consider the alternative -- a money that people do not trust and do not want to use. That does not help the economy at all.

What does this mean for the way we should operate? Essentially, it means that we need to work at limiting the pace of monetary expansion so that money will not lose its value over time. In other words, we need to keep the pace of monetary expansion consistent with stability in domestic prices.

This is not, however, the situation we have faced during the past few years. Certainly, inflation came down from the disastrous double digit rates of the early 1980s. That was a tremendous improvement, and since then the Canadian economy overall has known some good years. But progress towards price stability stalled in the latter half of the 1980s, and worse still, inflation began to move back up.

What essentially lay behind the accumulation of inflation pressures was the much faster rise in dollar spending in our economy. Demand came from many quarters -- from exports, from business investment, from housing demand -- and the net result was that spending in Canada grew much faster than the possible growth of output, and I might add, at a pace appreciably faster than in the United States.

In Quebec, over the 1987-1988 period alone total dollar spending rose by more than 20 per cent. This pace was in fact typical of the country as a whole, and it was against this background that the Bank of Canada encouraged progressively tighter monetary conditions. In retrospect, perhaps we did not tighten enough back then.

Let me at this point insert a brief word about a topic that seems to come up very often in Canada -- namely, the scope for a monetary policy differentiated by the various regions or provinces in the country. With our efficient financial system in Canada, where funds can be easily transferred from one part of the country to another, monetary policy cannot be conducted on a regional or provincial basis. Decisions on monetary policy actions are necessarily taken in the broad national interest. This means that they are taken on the basis of information on economic conditions relevant for the country as a whole, not just on considerations relevant for only a part of it. This is, I will emphasize, exactly the way that monetary policy is implemented in all the other advanced industrial nations. They all benefit from efficient financial systems. That is one reason why they are advanced.

Returning to my narrative, in 1989, beginning about the spring, spending in Canada began to rise somewhat less rapidly. But despite this welcome moderation, the cumulative effect of the years of buoyant increases in demand had pushed the Canadian economy to a very high level of market pressure. This pressure was sustained into the latter part of 1989. In particular, Canadian labour markets tightened further, with wage increases speeding up through the year. Furthermore, looking at information that reflects rather closely the Bank of Canada's responsibilities, the expansion of both money and total credit in Canada surged at a pace above 10 per cent. These are very large numbers for an economy whose capacity to produce does not expand at a rate much above 3 per cent.

It is not surprising, then, that the year-to-year rate of inflation rose above 5 per cent last June for the first time since 1984, and has since stayed there. What is also striking is that inflation has become more generalized across the country. Prices not only rose more quickly in every region in 1989, but the acceleration was largest where inflation pressures had previously been the weakest.

It is important to point out that inflation speeded up during a period when a steady appreciation of the Canadian dollar made imports cheaper. Without this effect of the exchange rate, prices paid by Canadians would have risen still faster. What this underscores is that the domestic forces pushing up costs and prices in Canada have been very powerful indeed.

Bank of Canada actions in financial markets have of course been addressed to resisting and reversing those inflation pressures. Not to have done so would have meant avoiding our responsibilities. More importantly, it would not have helped sustain the necessary basis that monetary policy can provide for good Canadian economic performance.

As I have indicated, a useful way of looking at what we should do is in terms of achieving a moderate rate of monetary expansion. In a situation of strong demand and inflation pressures, seeking this moderation has meant upward pressure on monetary conditions. Short-term interest rates rose by a further 1 1/4 percentage points in early 1989, and then stayed relatively steady for the remainder of the year. In addition, although monetary policy is by no means the only factor affecting our exchange rate, there is no doubt that it was a factor in the further upward movement in the value of the Canadian dollar in 1989.

I want to stress at this point that a policy of monetary stability is not, to quote a phrase that has received a lot of use lately, a "high interest rate policy." The way to get low interest rates is to have, as we do, a policy of low inflation.

What creates sustained upward pressure on interest rates are policies that accommodate and encourage inflation. We might, if people are not paying close attention, be able to produce a temporary reduction in short-term interest rates by pumping even more liquidity into the economy. But this is a short-sighted policy in terms of both inflation and interest rates.

It is short-sighted because an inflation that is sustained inevitably affects the attitudes of both lenders and borrowers. Lenders, that is to say, savers, demand compensation through higher interest rates for the likely loss in the real value of the funds they are committing. Borrowers, because they see the same inflation in their future, are prepared to pay higher interest rates without curbing their demand for funds. Interest rates go up under these conditions, not down.

Now let me put what has been happening over the past few months in the context of these comments.

Evidence from the latter part of 1989 suggested that the economy was, on balance, beginning to move from a situation where the pressures on costs and prices were steadily mounting to one where those pressures were starting to ease. A slower pace of advance in spending, which is vital to a sustained improvement on the inflation front, had gradually been developing.

These national developments are reflected in Quebec's economy. After a very strong expansion for most of the 1980s, Quebec has lately exhibited a much more moderate rise in demand -- one more consistent with a non-inflationary, as opposed to inflationary, outcome.

At the beginning of this year, given the apparent shift in spending in the economy towards a more moderate pace of advance, a modest easing in monetary conditions was judged to be appropriate. But while there were some early signs that pressures on inflation had begun to lessen, they were not by any means assured. It followed that any easing of monetary conditions in Canada could be only of a very limited nature.

Accordingly, in mid-January the Bank of Canada oriented its day-to-day operations in money markets to encourage a decline in short-term interest rates by about a quarter of a percentage point. Participants in domestic financial markets quickly picked up the signals we sent out, but tended to push interest rates down by more. The Bank of Canada immediately intervened in the Canadian money market to indicate strongly that a larger reduction was not warranted.

It was to be expected that even the limited easing in monetary conditions contemplated by the Bank would involve some downward pressure on the Canadian dollar. Indeed, it is worth emphasizing that the term "monetary conditions", which I have already used, covers not only short-term interest rates but also the exchange rate. This is because both short-term interest rates and the exchange rate are channels through which the influence of monetary policy is exerted on monetary expansion and spending in the economy. It is also worth emphasizing that since financial markets are overwhelmingly influenced by expectations about future developments, we have always known that there can be no complete assurance about how strongly or abruptly those markets will respond to Bank of Canada actions.

In the event, public commentary and market participants became highly speculative as to what the future held. One factor, that I have already mentioned, was the tendency in Canada to extrapolate the Bank's actions into sustained major declines in Canadian short-term interest rates in the months ahead. Another factor was that there also turned out to be an accelerated gathering of sentiment abroad in the direction of seeing higher rather than lower interest rates. After an initial response that was relatively muted, the Canadian dollar fell sharply against foreign currencies, going from about

86 1/2 cents U.S in mid-January to under 83 cents in mid-February.

The Bank of Canada needed to respond vigorously to this decline for two important reasons.

First, the Bank as a matter of principle seeks to avoid instability in financial markets. A market over-reaction in the case of the exchange rate carries with it the risk that it would feed upon itself and gain strong downward momentum.

Second, and more fundamentally, the decline in the exchange value of the Canadian dollar meant a large easing in monetary conditions. This easing was appreciably larger than was warranted by any progress made in reducing the pressures on inflation.

As you know, short-term interest rates in Canada moved back up. Part of the explanation for the reversal lies in the reaction of participants in the Canadian money market, especially those who buy treasury bills and other kinds of short-term financial assets. As is to be expected in an uncertain exchange rate situation, that is, where there is increased doubt about the future value of Canadian dollar investments, participants in money markets began to seek higher yields to compensate for the increased exchange rate risk that they saw. In this way they pushed short-term interest rates back up. Another part of the explanation is that the Bank of Canada at times helped this movement along by its own direct actions in money markets. This backing-up culminated in short-term interest rates rising by almost a percentage point above where they had been at the beginning of January, and in mid-February commercial banks raised their prime lending rate by three-quarters of a percentage point.

Since mid-February interest rates have remained relatively stable and the Canadian dollar has risen back quite a long way. With short-term interest rates higher than they were in early January, monetary conditions have tightened somewhat further since then. When one takes into account the evidence in the most recent economic and financial statistics of persistently strong spending and inflation pressures, that tightening appears to have been well advised.

How will the Bank of Canada orient monetary policy in the period ahead? From what I have already said, you will not be surprised if I indicate that in broad terms the Bank will continue to encourage sufficient monetary restraint to bring about a significant improvement in Canada's underlying inflation performance.

As I have implied, there is a lot of judgment in deciding what setting of monetary conditions is necessary to achieve this outcome as economic conditions evolve. The Bank of Canada must take into account a range of factors affecting financial markets and our economy.

Furthermore, the Bank's activities, like most economic activities, are affected by market forces. We cannot set the level of interest rates by fiat, however attractive that concept might appear to some. Our actions have to be seen as credible by savers and investors. We recognize and welcome that. Without a commensurate reduction in pressures on inflation, steps to push down interest rates would be arbitrary. They would merely accommodate and encourage the forces that lead to higher interest rates.

We are also affected by events abroad. Of particular relevance here is the fact that short-term interest rates have been rising in some of the major industrialized countries, particularly Japan and West Germany. And there has been a more general increase this year in long-term interest rates, including those in the United States. The crucial impetus behind these developments has been concerns about higher inflation in these countries.

However, the Bank of Canada is still ultimately capable of influencing the rate of monetary expansion in Canada. And we must continue to use this influence to good purpose, to generate a non-inflationary climate.

Monetary policy is aimed at ensuring a moderate pace of monetary expansion and of dollar spending in Canada.
A substantial effort is also being made to bring down the federal fiscal deficit. A beginning has been made, but these policies must persist in their efforts as cost and price pressures in the Canadian economy remain strong. A significant abatement in these pressures is a vital element in an easing in monetary conditions. That was a key message of the recent federal budget as well.

There are many problems that monetary policy can do very little about directly. But there is one vital thing it can do. By pursuing monetary stability it can help provide the necessary framework for sustainable economic expansion and sustained low interest rates in the future.