BANK OF CANADA

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

to the
Saskatoon Chamber of Commerce
Saskatoon, Saskatchewan
22 June 1990

**Not for publication before 22 June 1990 at
12:45 p.m. central standard time
(2:45 p.m. eastern daylight saving time)**

Notes for Remarks by
John W. Crow
Governor of the Bank of Canada
to the Saskatoon Chamber of Commerce
Saskatoon, Saskatchewan
22 June 1990

It is a pleasure to be here in Saskatoon today. The actions of the Bank of Canada get wide attention. Therefore, it is essential that the Bank explain its policies often, and across the country.

Monetary policy is only one element in the economic panorama. There are many problems it cannot deal with directly. But what it can do is important, so I want to leave you today with a good idea of the Bank of Canada's responsibilities and objectives. I want to bring out not only what monetary policy has been doing recently but also the need for its actions to be guided within a clear and consistent framework. The essential point about that framework is that it has to be geared to providing Canadians with a money they can trust.

The Bank of Canada is unique because, being at the heart of the money creation mechanism, it can influence the pace of financial expansion in our economy. Although some people appear to believe that the Bank can do many different things, in fact its power to print money essentially sums up the leverage available to monetary policy. Without question we want to use this leverage so that it contributes to good economic performance for Canada. This means using the Bank's influence to help keep the pace of advance in money and credit, and therefore of dollar spending, in line with the capacity of the economy to grow -- that is to say, to a pace that provides for economic expansion but that discourages inflation. This is the contribution that the Bank of Canada can make to the health of the Canadian economy.

Does this matter? It matters vitally. Canadians would be badly served by a monetary policy that promoted inflation. The temptation to see a rapid printing of money, or debasing the coinage as it was called in older times, as the solution to economic problems is very great. Printing money is easy, and if our problems could really be solved in this way it would be an appealing course of action. But experience shows that it does not work. It cannot work in an economy that in going about its business relies on money. How could it? Inflation makes our economy less productive, less efficient. It creates needless uncertainty, and it also creates inequity. Anyone who gains through inflation must gain at the expense of everyone else, because inflation is the enemy of economic growth on any kind of sustainable basis.

The adverse impact of inflation is in some ways like the damage done by soil erosion. When inflation is high and rising, it's like a dust storm -- the harm is obvious to everyone. A slower rate of inflation may be less dramatic, but there still are losses and they are progressive. Like gradual erosion, the harm done in any one year may not seem very large, but over time the damage will be great. The benefits from efforts made today to combat the problem may not be quickly apparent. But the sooner action is taken the more successful and the less costly that action will be.

The Bank of Canada has emphasized that there is no "ideal" rate of inflation -- that the best outcome is price stability. Since inflation is a hindrance, not a help, to the economy, this is the only sensible long-run objective. Trying to engineer some particular rate of inflation would entrench the burden of chronic inflation, and would not be a believable policy. So price stability must be given central importance and kept clearly in sight as the anchor for monetary policy.

But the immediate challenge facing monetary policy has been far from one of managing the pace at which we move towards price stability. Over the recent past, the task facing the Bank of Canada has been to deal with a deteriorating inflation situation; where policy has had to focus on stopping inflation from speeding up. From the double digit rates of the early 1980s, inflation had come down to about 4 per cent. But the pressures behind inflation have clearly mounted in recent years, and inflation moved back up.

What has given rise to these inflationary pressures? To judge by what we generally read and listen to, there are all kinds of particular elements. But we should not lose sight of the forest because of the trees. What I can tell you is that the central factor has been the overall strength of total dollar spending in the Canadian economy. Strong demand has come from abroad and from within Canada, and from both investment and consumption. Over the last three calendar years alone, total dollar spending in Canada has risen by 30 per cent. Broad measures of money and credit have increased by even more. The resulting high level of demand relative to supply put accelerating upward pressure on prices and costs in our economy.

Not all regions of Canada have shared in the spending boom to the same degree. And the pressures on inflation have tended to emerge at different times in different amounts. This reflects the diversity of our economy. But inflation did rise in all regions of the country, increasing most last year where inflation pressures had previously been the weakest. Today, the highest rates of inflation in consumer prices are found in some parts of the West. That cost and price pressures have become stronger and more generalized across the country is not a welcome development, but it is one we must nevertheless recognize.

This does not mean, however, that it must be accepted.

Monetary policy has been resisting the mounting inflationary tendencies in our economy. This has been controversial. Some argue that inflation of about 5 per cent does not warrant resistance from monetary policy. And one can wonder of course at what rate of inflation such critics would think that an anti-inflationary monetary policy would truly be in order. In any case, the seriousness of inflation at current levels should not be underestimated. Take the case of someone who retires on a fixed pension at age 65. At 5 per cent inflation, when that person reaches 70 the amount that can be purchased with his or her pension will have been reduced by more than a fifth. And by age 80, the purchasing power of that pension will have fallen by more than a half. This is a big loss. And since inflation, if not resisted, feeds upon itself, the loss could get even larger.

Monetary policy must counter the spending pressures behind inflation. As I described earlier, those pressures have been extraordinarily strong, much stronger than the inflation numbers themselves might suggest. Indeed, their force is highlighted by the fact that inflation has speeded up despite the monetary restraint, including the price-dampening impact of a stronger Canadian dollar.

And I want to emphasize that if the Bank of Canada had not progressively tightened monetary conditions in response to intensifying inflationary pressures, the inflation problem that we face today would have been greater still.

The point is this: monetary policy has not failed to have a beneficial impact. We are in fact feeling the benefits from having taken action early. Those earlier actions have made the task faced today less difficult -- not easy, but less difficult. The fact that inflation is not lower does not mean that monetary policy has been ineffective, but that the inflationary pressures we have been combatting have been powerful.

Up to this point I have barely mentioned interest rates. This may seem odd to some, given that public commentary on monetary policy hardly refers to anything else. Interest rates should not be seen as the essence of monetary policy for a very good reason.

The reason is that low interest rates follow <u>from</u> a record of low inflation, they do not precede it. It is true that Bank of Canada actions to limit the expansion of money and credit in our inflationary environment have been one factor pushing up short-term interest rates in the past three years or so. But let me emphasize that what leads to upward pressure on interest rates that is really sustained is a monetary policy that persistently accommodates, and therefore encourages, inflation. And in the extreme such policies can result in interest rates at stratospheric levels.

This point is very important, so let me dwell on it.

What if the Bank tried to encourage easy credit by pumping out more and more liquidity? In an inflation-prone economy we would not succeed for long, if at all. People know better. For example, savers would demand a better rate of return, that is, higher interest rates, to protect themselves from higher inflation.

Therefore, it is a mistake to say that the Bank of Canada is following a "high interest rate" policy. What it is following is an inflation-fighting policy, which will in turn create a climate for low interest rates. To confirm this, one only need look abroad. It is in those countries that have successfully maintained confidence in their money with policies generating low inflation that one tends to find low interest rates.

The beneficial effects of monetary policy do not come quickly. So it is not surprising if people wonder whether there is some easier way to slow the growth of money or credit to a non-inflationary pace. A short-cut, as it were. One familiar proposal is to introduce some form of credit controls to limit the overall availability of loans. It has been suggested for example that credit might be rationed by stipulating downpayment requirements, perhaps varying the size of the downpayment according to the purpose of the loan, perhaps by region as well.

This reflects a common tendency to look to controls of various kinds as a way of cutting through difficult situations. After all, why deal with something like too much credit or spending through indirect, market-based means like monetary policy, when it can be tackled directly? And I would guess that when people refer to monetary policy as a "blunt instrument," they are at least in part referring to the fact that it works broadly, through financial markets, rather than with the supposed deftness of direct controls of various kinds.

However, the temptation to see controls as an easy way out must be resisted. This is because they are not in truth an easy or costless solution. They are an interference with something that is basic to the way our economy works -- the system of markets, market forces, and private decision-making.

Admittedly, this objection to administrative controls as a way of economic management may seem to many as a bit abstract. But it is not to someone who has had to live through an economy based on controls. The world has seen vivid evidence in Eastern Europe of the profound economic deterioration caused by such an environment. Eastern European countries are now preparing to take on the monumental task of reform. Above all, they want to get rid of controls and rely more on market freedom. This is essential if their economies are going to prosper -- and their peoples know it from bitter experience.

Simply put, controls cannot act as a substitute for sound general economic policy.

One final point. Although controls are usually suggested as only a temporary measure, it is often more difficult to remove them than to impose them. In other words, they can be addictive.

Recent years have been difficult for the Saskatchewan economy. The agricultural sector in particular has had to confront drought, protectionist actions abroad, and high debt burdens. The provincial economy rebounded last year, but this should not mask the serious structural problems and ongoing difficulties.

The Saskatchewan economy has been responding to these challenges. Important investments that will bring long-term benefits have been made in the natural resource industries. The natural gas industry is a particular source of strength. And perhaps even more important is that the economy has been evolving from so much reliance on its traditional agricultural/natural resource base. Other sectors of the economy, including services, manufacturing and utilities, have become increasingly important, supported by a significant expansion in small business activity. The diversification and development of the Saskatchewan economy should continue this year, given plans for a sharp increase in business investment.

In bringing these remarks to a conclusion, I will note that it is curious that a policy of resisting inflation, of seeking to provide Canadians with a money they can trust, has been described, for example, as a "gamble". This is truly a strange way of looking at things. The real gamble would have been to sit back and do nothing in the face of the mounting inflationary erosion of our economy. Monetary policy would eventually have had to deal with an even more serious situation -- a dust storm -- and take a correspondingly tougher stance. That was what our economy faced in the early eighties. We can surely all agree that we do not want to repeat that experience.

An encouraging fact is that spending in Canada is now beginning to advance at a somewhat less rapid pace. The financial variables monitored by the Bank, for both money and credit, also suggest that some easing is underway. A moderation in demand pressures is a crucial step in bringing about an abatement in cost and price pressures. Some progress has been made, and we are on the right path to continuing that progress.

Nevertheless, it is important to persevere while strong inflationary forces persist. If we care about having a healthy economy in the future, we must resolve our problems now. No part of this country would benefit if we were to encourage inflation and thereby contribute to further problems and sustained high interest rates down the road. This would not meet our common goal of maintaining the basis for sustainable, and sustained, economic expansion.