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

to the
Canada-U.K. Chamber of Commerce
Annual Financial Services Luncheon
London, England
12 June 1990

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What I shall do first is share with you some thoughts from our vantage point at the Bank of Canada on what we see happening on this side of the Atlantic. Canadians are profoundly interested and involved in what is happening in Europe. Given our trade, investment patterns and origins, this could hardly be otherwise. Let me also note that besides being an Atlantic nation we are a Pacific nation, and an important part of the Americas as well. We look outward in all directions and are gratified when it is confirmed that Europe does too, even if intra-European matters must nowadays be intensely preoccupying for Europeans -- including those with an international outlook.

From the Bank of Canada's viewpoint, the developments that most fully catch our attention are those involving the monetary evolution of Europe -- centring on the Community.

Two areas that we find particularly absorbing in this regard are: firstly, the discussion over the objectives of monetary policy and the accountability of central banks for their actions; and secondly, the development of thinking in Europe about exchange rates.

As regards the first set of questions, the central issue is the way institutional arrangements might improve the chances for good policy -- above all in this instance good monetary policy.

By now everyone knows that sorting out the issues of monetary union in Europe raises all kinds of knotty problems.

That being said, I am keen to underline that it is very helpful that proper emphasis has been given in the European discussions to the need for monetary stability -- in other words, price stability -- as the heart of monetary policy, and the need for institutional arrangements to underpin this goal. As it looks to us from across the ocean, the fundamental importance of price stability as the objective of monetary policy is for all practical purposes uncontested in these discussions. This is, if we have an accurate view of matters, a happy state of affairs indeed, since it represents a victory for clear thinking.

The particular institutional arrangements for central banks matter because a policy that aims to bring about monetary stability must underline in practical, operational terms the vital distinction between the power to spend money and the power to create it. If this distinction is not clear, obviously the risk of excessive money creation is all the greater. I will also note that with that clear distinction, there is a need for arrangements to ensure the public accountability of the central banking institution. Such arrangements of course need a lot of thought. And as Europe is demonstrating, there can also be lots of interesting debate as regards the elements that constitute a suitable framework for that accountability.

My final comment in this area is to point out that these questions are of course not confined to Europe. For example, quite recently major statutory changes were enacted in this area in New Zealand. In particular, the new statutes explicitly establish price stability as the central objective of monetary policy, and in the light of that explicit objective provide an accountability framework for the Reserve Bank that is particularly carefully and clearly spelled out. The accountability of the Bank of Canada, given its responsibility in formulating monetary policy, is crystallized in the power of the

government to give the Bank a monetary policy directive. That directive has to be specific in terms of Bank actions and for a limited period. This is not the occasion to explore the various implications surrounding, or consequential upon, the issuance of a directive, but an important additional point is that such a directive also is required to be published forthwith, and therefore will be open to public scrutiny.

Let me turn to exchange rates.

In Europe, the overwhelming weight of conventional wisdom has shifted towards emphasizing the benefits of fixed exchange rates. Perhaps a considerable part of this momentum stems from what many see as an imperative for political union underlying the vision of a single market. But you will appreciate that a central banker's comparative advantage, especially in light of the remarks on institutional arrangements that I have just made, does not lie in discussing the political side. So from this angle I will limit myself to registering one point. The term "monetary union" does not mean simply that exchange rates are fixed across the union. It means more. It means exchange rates that are, as far as anything can be fixed in this world, fixed irrevocably. And from that perspective the relevance of discussions about monetary union in Europe is that they are being conducted among nations that want to come closer together in many different respects, not simply in monetary terms.

It is well recognized that across a system of fixed exchange rates, real economic adjustment works better the more similar are the economies. In this regard Europe appears to present no extreme difficulty, as economic structures are indeed rather similar over most of the Community. This is true even though some understandable concern has been expressed about the

relative economic performance of peripheral regions, and the Community literature does emphasize the existence of structural programs to meet those concerns. Let me add, however, that the importance of oil and gas production to the United Kingdom and Netherlands economies does present a noteworthy potential difference compared with the structures of their Community partners -- depending of course on what happens to the prices of oil and gas relative to the prices of other things, and on how long European supplies last.

If one is to achieve the goal of fixed exchange rates, the need to orient policies of partner countries towards price stability gains particular importance. Without a common standard of underlying inflation performance, the goal of unchanging exchange rates will tend to be honoured as much in the breach as in the observance. And in any event there simply is no point in terms of broad economic well-being -- given that we are, after all, talking about economies that depend on money to function -- in trying to converge to some common standard of monetary performance other than price stability.

Canada, to make the contrast, has a flexible exchange rate regime, and indeed among major industrialized countries has been one of the more consistent practitioners of such a regime. In this regard, one aspect of our economic structure is worth stressing. Unlike most European countries, Canada's exports are more concentrated in natural resource products (which are not likely to be exhausted any time soon), while our imports are particularly concentrated in manufactures. As a result, our international terms of trade (export prices compared to import prices) tend to move strongly in response to cyclical swings in the prices of major world commodities. More importantly perhaps, our terms of trade tend to move over the economic cycle in the opposite direction to those of our main trading partners.

For reasons such as these, changes in the exchange rate can help in macroeconomic adjustment.

At the same time, however, we have to be sure that the wrong lessons are not drawn about the advantages that a flexible exchange rate regime can offer. In particular, the Bank of Canada has been at some pains to emphasize that having a flexible exchange rate regime in no way provides an excuse for following a monetary policy that is inflationary.

In this regard, it is perhaps useful to recall the ill-fated "dash for growth" economic policy experiment that was tried by the United Kingdom in the early 1970s. The move to floating currencies appeared to the U.K. authorities at that time to provide an opportunity to break out of the "stop-go" demand policies dictated in the 1950s and 1960s by successive balance of payments crises under fixed exchange rates. If the balance of payments worsened, the new recipe was to be simply to let the pound depreciate. What seemed to be played down was the fact that it was still necessary to maintain strong domestic financial discipline. The experiment ended with runaway inflation, but not growth.

These latter comments also provide a useful crossover to some concluding observations on the challenges currently facing Canadian monetary policy. It seems that these are not so different from those faced in the United Kingdom today.

As I trust is well known -- the Bank of Canada has certainly emphasized the point a lot -- monetary policy in Canada is directed at domestic monetary stability. The reasons would be, at bottom, the same as those emphasized in Europe and, for that matter, elsewhere in the world. To put it very simply, there is no sound basis for operating monetary policy in a way

that provides for systematic losses in the domestic purchasing power of the national currency.

Accordingly, the thrust of monetary policy in Canada has been to generate monetary conditions consistent with a decline in inflation and progress towards price stability.

What is the record? Inflation in Canada came down from double digits in the early 1980s to about 4 per cent. But inflationary pressures have mounted in recent years, with inflation tending to move up again -- most recently to 5 - 5 1/2 per cent in terms of consumer prices. This, by anybody's definition, is far from price stability. Furthermore, to underline that the inflation pressures are of domestic origin, it is worth noting that this acceleration has taken place despite the price-dampening effects from a significant appreciation of the Canadian dollar. Import prices paid by Canadians have actually fallen over the past three years.

There have been no adverse supply shocks of any significance. The buildup in inflation pressures in both our countries has come from an extremely strong expansion of total spending. In Canada, this surge was initially concentrated in exports, led by the boom in commodities and to some extent by auto sales to the United States. Then more recently, housing construction and plant and equipment expenditures came to the fore. An underlying element has been well-sustained advances in consumer outlays as Canadians' income has grown relatively rapidly.

In response to these spending pressures, both credit and money expanded very rapidly. The actions of the Bank of Canada since 1987, in its efforts to bring about a more moderate, and therefore sustainable, pace of monetary expansion and dollar

spending, have meant a pronounced upward shift in short-term interest rates -- one comparable to that which has occurred here in Britain. And as I noted earlier the Canadian dollar has appreciated, contributing to the tightening of monetary conditions.

Monetary policy actions in Canada have elicited a lively public reaction. What has captured attention as much as anything has been the fact that Canadian money market interest rates have for some time been well above corresponding rates in the United States. With the decline in U.S. short-term rates beginning in the spring of last year, a spread of some 5 percentage points or more against U.S. money market instruments has opened up. The historical spread has averaged less than 2 percentage points.

But, of course, this is not the only difference with the United States, and in any event it is a derived rather than a primary difference. What I mean by "derived" is that Canadian demand conditions have been appreciably stronger, and more inflationary, than those in the United States. Pressures on inflation in Canada have been extremely persistent, and it is essential that Canadian monetary policy reflect the situation and the challenges that exist for Canada.

From a more fundamental, that is longer-term, point of view monetary policy is not an interest rate policy but an inflation-fighting, inflation-control, policy. In this light, we have pointed out that the only sure way to get interest rates down -- that is, in a way that they stay down -- is to generate price stability, and confidence among the holders of claims in Canadian dollars that price stability will be maintained.

In concluding, let me say that I am conscious that I have given you not only a report on monetary policy that is necessarily quite summary, but also a report that emphasizes work in progress. Canadian monetary policy continues to be anchored to an anti-inflation objective, not as a matter of taste but because that is the essential contribution it can make to the well-being of the Canadian economy. And what the Bank of Canada finds gratifying, as it looks at developments and discussions in Europe, is that the need to provide monetary policy with this basic anchor, whether within or across countries, commands strong support.