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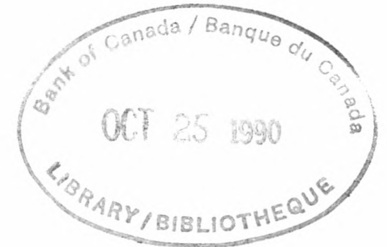
Notes for remarks by John W. Crow Governor of the Bank of Canada



to

The Greater Moncton Chamber of Commerce
Moncton, New Brunswick
24 October 1990

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Notes for remarks by
John W. Crow
Governor of the Bank of Canada
to The Greater Moncton Chamber of Commerce
Moncton, New Brunswick
24 October 1990

It is an honour to be with you this evening at your celebration of business excellence. I also welcome this opportunity to discuss with you the policies of the Bank of Canada -- both the principles behind them and what we have been doing in light of recent economic developments.

The Bank of Canada has responsibility for designing and putting into effect monetary policy. This is not a small responsibility, for it means taking decisions that affect all Canadians. And if we are to take the right steps in our day-to-day actions in financial markets, then they must be firmly based within a clearly thought-out and consistent monetary policy framework. We have such a framework. At its heart is the goal of providing a money that can be trusted, a currency that can be counted on <u>not</u> to lose its value over time. In other words, the sensible long-run objective and anchor for monetary policy is one of stable prices in our economy.

Price stability is not an end in itself. What counts is what price stability can deliver. We have a market economy, and one of its pillars is the institution of money and monetary exchange. Admittedly, anyone who feels that this institution, and its contribution in making our economy work well, is of no fundamental importance, will find the notion of price stability and monetary confidence somewhat bizarre. But we <u>do</u> have an economy in which money and monetary exchange is crucial, and for our economy to work as well as it can, sound money is essential.

The prices of goods and services are set in money terms. We keep economic score and we frame our day-to-day and longer-term decisions in money terms. Damaging that institution, as inflation must, introduces needless uncertainty and thereby makes our economy less efficient and less productive. It also injects inequity, hurting some groups of people to the benefit of others, and for no socially worthwhile purpose.

The lower the rate of inflation the better. The lower the rate of inflation, the less severe are the losses from inflation. But there are losses even with low rates of inflation and they cumulate over time. Furthermore, treating inflation as acceptable today opens the door to progressively higher rates of inflation later. People who advise the Bank of Canada that it should fight inflation only when it is accelerating are in effect suggesting that at all other times monetary policy should ignore inflation, addressing itself say to printing money to finance deficits or to drive down the exchange rate. Perhaps people who give us this advice do not realize that they are in effect advocating a built-in upward ratchet to inflation. That is why we are bound to disappoint them.

In securing a trustworthy monetary standard, the Bank of Canada seeks a rate of growth in money and credit consistent with monetary stability and steady growth in the economy. This is frequently, and incorrectly, referred to as a "high interest rate" policy. In reality, the very opposite is true, since the effect of achieving a non-inflationary environment will be to bring about low interest rates.

It is certainly true that in an environment where inflation pressures are already strong, a policy aimed at ensuring a pace of monetary expansion that is moderate will, other things being equal, induce upward pressure on short-term

interest rates. In addition, the Bank's influence on short-term rates can be expected, again with other things remaining equal, to have an effect on the Canadian dollar. However, it is also important to recognize that interest rates and the exchange rate cannot be regarded as monetary policy objectives in themselves. They are the channels through which monetary policy influences spending in the economy as it combats inflationary pressures. More important still, as inflation pressures recede, and people's fears of inflation decline, then the basis is being laid for durable reductions in interest rates. In such an environment, savers do not have to seek high interest rates to compensate for future losses in the value of money.

I have emphasized that we are seeking reductions in interest rates that are durable, and that this durability depends crucially on what Canadians expect to happen to inflation in the future. Nevertheless, some observers appear to believe that the Bank of Canada can dictate interest rates across the spectrum of yields, whether short- medium- or long-term. This is not the case at all. In fact, the only interest rate over which we exert a major direct influence is the one-day interest rate on liquidity balances held by financial institutions. Our influence over rates longer than one day, the rates at which businesses, households and governments borrow, depends very much on the credibility of our actions. In particular, the Bank's ability to guide interest rates down in a way that they stay down depends on the extent to which our actions are viewed by the market as being consistent with an improving inflation outlook. In this light, trying to force down short-term interest rates by pushing central bank liquidity into the market could well have the opposite effect on longer-term rates, particularly if that inflation outlook is fragile.

Let me at this point also note another widespread view -- that a policy of restraint in monetary expansion is totally misguided because in fact it adds to inflation rather than lowers it. This view focusses on the effect of higher business borrowing costs that may be passed on to the consumer, as well as any possible effect of higher mortgage interest rates on prices and on income demands. This is a serious charge, because if it were the whole story, then it would obviously imply that the faster the Bank of Canada prints money, the less inflation there would be. But that does not make sense, and it does not make sense because the effects I just alluded to are far from being the whole story. The overwhelming effect of maintaining a moderate rate of monetary expansion is to keep spending in line with output and to restrain prices. And for reasons I spelled out earlier, there is no justification at all for arguing that inflation, if left unchecked, will lower interest rates. Look at Latin America, where high inflation has led to remarkably high interest rates.

The Bank of Canada's actions are not based on the premise that price stability should be achieved virtually immediately regardless of the short-run consequences. However, it is essential that we obtain gradual but progressive reductions in inflation over time. Similarly, the benefits from greater confidence in our money, which stem from a fairer, better-functioning economy that is less prone to debilitating swings in economic activity, do not all appear immediately. Those benefits also accrue over time.

Let me now turn from the framework to the way that policy is put into effect. How the conduct of monetary policy is reflected in financial variables will depend on the economic and financial environment. That environment is constantly changing

of course, and part of the Bank of Canada's job is to understand how and why it is changing.

From the early 1980s, our economy enjoyed a long expansion during which the nation's production of goods and services expanded by a third. Output in New Brunswick increased at about this same rate. But the demands placed on the goods and services available rose even faster, and spending pressures in the economy became particularly marked in the latter part of this expansion. Over the three calendar years to the end of 1989, total dollar spending in Canada rose by 30 per cent. That is a large number. Broad measures of money and credit increased even more quickly. The resulting high level of demand relative to the capacity of the economy to supply goods and services put accelerating upward pressure on prices and costs in our economy. To put it simply, the expansion was not sustainable in the form it was taking. Because less room was available in the economy for output to grow, inflation was taking up an increasing share of total spending. And inflation began to feed upon itself, as demand pressures led to increases in prices, which led to increases in costs, which fed back into prices, and so on.

To resist and reverse those inflation pressures, the Bank of Canada progressively tightened monetary conditions. It has been contended in some quarters that the rates of inflation Canada has been experiencing, reaching 5 1/2 per cent at the beginning of this year, do not warrant the degree of resistance offered by monetary policy, gradual though this resistance has been. Let me pause a moment to consider what could be behind this contention.

It could simply be an expression of the view that monetary policy should not aim at monetary stability. This is an argument whose fundamental deficiencies I reviewed earlier in

these remarks. Then again, it could reflect a view, also finding support recently, that our inflation is in fact unrelated to excessive demand. However, a careful examination of the record of the past several years reveals this to be an inaccurate view of what has been happening. To be sure, indirect taxes increased, for example, but these are a small part of the overall inflation in prices that has occurred. Furthermore, the strength of home-grown inflationary forces, responding to demand pressures, has in fact been much greater than has shown up in domestic prices. This is because the effect on prices of those domestic forces has been offset in important part by the moderating impact of the rise in the external value of the Canadian dollar -- in effect, making imports cheaper.

Finally, the view could reflect a hope that elements or policies in the economy other than monetary policy could be less inflationary. The first point to be made in this regard is that analysis as to how other policies could be improved to help create a less inflationary economy is of course very helpful. Action would be even better. At the same time, monetary policy must deal with the world as it is, not as it might be in some possibly better set of circumstances. The second point is that if there are cost-raising forces in the economy that somehow persist independently of the broad market forces that monetary policy deals with, they are indeed an issue for the economy and for society. So are all forces exploiting monopoly positions in the economy. What does not at all follow, however, is that any damage caused by such forces is eased or reduced by an inflationary monetary policy. Such a policy, by injecting systematic pessimism regarding prospects for inflation, seems more likely to encourage such damage than to diminish it.

Returning to the narrative, and to 1990, it is clear that the situation has been changing considerably this year.

Demand in the economy has fallen back from the unsustainably high levels of last year. Output declined in the second quarter, and the measured rate of unemployment has risen.

Indications of easing are also present in the financial aggregates. The pace of advance in the monetary aggregate M2 (the measure of money we look at most closely) slowed markedly in earlier months of this year. And the rate of increase in total credit has decelerated significantly. With respect to the recent slowdown in the growth of monetary aggregates, it is important, as with the economy generally, to view it in the context of the earlier strong and prolonged surge. For example, M2 remains well above its level of a year ago. Sustained weakness in monetary aggregates would certainly be an important consideration propelling Bank of Canada actions in the direction of ease, but there is a good deal of short-term volatility in the aggregates and it is important to look at averages over longer periods of time.

As the demand pressures on inflation became less intense, scope emerged for easier monetary conditions. Short-term interest rates have declined in recent months by about one and one-half percentage points. Given the change in economic conditions, this change in interest rates is of course consistent with a monetary policy framework oriented in the direction of price stability. The lower inflation generated by an easing of inflation pressures is, after all, a basic condition for lower interest rates.

Many would like to have seen much larger reductions in interest rates than have occurred. However, the present turbulent situation, with so many cross currents and uncertainties, calls for particular caution in monetary policy actions.

Because inflation pressures persisted for so long in Canada, concerns about continuing, even worsening, inflation have accumulated. Accordingly, the momentum that had so clearly developed in inflation has been slow to reverse.

Other factors also are at work. A recent development has been the crisis in the Middle East and related developments in the international oil market. Oil prices have risen dramatically worldwide, with an immediate impact on bond, equity and foreign exchange markets. Longer-term interest rates have risen both in Canada and abroad, reflecting, besides a general increase in the demand for funds on world capital markets, heightened uncertainty over the potential effect on inflation and the adequacy of the response of economic policies.

Canada's experience with the rapid oil price increases in the 1970s and early 1980s shows that oil shocks can be a significant direct source of inflation. In addition, attempts to seek higher money compensation to avoid the implied, but ultimately unavoidable, reduction in real incomes that accompanies high oil prices would contribute further to inflation. One element that is helpful this time round is that our economy is now more energy-efficient and relies less on oil relative to other forms of energy, but the potential effects of the price increases are nevertheless sizeable.

Monetary policy must guard against allowing such pressures to fan an inflationary process. It would be irresponsible for monetary policy actions to encourage fears of resurgent inflation, because this would damage progress in improving the overall economic situation. It is not possible to avoid blips in prices, but monetary policy needs to encourage people to take economic decisions on the basis that inflation will decline over time, and not the reverse.

The oil shock has the same inflationary potential for New Brunswick as for the rest of the economy. As I noted earlier, New Brunswick shared in the sustained expansion of the 1980s, experiencing a particularly high level of investment in recent years. Employment growth was strong over much of the period, although the unemployment rate fell relatively slowly, given large increases in the labour force. The provincial inflation rate accelerated in 1989, and in the first half of 1990 was over 5 per cent. Inflation has since eased. As with Canada generally, the New Brunswick economy, in part affected by less buoyant demand in its major export markets, is showing signs of slowing in 1990.

In concluding, let me extend the congratulations of the central bank, its directors and officers, to the City of Moncton in its centenary year. The Bank of Canada was established some 50 years ago, so you have been around almost twice as long as we have. And the sense of history and continuity that goes with the territory can give you a good sense of perspective from which to view and participate in the changing scene.

The Bank of Canada, in fulfilling its monetary policy responsibilities, also needs perspective if it is to do its job properly. We are constantly engaged in dealings with financial markets. But, as I have aimed to indicate, what we do in markets is shaped above all by our responsibilities for Canada's future, to provide a money that can be trusted. That is the assurance and the continuity that we can provide as you enter your second century.