BANK OF CANADA

Introductory Statement by
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Governor of the Bank of Canada
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Mr. Chairman, I welcome this opportunity to explain monetary policy and respond to the questions of your Committee.

The Bank of Canada implements monetary policy on the basis of a carefully thought-out framework. At its heart is the goal of providing Canadians with a money that can be trusted, a currency that can be counted on to retain its value. This goal is not important as an end in itself, but is the essential contribution that monetary policy can make to sustained economic progress. We have a market economy, for which the institution of money and monetary exchange is fundamental. Allowing inflation to undermine that institution, to make our money less trustworthy, can only make our economy less productive, less prosperous and less fair.

In securing a trustworthy monetary standard, the Bank of Canada seeks to encourage the development over time of a rate of growth of money and credit consistent with monetary stability as the best contribution monetary policy can make to sustained 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 achieving a non-inflationary environment brings about durably low 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.

There are a number of factors, including Bank of Canada operations, that influence interest rates in the economy. But whatever influence the Bank of Canada has over the range of interest rates in the marketplace depends very much on the credibility of its actions. In particular, if interest rates are to be guided down so that they stay down, then our actions must be viewed by savers and borrowers as consistent with an improving inflation outlook. Trying to force down short-term interest rates by pushing up central bank liquidity could well have the opposite effect on longer-term rates, particularly if that inflation outlook is fragile.

Even if the framework of monetary policy does not change, the economic and financial environment in which monetary policy is conducted does change.

Rapid increases in dollar spending in the Canadian economy over the past several years – 30 per cent over the three years 1987-89 for example – and the resulting high level of demand relative to the capacity of our economy to supply goods and services put accelerating upward pressure on prices and costs. It is clear that the situation is now changing. Demand in the economy has fallen back from the unsustainably high levels of last year.

At least from the side of demand, pressures on inflation have become less intense. 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 was consistent with a monetary policy framework oriented in the direction of price stability.

I realize, Mr. Chairman, that many would like to have seen much larger reductions in interest rates than have occurred. However, the present turbulent situation, with so many uncertainties, calls for particular caution in monetary policy actions.

It should not be forgotten that inflation pressures built up in Canada over a period of years, and concerns about continuing, even worsening, inflation have accumulated. Accordingly, the momentum that had so clearly developed in inflation has been slow to reverse.

There are other factors at work as well. One that has emerged recently is the crisis in the Middle East and related developments in the international oil market. Canada's earlier experience with rapid oil price increases indicates that they can be a significant source of inflation pressures.

It is not possible to avoid blips in prices, but monetary policy must encourage people to take economic decisions on the basis that inflation will decline over time, and not the reverse. It is imperative that we achieve gradual but progressive reductions in inflation if confidence in the value of our money is to be preserved.

One final point, Mr. Chairman. What monetary policy contributes will not be everything that can be done through public policy for sustained economic progress. Analysis as to how other policies could be improved to help create a less inflationary economy is of course very helpful. 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. Furthermore, there is no reason to believe circumstances would be better if monetary policy were to become inflationary.