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BANK OF CANADA

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

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to the

Canadian Club of Toronto and
The Empire Club of Canada
Toronto, Ontario
2 December 1991

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I regard occasions such as this, speaking to a broad, civic-minded audience, as excellent opportunities for commenting on current issues in monetary policy. In that vein, today I will first survey where we are in regard to monetary policy developments and their contribution to the Canadian economy. In the latter part of my remarks I will focus on one aspect that has drawn exceptional attention in recent months -- the external value of the Canadian dollar.

In this "information age" we are bombarded with news and views of all kinds. I am sure you find that you have lots to digest in the area that particularly concerns the Bank of Canada -- monetary policy, monetary developments, and the economy. My purpose today, as always, is to bring you the Bank of Canada's perspective.

The main point I wish to convey from this monetary policy perspective is that Canada is now much better placed to enjoy good economic performance than it has been for some time.

To ward off misinterpretation, I had better note that this is not a blanket statement. It is not meant to deny the evident uncertainties that exist, both within our borders and beyond. Developments outside Canadian monetary policy will of course affect how well Canada does. What I am saying is that monetary policy has made major progress over the past several years in assuring a solid, credible, monetary basis for good economic performance. I am also saying that this is important.

In what way is it important?

Well, the fundamental contribution that monetary policy can make to Canada's chances of economic success is to provide a trustworthy money. This is, I believe, becoming increasingly accepted. Given our experience with inflation, the notion that monetary policies designed to generate or tolerate inflation will help the economy to perform better, no longer gets the following it used to. Simply put, inflationary policies have nowhere delivered the goods, or the services, or the jobs.

It is worth emphasizing that a monetary policy aimed at encouraging price stability means specifically that the Bank of Canada's unique powers to print money should be exercised with great care. This care provides the basic assurance that money will retain its value. The confidence this generates among savers and investors in turn contributes to growth. This is why the task of the Bank of Canada is to see to it that Canadian monetary expansion, and by extension the trend of spending in the economy, proceeds at a non-inflationary pace. The details of how this is done may be quite complicated, but these details should never be allowed to obscure the basic point.

And in any case the Bank of Canada can report a monetary expansion that is proceeding quite well. In particular, the monetary aggregate M2, which seems on balance the most reliable of the range of aggregates we monitor, has been growing this year by about 6 per cent annually. This compares favourably with the double-digit pace that was typical of the three previous years.

The expansion of private sector credit is also below the inflationary rate of the late 1980s. Total private sector credit, from bank and nonbank sources combined, has this year been growing at a 4 per cent annual rate, with a particular boost from the household mortgage sector in response to lower interest rates. Housing starts, which at the beginning of the year were down to an annual pace of less than 100,000, have recently been running far higher.

It is important, especially in this shorter-run context, to draw a distinction between the objectives of monetary policy on the one hand, and monetary conditions on the other. Thus, while monetary policy objectives have stayed constant, monetary conditions have eased a great deal since the spring of 1990. This is true whether one gauges monetary conditions by interest rates alone or by the combined effect of interest rates and the exchange rate.

Looking directly at the indicators of economic activity, it appears that for the economy as a whole the recessionary forces began to give way in the spring. Indeed, in the second quarter of this year total output rebounded by close to 6 per cent at an annual rate. And while more recent statistics indicate some hesitation, the underlying momentum of economic activity is positive. One element holding back Canadian expansion has been the fact that the upturn in the United States, our main export market, has been comparatively slow to appear. The slow U.S. recovery, along with less buoyant economic activity in major overseas countries, has also been a factor in the recent weakness in the prices of quite a few of Canada's industrial commodity exports.

Therefore, and not surprisingly, the patterns of demand so far indicate that the major impetus to Canadian expansion has come from the response of the interest-sensitive sectors, such as housing and car sales, to the decline in Canadian interest rates over the past year and a half. At the short end of the maturity spectrum, market rates have dropped by more than 6 percentage points, while at the long end the fall has been well over 2 percentage points. Now, only the United States and Japan among the other G-7 countries have lower short-term interest rates than here.

In referring explicitly to the behaviour of interest rates, I realize that I am in danger of giving encouragement to the regrettably widespread idea that monetary policy is defined by what happens to interest rates at each point in time. According to this view, it might be said (although I would not say it) that since monetary policy "pushed interest rates up" in the first place, all it is doing now is pushing them down. Quite a few would add that interest rates should in any case not have been "pushed up" in the first place.

This view of monetary policy as one whose purpose is to push interest rates around may appear superficially to be right. But it is fundamentally wrong. Monetary policy can affect market interest rates in various ways, but monetary policy -- as I indicated earlier -- is basically about the pace of monetary expansion and the integrity of money. And furthermore, even in terms of interest rates, the implication that rates are somehow arbitrarily set by what the Bank of Canada does is a far cry from reality. This view, incredibly, takes no account of the expectations of savers and borrowers. Of course savers and borrowers react in financial markets to what they think is happening to the value of money, and of course this reaction makes a difference to what happens to interest rates. This view also ignores the important influence on rates from other policy developments. Notable among these other developments are budgetary policies (how much governments borrow) -- both abroad and at home, both federal and provincial.

I will not on this occasion discuss at any length the relationship between what the Bank of Canada does, monetary policy, and the way interest rates have been developing. Much of this territory was reviewed in the Bank's latest annual report, released last spring. However, I will note here that there is a more accurate view than the notion of the Bank pushing interest rates up and down like a "yo-yo." The more accurate view is that interest rates rose from 1987 to 1990 as inflation pressures accumulated, and that a consistently anti-inflationary monetary policy has helped to promote a climate of expectations among savers and investors under which interest rates have been able to come down, and come down a long way. Furthermore, patiently continuing such a policy will provide the essential monetary

foundation for low interest rates on a sustained basis. It will do this by encouraging further the increasingly well-based view that inflation will not be a threat to the future. This has been, is, and will be, good for the economy.

Finally, in this look at the current situation, I want to underline explicitly that inflation is in the process of coming down. Looking through the extraordinary jump in indirect taxes in the first half of this year, which by itself added virtually 2 1/2 per cent to retail prices, it is apparent that the rise in consumer prices has slowed a great deal. The slowing is probably more than most people had anticipated at the beginning of the year and perhaps more than many have yet fully taken on board. The targets for reducing inflation, beginning with the initial objective of 3 per cent year-over-year by the end of 1992, are at this point looking very reachable. Underlying this improvement is the distinct moderation that has started to take place in recent months in the rise in Canadian costs of production. Such a moderation in our production costs needs to continue. It is of course crucial for broad stability in the prices we pay for the goods and services we use.

You will probably have noted that in this account of developments I have not dwelt on the exchange rate. In part, this was because I plan to focus on it in the rest of my remarks. However, there is another, more general, reason -- namely, that the exchange rate is a variable in the economy, not an objective. While the Bank intervenes in the exchange market, on behalf of the Government, to smooth exchange rate movements, monetary policy does not target a particular level for the Canadian dollar. Certainly, the exchange rate should not be seen as an ultimate goal of economic policy on a par with sustained, that is non-inflationary, growth in employment and output.

But let me also add that in drawing this distinction between economic variables and economic targets, I am by no means aiming to suggest that the exchange rate is not important. It is an important price in the economic system, especially for an economy that is as open as Canada's. Movements in the rate will have a near-term impact on such broad developments as Canadian inflation and Canadian economic activity. Obviously, the Bank of Canada has to seek to understand what is happening to the Canadian dollar. It does this because it needs to cope with all major demand forces affecting the economy. And even if we do not, despite what many people seem to think, have a policy that is aimed at pushing the exchange rate around, we certainly take developments in the Canadian dollar's exchange value, and the effects of these developments, into account when we chart monetary actions.

Let me now turn more to the specifics.

I will note initially that it does matter how the exchange rate is measured. The best way to measure the exchange value of the Canadian dollar is against the currencies of all our major trading partners, weighted by our trade with them. On this global basis, the appreciation of the Canadian dollar has been substantially less than against the U.S. dollar taken by itself. For example, on this weighted average, or "effective", basis, the Canadian dollar in 1991 has been about 5 per cent above its average for the 1980s, compared with the considerably larger increase for the Canadian dollar against the U.S. dollar taken alone of 10 per cent. Still, the spotlight has been on the partial, U.S. dollar relationship -- no doubt because it has moved more.

And as the Canadian dollar appreciated recently, calls multiplied for some form of specific action to push it down.

The way this relates to monetary policy is, essentially, to call for an easier monetary policy. That is to say, the Bank of Canada is, effectively, called upon to print more money. It is called upon to increase the supply of Canadian dollars relative to that of other currencies to the extent it takes to drive down the market value of our currency in relation to other currencies. (Not, I might add, that it can be argued convincingly that Canadian "money" is growing very slowly in and of itself, or by comparison with the general record for other major industrial countries.)

Admittedly, the argument is put not so much in terms of faster monetary expansion, but rather, in this exchange rate context, in terms of the need to reduce the interest differential over, say, U.S. rates.

I have already cautioned against the tendency to define monetary policy in terms of interest rates. Here I am going to add that looking at monetary policy as a matter of securing a specific level of interest rate spreads is also of course misleading. And it is especially misleading in this particular context because, in the scenario to which I have just referred, there is in fact no assurance that interest rates, or interest rate spreads, would in fact come down. Indeed, if a decline in the external value of the currency was seen as being provoked by an inflationary monetary policy, the path of interest rates is in fact most likely to be in an upward direction. That is what inflation, and expectations of inflation, inevitably do to interest rates.

Let me underline that the exchange rate is the net result of many different forces. It is clear that interest rate differentials can't be the whole story, because over the past year and a half the Canadian dollar has risen against the U.S. dollar even though the spread of Canadian over U.S. interest

rates has shrunk a great deal -- across the entire maturity spectrum of interest rates. Another part of the story, as always, is confidence. Obviously, confidence in economic policies matters a great deal in determining how a currency will be valued in the marketplace. And for the Canadian currency, the confidence that is central is the confidence of Canadians themselves.

What I am seeking to convey is that while monetary policy should concern itself with the exchange rate in assessing what is happening to economic activity and inflation in Canada, and in deciding what to do, the real issue for monetary policy cannot be narrowed down to the exchange value of the Canadian dollar. The real issue is deeper and broader than this. It is whether monetary policy, by seeking to provide a trustworthy money, is on the right track to contribute to a sustained, that is non-inflationary, economic expansion. The Bank of Canada's considered judgement, for the kinds of reasons I have reviewed with you today, is that it is.

To conclude, monetary policy's contribution to good economic performance is becoming more apparent with the increased confidence that inflation will decline along the lines spelled out in the inflation-reduction targets. This will improve people's trust in money, thus making possible low interest rates on a sustainable basis. No doubt uncertainties and difficulties lie ahead, but this is a good track to be on and a good investment that is already beginning to pay off.