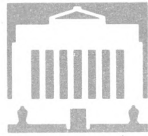
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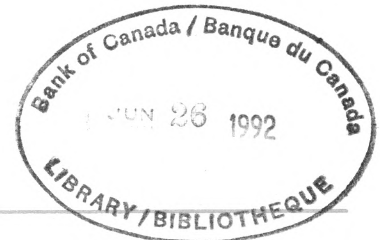

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Breakfast remarks by
John W. Crow
Governor of the Bank of Canada

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to the
Saskatoon Chamber of Commerce
Saskatoon, Saskatchewan
26 June 1992

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The Economy and Canadian Monetary Policy

In my remarks today, I plan to focus on the economic scene and on what monetary policy has been doing, and can and should do, to contribute to good economic performance in Canada.

Economic conditions vary quite a bit across regions, but for Canada as a whole the notable feature has been our slowness in getting out of recession. After a pickup in activity a year ago, demand and output flattened and employment weakened further in the winter months. Now, signs of renewed economic expansion are mounting, although they do not yet add up to a fully formed cyclical recovery.

Underlying this brief summary of recent economic developments are a host of forces -- some structural, some cyclical, some international and some domestic. In this challenging environment, many issues are being raised and many comfortable assumptions are being questioned. Much more attention is being paid to questions regarding what it takes to compete and do well. Difficult as these issues are, they have to be addressed and they are being addressed.

Here in Saskatchewan, you will have a lively appreciation of the relevance of international trade policies and structures. In this regard, the importance of progress through the current round of GATT negotiations, especially in the area of agricultural trade, cannot be stressed too much. Indeed, there is much greater awareness among Canadians than there has been for a long time of the kinds of international challenges and opportunities we face. As changes in the technologies and techniques of production and distribution have proceeded apace, world markets have become economically closer and more competitive. Canada's challenge does not arise from a lack of talent or physical resources. Of these we have plenty -- indeed, as one makes the global comparison, perhaps even an abundance. Our challenge, and our opportunity, is in developing and applying our considerable endowments to best advantage in a world of globalizing markets and economic transformations. And as a trading nation, our interest is in open and broad markets, not closed or narrow ones.

In this province you will also be aware that worldwide forces of supply and demand have an important influence on economic conditions in Canada. Recently, foreign markets have been generally slow, particularly the economies of our major trading partners. As was pointed out in the Bank's latest Annual Report, the persistence of sluggishness abroad has to an important extent been the result of overhangs of debt and unsold assets arising from the strongly speculative character of the preceding boom. The effects of such overhangs have been particularly marked for the economies of the United States, Japan and the United Kingdom. Households, corporations and governments all, to a greater or lesser degree, allowed their balance sheets to become distorted by taking on sharply higher debts. The legacy of these decisions has included increased levels of debt servicing, fiscal deficits that are high in some cases, emerging in others, and relatively high real interest rates worldwide as a result of old and newer demands being placed on world savings.

Besides the impact arising from sluggish demand abroad, difficulties originated in Canada as well. Overbuilding in commercial real estate is one element we share with other countries. Also, Canadian households ran up their indebtedness sharply in the 1980s, with debt loads remaining close to historically high levels. And governments have faced their measure of fiscal problems. As the federal government has striven to overcome its budgetary difficulties, the federal deficit as a share of gross domestic product has fallen substantially from the peaks of the mid-1980s and is projected to decline further. Other levels of government have also increasingly recognized the need to address their deficits because of the unpleasant implications for debt accumulation, the future burden of debt service and taxes.

It is also increasingly recognized that some of the policy routes that have been tried before or tried elsewhere to stimulate economic activity -- for example, government attempts to add stimulus through persistent resort to deficits and debt, or central banks trying to do essentially the same thing by printing money at an inflationary pace -- are paths that will lead to lots of future troubles. If either of these paths offered a real solution, the difficulties they are called upon to address should have been fixed up long ago, because they have been travelled often enough in different places and different times.

What we now see more clearly is that the more frequently use is made of so-called stimulative measures, such as deficit finance or bursts of inflationary monetary expansion, the more likely it is that the economy will get locked into deficits and inflation on a continuing basis. At the same time, the economy will become increasingly unresponsive to such measures.

How then can monetary policy contribute to good economic performance? What is monetary policy doing now in Canada? These are the questions to which I want to address the rest of my remarks.

Let me begin with some rather general points about monetary policy.

The first point is that money needs a bedrock of trust among its users. For Canadians, this means above all confidence that their currency will retain value in terms of what it can buy. This is a key ingredient in the health of an economy that uses money in order to function. This is also why monetary, i.e. price, stability is the Bank of Canada's underlying objective.

Secondly, monetary policy has to do with monetary expansion, with the value of money, and with the impact of expectations about that value on interest rates, on exchange rates, and on savings and investment. This implies that it works on the economy indirectly -- through financial markets and with considerable and complex lags.

For both these reasons, monetary policy does not provide a "quick fix." Indeed, no public policy really can.

My third point is to underline the important, but commonly neglected, distinction between monetary <u>policy</u> on the one hand and monetary <u>conditions</u> on the other. Monetary policy, as I have just suggested, is fundamentally about guiding monetary expansion so as to maintain and generate confidence in money. Monetary conditions, however, are gauged in terms of what happens to yields and prices in financial markets, in particular in money markets and foreign exchange markets, as monetary policy interacts with the whole range of non-monetary developments. In other words, as economic conditions and expectations vary over time, monetary conditions should be expected to vary as well. But such variation does not mean that monetary policy has changed from what it is basically aiming to achieve in order to contribute to good economic performance.

Let me add further in the light of what I have just said that to call the monetary policy of the Bank of Canada a "high interest rate policy" is profoundly incorrect. Seen in the context of its fundamental objectives, monetary policy is a low interest rate policy. This also is becoming increasingly recognized by Canadians as confidence in the future value of money has grown, and interest rates have indeed fallen across the whole spectrum of yields. Equally false is the notion that inflation is necessary for a strong economy, or that the Canadian economy is somehow special in that it needs an inflationary crutch in order to

function. Neither our experience nor that of other countries supports this paradoxical, but apparently quite popular, view.

Indeed, it is worthwhile reflecting on what our economic situation and prospects would now be like if Canadian monetary policy had followed a quite different path from the one it has followed. For example, what would be happening now if earlier the Bank had pursued an inflationary monetary policy instead of aiming to build confidence in money?

Well, clearly the rate of inflation would be higher. However, not only would inflation be higher, but the dynamic of inflation would be stronger. Given a loose and uncertain monetary policy, costs and prices would be bound to snatch at each other as business and labour sought to anticipate and stay ahead of an inflation that they would increasingly recognize could only ratchet up. No doubt the external value of our currency would also be lower. But at the same time our costs of production would be higher. And in an inflationary situation sanctioned by policy, the exchange market for the Canadian dollar would be increasingly volatile and uncertain. Interest rates would certainly be higher, with the extent of the rise depending basically on the degree of inflation uncertainty, that is, concern, about the future value of money. The impact on interest rates would quite likely be compounded by increasing concerns about how far the exchange value of the Canadian dollar might drop. Canadians and others would fret over the future value of their savings and other claims in Canadian dollars. They would demand compensation in the form of higher yields for additional inflation -- and for additional uncertainty as well.

In such a disturbed monetary, and therefore economic, environment it would be no consolation that at some point monetary policy could, or would, be re-oriented to fighting inflation. And when monetary policy was put right, the adjustment of markets, behaviour and expectations would be wrenching. We would be worse off because the defensive attitudes inevitably provoked by fears of inflation would be all the more entrenched, and all the more difficult to overcome.

So let me underline that in view of what monetary policy can do on a sustainable basis, the idea that the Bank of Canada must either support the economy or fight inflation sets up an entirely false choice. Since the Bank of Canada has of course rejected this false choice, one challenge that we do <u>not</u> face in the summer of 1992 is stagflation -- a pernicious situation of an economy that is slow but nonetheless beset by inflation and fears of inflation. The fact that we are not experiencing this situation, and indeed that there has been growing confidence in Canadian monetary policy, has been fundamental in allowing the Bank

to take actions to encourage easier monetary conditions.

Indeed, I am happy to report, as I am sure many of you have realized, that we are meeting our inflation-reduction goals handily at present. Especially important are the marked improvements we have seen in costs of production -- less visible than consumer prices but more basic to how well we do economically. For example, recent trends in labour costs per unit of output are now well below those we had been experiencing even a year ago, as money wage increases have come down and productivity gains have accelerated.

So a major easing has taken place in monetary conditions in Canada. This began in the spring of 1990 and has continued to date. It is worth restating that this easing, and the market actions that the Bank of Canada has undertaken to foster it, has gone such a long way because it has gone hand in hand with increasing confidence in Canadian monetary policy and in Canadian money among savers and investors.

Short-term interest rates, currently under 6 per cent, are at their lowest levels in about 20 years. Longer-term market rates and corresponding administered rates are also down sharply. Among the major industrial countries, only the United States and Japan have lower short-term interest rates than we do. This has not typically been the case. It has been achieved in a framework where monetary expansion has been brought to a single-digit pace from the more than 10 per cent rate of the late 1980s.

Coupled with the important benefits of substantial declines in interest rates is the fact that the United States, our most important market, is showing clearer signs of renewed vigour. Together, these two factors, greatly eased monetary conditions and improving external demand, are beginning to translate into better economic performance in Canada today and beyond today.

Activity in the housing market, both for resales and new homes, has been on an improving trend and has a better basis for further expansion. Debt service costs are down, automobile production has begun to climb, and merchandise exports have picked up significantly as demand, and our competitiveness in meeting this demand, improves. Declines in interest rates across the maturity spectrum have also reduced the cost of capital to Canadian firms. This aids investment in more efficient plant and equipment, in turn raising productivity and ultimately enabling us to compete successfully abroad and raise living standards further at home. With rising productivity and the continued containment of costs that stems from the assurance that the Bank of Canada will continue along the path of price stability, firms are beginning to rebuild their profitability.

Monetary policy is by its very nature an investment in the future. We have made a very solid investment, and the dividends are becoming generally apparent. Provided monetary policy retains confidence through a policy directed towards price stability, that confidence in turn generates major improvements in monetary conditions. We have come a long way, and on a monetary path that can only help the sustained growth of the Canadian economy.