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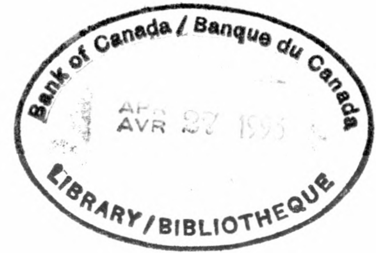

The economy and Canadian monetary policy

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

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John W. Crow
Governor of the Bank of Canada
to the Chambre de commerce
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Sainte-Foy, Quebec
April 27, 1993

The Economy and Canadian Monetary Policy

I am pleased to have been invited to talk to you.

The Bank of Canada recently issued its Annual Report. There, we looked at the main developments in Canada's economy in the light of the responsibilities of monetary policy. Today I would like to review with you some of the themes in that report, and also look at developments since it was written, back in February.

What can monetary policy really hope to achieve? Obviously, the Bank of Canada must make its contribution to a strong Canadian economy. But how can monetary policy do this? As we see it, its fundamental contribution is to provide Canadians with a money that they can trust, that is, a money which retains its value over time. This goal of price stability is what guides the Bank in its day-to-day, week-to-week, decisions about monetary policy.

The Bank came to this view for two basic reasons.

The first reason is grounded in the very nature of monetary policy -- in the very nature of what the Bank of Canada can do. Monetary policy is uniquely suited to promote sustained confidence in a trustworthy money, because at the heart of monetary policy is the Bank's unique ability to promote a faster or slower rate of monetary expansion. And promoting a faster or slower rate of monetary expansion will in the end result in more or less inflation. We do not believe that the Bank really helps our economy by following a monetary policy that promotes inflation as opposed to one that does not.

Why do we think that? Our view, based on our understanding of the way our economy works and on the lessons of experience, here in Canada and abroad, is that our economy will perform better year in, year out, if Canadians can count on a

money they can trust. That is our second reason for following an anti-inflationary monetary policy.

Let me explain. There are enough uncertainties in this world without injecting uncertainty of a monetary nature. With the assurance of overall price stability, investors, savers and others can plan for the future with fewer doubts on that score. They will therefore be able to make better decisions about where to invest, what to produce, and how to produce most efficiently. Assurance of price stability also means that households and businesses will not be driven to take defensive actions, themselves inflationary, to protect themselves against the effects of rising prices. And inflation is unfair, tending of course to hurt more those who find it difficult to take actions to protect themselves against its effects -- for example those relying on fixed incomes.

Inflation in Canada has come down a lot in recent years. Consumer prices in December 1992 were some 2 per cent higher than a year earlier, and just above the lower edge of the inflation-reduction target band set for that date. It is significant too that with the slowing in inflation that has occurred, consumers and businesses appear to have started to act on the basis that Canada's inflation performance has changed for the better. And despite the effects on prices of the recent depreciation of the exchange rate, we are well on track to further improvements in underlying inflation. We are well on track because of better control of our domestic costs of production.

Now I want to turn to two related questions. The first is how all this relates to interest rates -- in particular, how we get low, rather than high, interest rates. The second is the question of inflation and economic growth.

As regards interest rates, let me begin with a point that will perhaps surprise some of you. The point is that, contrary to what is often stated, or even simply assumed, the Bank of Canada does not control interest rates. What the Bank does control is the size of its balance sheet. Now it is true that through altering its balance sheet to affect the supply of liquidity in the market, the Bank can have an influence on short-term rates. But the level of interest rates is fundamentally determined in the marketplace. The marketplace is affected in its turn by a range of factors, both noneconomic and economic.

However, what is also true is that the Bank can have an important influence on the marketplace through the confidence it can supply to savers and investors in the future value of money. Thus the surest way that the Bank can help to reduce interest

rates is through increasing confidence that inflation will remain low. This is a process that takes both time and a basic commitment on the part of the Bank of Canada. This is the path we have been taking.

Over the past couple of years, as inflation has fallen, and as savers and investors have come increasingly to believe that inflation is coming under better control, we have enjoyed a substantial decline in interest rates. Over this period, the Bank of Canada has directed its monetary policy operations at helping to secure a decline in short-term interest rates that is steady. The Bank has operated the way it has because it believes that a decline that is steady holds out the best prospect of keeping rates down. Such a pace of decline can reasonably match the progressive improvement in confidence in the future value of money among savers and investors, and is more likely to encourage downward movement in longer-term interest rates as well.

The prime rate is now at a 20-year low of 6 per cent, compared with the peak of over 14 per cent in mid-1990, when inflation was still accelerating. Similarly, mortgage rates have approached the lowest levels seen for some time.

But the decline in interest rates was not uninterrupted. Financial markets rarely move in straight lines for very long. For example, in the autumn of last year some of the progress in shepherding rates down was reversed when financial markets became nervous. This financial market uncertainty was generated by a number of factors. One was turbulence in European financial markets that spilled over onto the Canadian scene. Homegrown factors behind the volatility included the lead-up to the constitutional referendum and, in November, the increased focus of investors, both Canadian and foreign, on developments in the Canadian economy, in particular the state of public and private sector balance sheets. Whatever the reasons, this uncertainty led investors to mark down the Canadian dollar in exchange markets and to demand higher interest rates if they were going to hold Canadian dollar claims.

Throughout this period, as in less difficult times, the Bank aimed to be a force for steadiness in the market. This does not mean that it thought it could, by its actions, somehow suppress the run-up in domestic interest rates that resulted from the uncertainty. Rather, the Bank's immediate objective was to help the markets settle down and trade effectively in ranges where investors could find what they viewed as appropriate returns. Savers and investors, Canadian or foreign, have wide choices in what they can do. Their views about an appropriate return are shaped by many factors, both at home and abroad. And

the Bank's job is to do what it can to reduce financial uncertainty, not to add to it.

This is an appropriate juncture for me to make a few comments about the exchange rate and how it fits in with monetary policy.

As I have said, the objective of monetary policy is to promote domestic monetary, that is price, stability. Therefore, the Bank does not have in any strategic sense a target for the exchange rate.

However, this does not mean that the Bank is, or can be, indifferent about what happens in the exchange markets and what happens to the exchange rate. The exchange rate is an important price in the economy; as you well know, it affects the prices received for the goods and services that Canada exports and the prices we pay for imports. Through changes in these prices, a change in the exchange rate affects sales, production and inflation in the Canadian economy. The Bank must take these effects into account in making judgements about its actions to achieve its basic monetary policy objectives. In particular, it needs to see to it that price increases arising from a depreciation of the Canadian dollar do not feed through into persistent inflation in Canada. That would only cause a further depreciation of the dollar, with a further effect on inflation, and so on.

Another reason why the Bank is concerned about exchange rate movements is that the exchange market can be susceptible to cumulative movements, that is to say snowball effects, arising from market uncertainty.

These are the kinds of considerations regarding financial markets that the Bank bore in mind as it coped with the turbulence in late 1992. If the Bank could help to steady markets, interest rates would recede from their peaks. And indeed, interest rates came back a long way. In fact, they have recently been close to their September levels.

The second question I would like to review with you is the matter of inflation and growth. Does sustained growth require inflation? The answer is no. Experience, both in Canada and in other countries, has shown that there is no contribution from inflation to the economy's ability to grow. Indeed, it hampers the performance of the economy. This is one of the fundamental reasons why the objective of price stability is the proper objective for monetary policy.

Yet, there is a lingering belief that to achieve faster expansion in the Canadian economy would require an increase in inflation. This view depends on the presumption that people can be fooled, and fooled persistently, into believing that they are better off as a result of an increase in prices and costs that represents only inflation and not any real improvement. Evidence does not bear this out. (Indeed, since people do understand what is going on around them, why should experience bear it out?) In fact, as I mentioned earlier, inflation not only does not help sustain growth in the longer term, it damages the ability of the economy to grow. This is because it increases uncertainty and adversely affects decisions that are made about investment, savings and production.

The argument is sometimes put another way as well. It is suggested that inflation may not be a cause of growth, but that it is an unfortunate but inevitable byproduct of strengthened economic activity in the short run. In fact, in other countries and in Canada in earlier periods we have seen that the economy can expand to higher levels of production without generating inflationary pressures. The progress made in reducing inflation is jeopardized only when the economy overheats. Rather, I would expect that as experience with lower rates of inflation accumulates, underpinned of course by a consistently anti-inflationary monetary policy, public confidence will strengthen that inflation will not re-emerge. This means that businesses and consumers in all parts of the economy take decisions with less concern about the threat from inflation. And this in turn means that their decisions are less, not more, conducive to inflation.

Experience amply demonstrates that the Canadian economy can achieve rapid growth at low rates of inflation. In the late 1950s and early 1960s, output rose by close to 5 per cent a year and employment by over 2 per cent at a time when the average rate of inflation was less than 2 per cent. And after inflation came down from the double-digit levels registered in the early 1980s, the economy expanded quite rapidly for some time without an increase in inflation pressures. It was only late in the 1980s, when spending began to run ahead of the ability of the economy to expand production at a sustainable pace, that inflationary pressures began to appear.

Now let me examine more closely recent developments.

The expansion of Canadian economic activity that started again in early 1991 has been modest relative to what we have seen in previous recoveries. There are a number of reasons for this. First, the economy has had to dig out from the effects of the inflation pressures, debt accumulation and speculative

activities which characterized the previous period. Secondly, Canadian business has been adjusting to increasing global competition -- a structural change. Furthermore, the international economy has been weak, and the prices for many of the commodities that Canada produces have been cyclically low.

However, on the plus side, as I mentioned earlier, inflation has really come down. And the decline in interest rates that the slowing in inflation has helped to make possible, has contributed to easing the financial and economic adjustment needed for the Canadian economy to work off the effects of the earlier period of high inflation and high debt.

Businesses across the country have been restructuring their balance sheets and their operations to meet the competitive pressures they face. Investment in machinery and equipment has remained strong. This is a good sign. Productivity is up and firms have a much better control of costs. This has contributed to an increase in the competitiveness of Canadian industry both at home and abroad, and thus to the strong growth of exports, particularly of manufactures, that we saw in 1992 and early 1993. The performance of the U.S. economy promises further good growth in exports this year.

The decline in interest rates has also relieved pressure on households by reducing the proportion of their incomes that they need to service their mortgages and other debts. The decline in interest rates together with some reduction in house prices after their earlier surge has also made housing more affordable. These factors have laid the basis for increases in spending by households.

These developments supply a crucial basis for a sustained, that is non-inflationary, recovery in Canada. In fact, economic activity did pick up distinctly in the last part of 1992, and it appears that this is continuing in the early months of this year. Demand for our exports has remained strong. And while there are some signs that domestic demand early in the year was still being adversely affected by the autumn turbulence in financial markets, it would appear that this reaction was temporary. Employment has been expanding significantly, notwithstanding the economic restructuring that has had to take place. The recent growth in narrow monetary aggregates suggests that demand is likely to strengthen.

In sum, we have made considerable headway in dealing with inflation and with the problems it left in its wake. I do not want to suggest that beating inflation is a cure-all, but it is important. It certainly helps a lot in providing a foundation for an expansion of our economy that is sound, and therefore can

be sustained. And this is what I believe we should expect from Canada's monetary policy.