BANK OF CANADA

# Notes for remarks by
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# Governor of the Bank of Canada



to the
Greater Charlottetown Area
Chamber of Commerce
Charlottetown, P.E.I.
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Luncheon remarks by John W. Crow
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I am pleased to be here again.

It is nine years almost to the day since the Bank's Board of Directors held its last meeting in Charlottetown. Board meetings outside Ottawa are far from the only occasions when people from the Bank visit around our vast country. In fact, with the help of our directors we do rather a lot. But it is a special occasion for us when we can visit and meet with you as a group.

I have of course been here since that time nine years ago, but this is also in part an occasion when I can pick up where my predecessor left off.

I was with Gerald Bouey then, and I do recall that the Bank's immediate policy preoccupation was, as he put it, "the rise in interest rates and the decline in the Canadian dollar that have occurred in recent months." I also remember that on that occasion I spent a lot of time on the phone checking market developments and what actions we could take. It's by no means constantly that way. But those things do happen, and it is part of the Bank's job to see to it that such disturbances are coped with so that the shock is absorbed, not magnified. This is what we did again, for example, last autumn at the time of the referendum campaign.

Another concern identified nine years ago was the budgetary situation, particularly in the United States because of its effect on interest rates in the United States and, therefore, in other countries, including of course Canada. I also will make some brief comments on fiscal matters a bit later in my remarks today.

I want to start by surveying what is happening in the economy since it is, after all, the purpose of all economic policies to make a contribution to economic performance. After touching on budgetary matters, I will finish with a few words on the Bank's central responsibility, monetary policy.

Let me begin with the world outside our borders. Starting there is of course not a coincidence. What happens outside by no means renders irrelevant the skill, good sense and determination we can show on the Canadian scene. But as a nation that depends so much on international trade, what happens outside is obviously of great importance for us.

This may seem to you to be stating the obvious, given the importance to Prince Edward Island of tourism and exports. It is, however, something worth saying because so much debate in Canada seems to take place on the assumption that the rest of the world, the international economic environment in which we earn our way, is of minor importance, or even an encumbrance to our economic aspirations. So I will reiterate that it matters a lot, and that we benefit enormously from open international trade.

At the moment the rest of the world, economically speaking at least, is a mixed bag.

Starting overseas, the broad picture is of slow-to-weak economic activity for the major industrial countries. Europe is going through a particularly difficult time, both economically and financially. On the financial side, it's worth noting that the European problems have been reflected in severe stresses on the Community's fixed exchange rate mechanism -- something that became vividly apparent last autumn.

Let me add that we seem to have moved away from a period when fixed exchange rates were clearly the 'in' thing. This is not because a floating exchange rate system, as we have in Canada, will give policymakers a free ride. The Bank of Canada can attest that it does not. But as I've discussed in detail on other occasions, the flexibility that a floating exchange rate system offers in coping with shocks, such as those we faced last autumn for example, is an important advantage. The one crucial qualification I will make here is that this flexibility only brings good results if at the same time there is a firm anchor for confidence in the currency. That anchor has to be, as indeed it is in Canada, a monetary policy geared to the achievement and maintenance of domestic price stability.

Looking across the Pacific, the economic situation appears somewhat less weak than in Europe, but activity can hardly be described as strong. This reflects mainly what is happening in Japan. Faced with the weakness of the economy, Japan has taken important budgetary actions to bolster consumption and investment. Japan is the only major industrial country where this kind of room for manoeuvre was retained, through timely fiscal restraint in earlier years. Offsetting somewhat the Japanese weakness has been the vigour of demand and output in China and in South East Asian countries. The dynamism they have been showing reflects in large part their outwardlooking orientation -- for quite some years in South East Asia, and increasingly so for China.

In a similar vein, I will also note that increased economic vigour has also been emerging in Latin America, as these economies deregulate, reduce the size of their public sectors, and open their economies to greater trade with other countries.

Canada's direct trading links with the areas I have referred to are important and they are growing, but they do not account for the bulk of our trade. That is with the United States. Still, what happens in these overseas countries does contribute importantly to the economic tone globally, and affects Canada through a number of channels. It affects the U.S. performance and also, through its effect on demand globally, exerts an important impact on the prices of primary commodities. As an aside, I can also note that developments in overseas countries can also affect flows of money in and out of Canada, and therefore financial conditions here.

So while the United States has been picking up, the softness of demand in industrial countries more broadly, combined with a jump in the supply of primary commodities from the former Soviet Union, has meant that primary commodity prices have generally been lower this year than might have been expected. Naturally, this has acted as a drag on the Canadian economy.

The pick-up in the United States has, however, been very important for the fortunes of Canadian exports.

At the same time, the U.S. expansion certainly has had its changes of rhythm, reflecting the fact that the pace of demand has been different in different areas -- both industrially and regionally. A great deal of industrial restructuring has been going on in the United States in response to increased global competition. This has increased uncertainty about the future in the minds of business and individuals. As well, consumers and business continue to make efforts to reduce the debt burdens accumulated in the speculative climate of the 1980s. The extremely heavy overhang of commercial real estate will affect construction spending for years, although banks do seem to have largely overcome the difficulties they went through as a result of the real estate downturn. Added to this overhang have been the pressure on the defence industry from the end of the cold war and, more recently, the efforts of the public sector to come to terms with its large deficits.

Accordingly, while there are good reasons to expect continued expansion in the United States, booming conditions are unlikely.

This, then, is the broad external environment in which Canada is making its way. As I said earlier, it is a mixed bag -- better in some parts than in others.

Let me now turn to Canada.

In fact, our performance on the export side has been quite good, especially in the area of manufactures. This is a tribute to that fact that we've become much more competitive. The decline in the exchange rate has been a factor behind this improvement, but we've become more competitive in a more fundamental way than that. With the drop in inflation, there has been a great improvement in our ability to contain costs, and this has been combined with a pick-up in our productivity.

Productivity improvement is the only way we can systematically improve further our living standards as a nation. Indeed, a noninflationary environment, one in which changes in incomes do not primarily reflect attempts to stay ahead of inflation, helps to highlight the importance of productivity improvement in raising incomes. Price stability also encourages gains by focusing business decisions on factors that not only raise profits but also increase productivity in the economy as a whole. This is in large measure why monetary stability helps economic growth. It allows production, trade and investment to take place in a way that puts in the forefront of decisions what is lasting -- that is to say, what matters for sustaining good performance for the economy.

Economic gains have also been made as interest rates have come down. Housing is one area where this has been happening.

At the same time, the need for industrial restructuring, which I mentioned in regard to the United States, also has affected Canada and has been a factor slowing the advance of spending in the near term. However, we are, I will re-emphasize, part of a highly competitive world economy; we benefit from the trade we undertake in that economy; and we are benefiting from the restructuring that is now taking place.

It is in light of a picture of better, but not uniformly strong, advances in domestic spending that concern has been expressed in some quarters that actions to restrain budget deficits have been inappropriate.

Of course, governments have not been taking actions of restraint because they wish to curb demand. Rather they have recognized that there are indeed limits to the amount of debt they can shoulder. But in some cases governments have had to act recently because they did not act earlier, such as in the second half of the 1980s, when general economic conditions were about as favourable as they could possibly be for budgetary restraint --

if that is what is required. In any event, it is worth bearing in mind that governments' tax and spending actions are only one of the factors affecting demand in the economy -- an economy that each year generates some $700 billion of goods and services all told. In other words, what happens on the budgetary side matters, but is far from being the only element affecting spending.

It is also worth stressing that questions of sustainability of fiscal positions weigh importantly on the decisions of investors and savers. More specifically, actions to deal with difficult fiscal situations can have favourable effects in credit markets, particularly on medium- to long-term interest rates, by reducing risk factors in interest rates.

This brings me to monetary policy.

As you probably are aware, and as I have already indicated, the Bank of Canada aims to maintain money's purchasing value for Canadians rather than to finance a persistent erosion in that value. That is what price stability is about. Price stability is the monetary foundation because the economy will perform better with a money that people trust than it will with one they do not. And people will only trust a money that is likely to keep its value.

This is also a framework in which interest rates will tend to be lower than if monetary policy had an inflationary bias. When lenders think that the funds they supply are going to drop in value before they are repaid, they certainly demand higher interest rates. At the same time, borrowers find high interest rates easier to swallow if they think that they can count on inflation pushing up their receipts and making high interest rates easier to pay. This is why it seems strange to us at the Bank when Canadian monetary policy is referred to, as it often is, as a "high interest rate" policy. In reality, it's quite the opposite.

Indeed, interest rates generally have been moving down for some time, in line with the substantial improvement in inflation that we have seen. It also appears that expectations about inflation have improved. That is what we expected to happen, and we are glad to see it happening.

You will no doubt agree that this improvement in our inflation outlook is doubly fortunate at present because of the pressure on fiscal positions, and the way the low interest rates that we are achieving can help. So let me just note here that the Bank fully recognizes the contribution easier monetary conditions have made to demand, and the relief that they provide to heavily indebted governments. But let me also underline that the purposes of monetary policy are clearly broader and deeper than any effects on government deficits. In particular, any suggestion that monetary policy should be twisted so as to use the printing press in the hope of providing cheap financing to government must be rejected. Such a manoeuvre wouldn't work because its success depends upon people not paying attention to what happens to inflation. But they certainly do pay attention, and react to protect themselves. That being said, the absence of pressure from interest rates is of course welcome, especially if it helps governments in tackling their imbalances in a sustained way.

It also helps if the economy can maintain a healthy rate of expansion. I have already noted the crosscurrents coming from abroad. What I will underline here is that the success we have had in Canada in combatting inflation is an important investment in a better economic performance now and in the years ahead. It's not the only thing that matters, but it is important.

Let me be more specific on this point. Sound money is the friend of sustained economic growth. So by providing a money that Canadians can trust as they go about their business, the Bank of Canada provides fundamental support for economic expansion. Furthermore, cyclical pick-ups in demand and economic activity, as we are experiencing in Canada, can, as in the mid-1980s, go a long way before running into bottlenecks and inflationary pressures. And provided confidence is maintained in the anti-inflationary thrust of monetary policy, this present recovery can go a very long way and become lasting expansion.

Many of the things the Bank of Canada does may seem a degree esoteric, especially when filtered through the commentary of money market professionals about what is happening from day to day. The Bank is of course very attuned to its role and responsibilities in money markets, bond markets, and exchange markets. But we don't plan to let this cloud our view of the fundamentals concerning what we are engaged in. The fundamentals are a strong economy and the contribution that sound monetary policy can make to that objective. That's our bottom line.