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# RECENT MONETARY DEVELOPMENTS

REMARKS BY
GERALD K. BOUEY
GOVERNOR, BANK OF CANADA
TO THE BUSINESS OUTLOOK CONFERENCE OF
THE CONFERENCE BOARD IN CANADA
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Remarks by Gerald K. Bouey, Governor, Bank of Canada
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May I begin by saying that I am very pleased to be here today to participate in this Business Outlook Conference. A good assessment of the economic outlook is a basic need for any central bank, and all inputs into the assessment process are welcome. I have, therefore, a keen interest in hearing how those attending this Conference feel about the period ahead. What I would like to do at this luncheon session, and I hope you will think that it is relevant in a conference of this kind, is to take advantage of the opportunity to explain the policy being followed by the Bank of Canada. In the course of doing so, I want to comment on recent monetary and credit developments and to say something about the current state of the economy.

For several months now the Canadian economy has been showing many clear signs of strain on productive capacity -- very high levels of activity, growing backlogs of unfilled orders in many industries, and lengthening delivery dates for many commodities. There are also signs of strain in the labour market, with widespread evidence of scarcity of available workers to fill particular categories of jobs, unskilled as well as skilled.

It is far from easy to reconcile virtually all the other evidence bearing on the state of the Canadian economy with the report from the Labour Force Survey that as recently as August of this year the number of Canadians unemployed was still a full 5 1/2 per cent of the labour force on a seasonally-adjusted basis -- a level which has traditionally been regarded in this country

as reflecting both a slack labour market and a slack economy. One can only conclude that at least for the time being the overall unemployment rate, as a measure of slack in the economy, cannot be read in the same way as it was in earlier years. In saying this, I do not mean to suggest that there are no continuing problems in the labour market. But it does seem to me that we should be wary about using the unemployment statistics in an uncritical way as evidence of inadequate aggregate demand.

Since the Canadian economy is now operating once again close to the effective limits of its existing productive capacity, it follows that its growth in real terms over the period ahead will have to be slower than the pace of the last twelve months, because this pace has been well in excess of the economy's long-term growth rate of 5 to 5 1/2 per cent a year. It also follows that unless this lesser rate of real growth is accompanied by a corresponding moderation of the growth rate of gross national expenditure in money terms, we must expect the rate of increase in our domestic price level to reflect this fact. That is why for several months now the policy of the Bank of Canada has been aimed at providing less stimulus to demand by moderating the rapid growth of bank credit and money we considered to be appropriate so long as there still seemed to be a good deal of slack in the economy.

There can be no doubt that monetary policy was very expansionary in character in 1971 and through 1972. This is readily apparent whether one looks at the growth in monetary aggregates or at the extent of the decline in interest rates from their peak levels of 1969 and 1970. It is true that from mid-1971 on the Bank of Canada kept the liquidity of the banking system under close control,

but it is also true that the Bank's policy accommodated large increases in the supply of bank credit and money, and that this policy stance persisted into early 1973.

The reasons for that monetary policy lay in the economic history of the period. A substantially less expansionary policy in those years with slower growth in money and credit, higher interest rates and a higher exchange rate would certainly have been difficult to justify at the time in the light of the levels of unemployment and unused industrial capacity that we were then experiencing. As little as a year ago, most Canadians were still highly skeptical about the underlying strength of the economic expansion, and impatient about the failure of the unemployment rate to show any signs of improvement. In retrospect, we can now see that a massive upsurge in economic activity was getting underway -- not just here in Canada but throughout the western world. At the time, however, there were genuine differences of view between those who believed that the underlying economic situation was stronger than it appeared to be on the surface and those who were more skeptical. This was especially so in the third quarter of last year, when widespread work stoppages and unusually bad weather temporarily gave the impression of an economic slowdown. There was also plenty of room for uncertainty about how long it might be before the Canadian economy would again be pressing on its capacity limits.

One aspect of the problem during most of 1972 was the fear that slower monetary growth and higher interest rates in Canada would attract capital inflows and put further upward pressure on our exchange rate. Our exchange rate had already appreciated considerably since it was allowed to float in May 1970

and given the existing slack in the economy and the fact that many of our industries were facing intense foreign competition both at home and abroad, any significant further appreciation of the Canadian dollar at that time would not have been welcome.

In any event, realization of the present remarkable strength of the Canadian economy, and indeed of the world economy, did not become widespread until the spring of this year. The most striking indication of the change in the external environment has been the wave of price increases for farm products and internationally traded commodities, the magnitude of which has gone well beyond previous experience under peacetime conditions.

The stance of monetary policy began to change early this year as the banking system came under growing pressure from the intense credit demands generated by rapid economic expansion. Up to that point there had been little change in the chartered banks' holdings of liquid assets for well over a year. Then, however, in order to prevent the upsurge in loan demand from bringing about an even faster rate of monetary expansion, the Bank of Canada kept the cash reserve position of the chartered banks under sufficient pressure to force them to begin drawing heavily on their already limited liquidity.

With the banks finding it increasingly difficult and costly to accommodate all of the increasing credit demands made upon them, strong upward pressure on interest rates began to develop. The behaviour of short-term interest rates in the United States and Europe, which were shooting up with unprecedented speed, was an additional source of pressure, even though the impact was softened by forward exchange rate movements in the foreign exchange market. These circumstances led in due course to the announcement early in April of the

first change in the Bank Rate since October 1971, and in subsequent months to a succession of further increases.

In order to leave no doubt as to how to interpret the traditional signals coming from the central bank -- namely, the pressure on bank liquidity and the increases in the Bank Rate -- we went to some lengths both in our public statements and in our discussions with the chartered banks to explain as frankly as possible what sort of response we were seeking. While emphasizing the need for the banks to moderate the recent pace of their overall lending activity, we made it equally clear that under present conditions we wished to avoid anything in the nature of a drastic curtailment of bank lending. In this way we hoped to avoid a repetition of the pattern of events seen on occasion in the past -- that is, a prolonged delay during which there was rather little change in bank lending policies, followed by an undesirably abrupt change when action could be put off no longer. In addition, we urged upon the banks that in accordance with their own expressed policies they should do their best to maintain a reasonable flow of bank credit to small businesses and to borrowers in the less buoyant regions of the country, while maintaining reasonable continuity in their residential mortgage lending as well.

We knew that it would be difficult for the banks to apply these general principles when dealing with individual applications for bank credit. There is no easy way in which the chartered banks can strike a nice balance somewhere in the middle ground between unrestricted bank lending and an abrupt turning off of the tap. We were encouraged, however, by the assurances we received from the banks that they would make every effort to co-operate along the lines we had suggested.

One consequence of shielding the more vulnerable categories of borrowers from restraint in bank lending is that the desired moderation of bank credit expansion must come about mainly through restraint on other classes of borrowers. Since in most cases large borrowers can turn to other sources of finance if denied access to bank credit, competition for funds is bound to push up interest rates to levels which will eventually bring the demand for funds and the supply into balance. Prompt changes in bank lending policies can make an important contribution to the control of credit and the money supply but interest rate changes still have an essential role to play. If monetary restraint is to induce some kinds of spenders somewhere in the economy to moderate their expenditure plans, it has to be either because they find access to credit too difficult or because they find it costs more than they are prepared to pay.

In recent months other central banks, both in the United States and a number of European countries, have allowed short-term interest rates to play a major role in their attempts to control the growth of money and credit. Interest rates in these countries have risen to historically high levels. Let me give you a few examples. In the United States the banks' prime lending rates for large borrowers are generally at 10 per cent and if allowance is made for the widespread practice of requiring borrowers to hold compensating deposit balances, the effective rate is in excess of 11 per cent. Rates on certificates of deposit with a maturity of 30 days to 90 days rose to a peak of 10 1/2 per cent to 11 per cent; they have recently declined to just under 10 per cent. You will recall that in the United Kingdom the Bank Rate was raised in two successive weeks in late July from 7 1/2 per cent to 11 1/2 per cent. Prime lending rates are about 12 1/2 per

cent in that country and in Germany they are just as high. Short-term deposit rates in the Euro-dollar market rose to a peak of about 11 1/2 per cent and have recently come down by about 1 per cent.

Although most Canadians regard the rise in short-term interest rates in this country since last spring as very steep, the fact is that rates in Canada have risen quite a bit less than in many other countries. As you know, the chartered banks' prime lending rates for large commercial borrowers are 9 per cent. Rates on short-term bank deposits have generally not exceeded 8 1/2 per cent and rates on short-term commercial paper have recently been in the 8 1/2 to 9 per cent range. These rates have moved up about 3 percentage points since the first quarter of the year but they remain significantly below external levels.

Because of the importance of chartered bank short-term deposits in our financial system, I think that there can be no doubt that the existence of the so-called "Winnipeg Agreement" has been an important factor in moderating the upward pressure on short-term interest rates in Canada. Under this Agreement, which in accordance with the Bank Act carries the approval of the Minister of Finance, a voluntary ceiling limits the interest rates chartered banks are able to offer on term deposits for periods of less than one year.

The interest rate ceiling set by the Winnipeg Agreement is now considerably higher than it was a few months ago. Increases were necessary in order to make it less difficult for the banks to continue to compete for funds in the short-term money market and to lessen correspondingly the pressure of bank competition for funds in those areas of the market principally relied on as a source of financing by institutions specializing in mortgage lending.

There is another reason why the interest rate ceiling set by the Winnipeg Agreement has had to be raised. In recent months the differentials between short-term interest rates in Canada and those in the United States and the Euro-dollar market have been much wider than we have experienced before, and forward exchange rates have adjusted accordingly in the foreign exchange market. In the current international monetary environment the movement of forward exchange rates has been unusually effective in moderating the outflows of short-term funds from Canada in search of higher interest yields abroad, and thereby in shielding the lower level of short-term interest rates in Canada. There is, however, always a limit to the protection that can come from forward exchange rates, and it is a limit which changes with circumstances. Thus increases in the Winnipeg Agreement ceiling were necessary to forestall large outflows of short-term funds with undesirable consequences for the exchange rate.

Having attempted an explanation of what we have been trying to achieve through monetary policy, I come now to the question, how has the policy been working out? It is really too early to attempt a full answer to that question but I think there are some things that can be said. The extreme response of a drastic curtailment of bank credit has clearly been avoided, even though the banks have been kept in a very tight liquidity position. While no doubt those who would like to have obtained more accommodation from their banks feel that the situation has been quite tight, and certainly banks would like to have said "yes" more often, bank loans have in fact continued to grow at a rather high rate. And so has the money supply. The behaviour of bank loans in recent months indicates that there has been some moderation of the very high rates of loan expansion we saw earlier

this year. So far, however, there is little evidence of any marked slowing of the rates of growth of the main monetary aggregates. The figures for the third quarter show a seasonally-adjusted rate of growth of the money supply, whether broadly or narrowly defined, of the order of 15 per cent a year, which is still pretty high. It was in part due to the view that the process of moderating the growth of money and credit had not gone far enough that the Bank Rate was raised again in September.

Usually when a central banker appears before a public gathering he can be reasonably sure in advance which aspect of the policy he has been following is most likely to strike his audience as requiring a rather full explanation, particularly when he has announced five successive increases in the Bank Rate in six months. Not surprisingly, Bank Rate increases tend to be more newsworthy than statistics on the growth of money and bank credit. Thus in many forums I would have expected to be confronted today with the job of trying to disabuse my listeners of the view that recent monetary policy in Canada has been undesirably and unnecessarily restrictive. I suspect, however, that an audience of experienced economy-watchers is unlikely to need much convincing on that score.

Nevertheless, I would like to say a word on the old question of the way in which one judges how restrictive or how easy monetary policy is. Some people concentrate on interest rates and conclude that the central bank has embarked this year on a very restrictive policy. Other observers tend to concentrate almost exclusively on the money supply and to conclude that monetary policy has been much too easy.

As you will have gathered, the Bank of Canada does not focus exclusively on the behaviour of any single class of indicators such as interest rates or monetary aggregates. We continue to pay a good deal of attention to the behaviour of interest rates both in Canada and abroad, if only because of the obvious importance of changing international interest rate relationships for our balance of payments and the foreign exchange value of the Canadian dollar. Of course we know, as you do, that interest rate levels, which on the surface look very high by comparison with the levels prevailing a few years ago are not in effect as high as they look to be. This is because everywhere in the world both lenders and borrowers have increasingly adjusted to the quickened pace of inflation in recent years, with the result that interest rates have come to incorporate a substantial inflation premium.

So far as the growth rates of bank credit and money are concerned, it is probably fair to say that nowadays these are watched a good deal more closely by most central banks -- including the Bank of Canada -- than tended to be the case a few years ago, and that they are given considerable weight in policy formulation. In our own case, we continue to have certain reservations about how confidently one can, as a practical matter, derive very precise, reliable or workable policy guides for the conduct of monetary policy in Canada solely from the historical behaviour of these monetary aggregates. Among other things, we have the problem of taking account of institutional changes. Since the last Bank Act revision our banks have entered the term lending and residential mortgage fields on a much larger scale than formerly and this enlargement of their field of operations continues to affect the bank credit and monetary statistics. In the last

twelve months, their holdings of residential mortgages rose by well over $1 billion, or more than one-third. Structural changes have occurred on the liability side as well: in the same period fixed-term personal deposits, which were not important before the Bank Act revision, have risen by over $2 billion or almost 40 per cent. And there is evidence that within the fixed-term category of deposits the banks have been seeking deposits with a longer term to maturity than was formerly the case. Some account must be taken of these developments when assessing the growth in the more comprehensive monetary aggregates. But, as I have already indicated, in my judgment the fact remains that recent monetary expansion in Canada has been on the high side.

In saying this, I am aware that there is evidence that the pace of economic expansion has slowed since the exuberance of last winter and as the economy has approached the limits of its capacity. There have also been major strike distortions in the third quarter. There are always uncertainties about the underlying trend of activity and prospects for the future -- the present always seems to be a poor time to choose to make an economic forecast -- but there appears to be a fairly broad consensus among Canadian forecasters that there is a good deal of underlying strength in the economy, and I share this view. I would agree that in recent months we have seen a level of auto sales that may not be sustainable and that the extraordinarily high level of house-building may moderate. More generally, consumers may be inclined to postpone some kinds of discretionary spending as a result of sharply increased costs, particularly of food. On the other hand, there is ample evidence that a strong upsurge in business outlays on plant and equipment is underway, and external markets for many of our most important

export industries, including agriculture, are likely to remain very strong next year.

I know that in the course of assessing the business outlook during this Conference you have been paying a good deal of attention to external developments, particularly those in the United States. In this uncertain world, which has become even more uncertain with the outbreak of war in the Middle East, this is not an easy task. However, while it is not a universally-held view, a majority of United States business forecasters do appear to believe that the Administration stands a good chance of achieving an easing of the rate of economic growth next year that will successfully skirt recession while creating a climate more conducive to improved price performance. In addition, some respite from the upward spiral of food and commodity prices in world markets may not be far away and this would greatly reduce the pressure on price levels in North America. If we in Canada are to be in a position to make the most of this situation, it is essential that we avoid internally-generated demand and cost pressures that would offset any potentially beneficial external influences. If we can manage our affairs well, the combination of these developments abroad and our own domestic policies could move our economy in an orderly way onto a sustainable path of economic growth with considerably lower rates of price increase than we have been experiencing.

While monetary policy is only one of the influences at work, it does seem to me that its task in the period immediately ahead is to try to help this process along, to try to avoid disruptive effects on credit markets and on the pace of economic activity in the shorter run while attempting to avoid rates of

money and credit expansion that contribute to domestic inflationary pressure in the longer run. This is a tall enough order but it is what we are trying to do.