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REMARKS BY
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TO THE
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SAINT JOHN, N.B., NOVEMBER 26TH, 1975

Remarks by
Gerald K. Bouey
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My topic today is national monetary policy -- a topic that I realize goes well beyond the problems of financing economic activity in Atlantic Canada, the theme of this seminar, although it obviously has some bearing on them. I have a considerable interest in these regional problems both in my capacity as a central banker and until recently as President of the Industrial Development Bank. The Industrial Development Bank has, I believe, played a useful and important role in the financing of business in Atlantic Canada, particularly small business, and I am confident that its successor, the Federal Business Development Bank, with which I am associated as a director, will continue the good work in this field. When I learned that your agenda for this morning included a discussion on the regional impact of monetary policy I was strengthened in the view that at a time when Canada is in serious economic trouble I should use the minutes you have allotted me to talk about monetary policy in national terms.

Finding a workable solution for the over-riding economic problem of our time, severe inflation combined with substantial unemployment, is as difficult an assignment as any that economic policy could be asked to undertake. Monetary policy alone can't provide the solution, but it is equally true that monetary policy alone -- if it is the wrong policy --

can make any solution of the problem extremely difficult to achieve. It is thus important that monetary policy be right, and that is why I want to explain as clearly as I can what I believe to be involved in getting monetary policy right.

To begin with, I think it is clear to everyone by now that we simply cannot afford to allow the drift into deepening inflation in Canada to continue if we are to avoid major economic and social damage. There can be no realistic hope of achieving a sound recovery and sustained economic growth in this country if we fail to bring inflation under control.

Indeed, we can no longer count on being able to have much impact on unemployment in Canada -- even in the short run -- simply by taking strong measures to raise the level of demand. There is a very real risk that further stimulation of demand in present circumstances would serve mainly to increase inflationary pressures rather than to create additional jobs.

What are the consequences of this for monetary policy? The suggestion is still heard, of course, that since we are passing through a period of depressed economic activity the main objective of monetary policy should surely be to keep interest rates as low as possible, at least until the recovery is well advanced. According to this argument, if this means letting the money supply expand for a time at very rapid rates, so be it; there will be time enough later on to slow it down again.

This approach has been followed in Canada and in other countries on past occasions but inflation is much more serious now and the risks involved in departing from a policy of moderation in expanding the money supply are much greater. Moreover, experience has shown that this approach runs into serious difficulties. The lags in monetary policy are long, economic forecasting is far from an exact science, and it has proven to be almost impossibly difficult to turn around a very expansionary monetary policy and bring down the rate of monetary growth quickly enough to keep the whole process from contributing to another round of inflation. In other words, it is not realistic to aim at continuous fine-tuning of monetary policy; greater steadiness in the rate of monetary expansion is required. In our present circumstances, I believe the only practical choice for monetary policy is to aim at maintaining a moderate rate of monetary expansion sufficient to support rising levels of economic activity together with a gradual decline in the rate of inflation.

For some time now we in the Bank of Canada have felt and have said that a monetary policy of this character was an essential element in any practical programme of measures to combat inflation in Canada. I welcome the support for this view contained in the programme to fight inflation announced last month by the Government. I welcome also the recognition of the need for fiscal restraint, and the introduction of a prices and incomes policy to supplement monetary and fiscal policy. Fiscal and monetary restraint alone, if sufficiently severe or protracted,

could eventually bring down the rate of inflation, but in the meantime the costs involved in terms of output foregone and job opportunities lost could well be very high. Inflation is now deeply entrenched in Canada, and the rates at which prices and costs have been rising recently must come down a very long way indeed. If price and income restraints, difficult as they may be, can help bring these rates down, Canadians collectively will be much better off in the years ahead. We should not forget that without direct restraints of this kind, price and income increases would have to be restrained by the only other means available for bringing them under control -- that is, by running the economy sufficiently far below its capacity for as long as turned out to be needed. This approach is sometimes called "the old-fashioned medicine"; how many Canadians would prefer it?

So much for general comment. Let me turn now to some more specific comment on aspects of our current monetary policy.

Most of the criticism we receive at the Bank of Canada these days about our policy falls into one of two categories. The first considers that what we say about the need for reasonably steady monetary growth at moderate rates is excessively vague, and may indicate a lack of sufficient commitment on our part. Why don't we state a specific target for monetary growth and accept responsibility for achieving it? Others, even if they are pleased with our objective of controlling the growth of the money supply, are very unhappy about what we seem to be doing to interest rates.

What can be said about the first set of questions -- those having to do with the Bank of Canada's lack of precision both in stating its targets for monetary growth and in following them in practice?

The first point I want to make is that the Bank of Canada has in fact given the public a fairly clear indication of the monetary growth target it is currently pursuing. On a number of occasions I have explained that in recent years the Bank of Canada has focused increasingly on the growth rate of M1 -- the public's holdings of currency and demand deposits, the main forms of money used for making payments in Canada -- as one of the more reliable of the available indicators for judging the general thrust of monetary policy. I have also reminded people that, on this definition, the money supply in Canada grew at an average rate of about 15 per cent per year over a two-year period ending in the second quarter of 1973. Over the subsequent two-year period ending in the second quarter of 1975, this rate was brought down to about 10 per cent a year. Given the fact that it is not reasonable to expect the rate of price and cost inflation in Canada to decline rapidly, I have offered the view that it would not seem appropriate for the time being to have an underlying rate of monetary growth below 10 per cent a year, but that on the other hand, an underlying rate of 15 per cent a year would be too high.

Looking beyond another year or so, I have said that the underlying rate of monetary expansion will gradually need to be brought

down in line with the over-all objective of reducing the rate of inflation gradually over time. If the ultimate goal -- the restoration of a completely stable price level, that is, a zero rate of inflation -- is to be achieved, this will eventually require the maintenance of an average rate of growth of the money supply no higher than the long-term average rate of growth of production of goods and services in Canada -- that is, a rate of about 5 per cent a year.

I want to emphasize that the reason that a rate of monetary expansion as low as 5 per cent a year should not be sought immediately is that a substantial underlying rate of inflation is now deeply entrenched in the economy. Because of this, a sharp reduction in the rate of growth of the money supply, and thus in the rate of growth of spending, would have much less impact on the trend of costs and prices in the short run than it would have in reducing economic activity and employment. The only feasible approach, therefore, is to slow down the rate of monetary expansion gradually over time.

That, some of our critics say, is all right as far as it goes, but it does not go far enough.

Why is the Bank of Canada reluctant to commit itself publicly to more precise objectives for monetary growth than those I have already stated?

It is not because we fail to recognize that public support for clearly-stated targets of this kind would be of great help to a central bank in doing its job. A target for monetary growth that attracted widespread public support would make it easier for a central bank to stick to its guns rather than be deflected by problems of various kinds that were not of its own making, such as unwelcome interest rate and exchange rate levels if, for example, governments were trying to borrow too much money, or a rapid increase in the price level if wage and salary settlements were pushing up costs. I am not at all unhappy to observe that public recognition of the need for sustained monetary discipline is now pushing central banks to go as far as they dare towards explicit monetary growth targets, and in a few countries targets have been published. In the case of the United States, the Federal Reserve System has published fairly wide target ranges but has qualified them by stating that there are many other indicators that must be looked at as well in conducting monetary policy.

In my opinion the main reason that central bankers show considerable reluctance to commit themselves to more specific targets is that, in the present state of knowledge about these matters, there are questions in our minds about how far we can properly rely on any one indicator to get a good reading of the thrust of our policy actions. Until we have had more experience with the problems encountered in trying to adhere to particular monetary growth targets, we will feel

bound to regard such targets as tentative and subject to revision in the light of developments that may not have been anticipated.

This problem is compounded by the fact that it is difficult to convey to people that the central bank is primarily interested in the underlying trend of the money supply series over rather long periods of time, and that good judgments about the underlying trend of the numbers depends on familiarity with how they have behaved in past years and in diverse circumstances. The behaviour of any monetary aggregate -- particularly that of currency and demand deposits -- is subject to rather wide and unpredictable fluctuations over short periods; these cannot be prevented by the Bank of Canada through the use of its existing technical powers nor would it be sensible to prevent them if we could for they play a useful role in accommodating day-to-day changes in a dynamic environment. Two transient influences that are causing very large fluctuations in demand deposits this month are the current interruption of mail service and the money flows related to the sales of Canada Savings Bonds. The Bank of Canada tries to avoid over-reacting to temporary disturbances since if it reacted sharply to every spurt or pause in monetary growth -- however brief -- its actions would involve much larger and more frequent changes in interest rates than would serve any useful economic purpose. Instead, it feels it should be content with exercising a broad controlling influence over the underlying trend of monetary expansion -- not from week to week or, depending on the circumstances, even from quarter to quarter -- but

certainly over periods long enough for the behaviour of the economy to be significantly affected by the trend of the money supply. Nevertheless, the short-run volatility of the money supply series seems inevitably to lead to public misunderstanding of the central bank's intentions, and to undesired market activity based on misinterpretations.

That's all I want to say today on the subject of money supply targets. Now I would like to say a word or two on the subject of interest rates.

Some people seem to have it firmly fixed in their minds that the reason we have such high interest rates in Canada today is because of what they refer to as the "tight money policy" being followed by the Bank of Canada. They believe that the Bank of Canada is deliberately pushing interest rates as high as it dares in the mistaken belief that this is anti-inflationary. They express surprise that central bankers are apparently not bright enough to see that high interest rates add to costs and thus contribute to inflation.

A reply to people who take this view should start with a question. What do you mean by "high" interest rates? "High" in relation to what?

People who are trying to save some money don't think interest rates are all that high. Anyone who receives 10 per cent interest on a hundred dollars he puts away for a year will end up with $110, but

if a year from now a dollar will buy no more than 90 cents will buy today, his $110 will then be worth only $99 in terms of its purchasing power. In other words, even with interest at 10 per cent, the return on savings in real terms may not be positive at current rates of inflation.

For borrowers, of course, inflation works the other way round, because so long as it continues they can pay back the money they owe in dollars that are worth a lot less than those they originally borrowed. No one who has borrowed in recent years has got anything but a good deal in terms of the real cost of the money.

But even though interest rates today are low in real terms they are high in nominal terms. They are much higher in all countries than they were ten years ago. Why is this? It is not because central banks have kept the growth of the money supply under too tight a rein over the past ten years. The reason that today's interest rates are so much higher than they were ten years ago is the same reason that today's prices are so much higher than they were ten years ago -- namely, that around the world the level of spending and the quantity of money have been allowed to rise much too rapidly. In short, it's creating too much money that eventually leads to higher interest rates -- not creating too little. Or to put it the other way round, only if we can manage to reduce the rate of monetary expansion over the next several years can we expect to end up with interest rates substantially lower than they are now.

Increasing the rate of monetary expansion may help to keep interest rates down in the short run -- provided the effect on inflationary expectations is not too great -- but it tends to raise them even higher over the longer run. As inflation becomes more severe, interest rates rise to new peak levels both because lenders demand compensation for inflation and borrowers, recognizing that inflation reduces the interest burden, are willing to pay these high rates.

The influence that the Bank of Canada exerts on money market interest rates in its day-to-day operations stems from the fact it is able to control the quantity of cash available to the banking system to support bank credit expansion. Thus if the money supply appears to be expanding too rapidly and the Bank of Canada takes action to slow it down, short-term interest rates must rise, at least temporarily. If the money supply appears to be expanding too slowly, the action taken by the Bank to speed it up will necessarily involve at least a temporary decline in these rates.

The main point that needs to be emphasized in this connection is that there is simply no way of avoiding temporary changes in the level of short-term interest rates if the growth of the money supply is to be stabilized. But these interest rate changes won't necessarily all be in an upward direction, nor will they necessarily last for very long. I can assure you that the Bank of Canada doesn't like rising interest rates any more than it likes rising prices. Indeed, the whole object of monetary

control is to help ensure that interest rates as well as prices don't keep rising forever.

The action taken by the Bank of Canada towards the end of the summer to slow down the burst of rapid growth in the money supply involved, at least for the time being, a fairly large jump in short-term interest rates. In the United States and a number of overseas countries, on the other hand, short-term interest rates have recently declined. No one should regard this as surprising, because our situation is quite different from theirs. Our economy has been going through a much milder recession than elsewhere, and our costs and prices have been rising much faster than in many countries, and, in particular, much faster than in the United States.

Indeed, inflation in Canada has by now become largely the home-grown variety, and we in Canada must find a way of bringing it under control in Canada if it is to be controlled. Given the position from which we start and how far we have to go, it certainly won't be easy. Canadians are going to have to show a good deal of co-operative spirit, moderation and patience to achieve a steady lowering of our inflation rate and a reasonable rate of economic recovery at one and the same time. But I believe that we are at least headed in the right direction and that we must press on.