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REMARKS BY
GERALD K. BOUEY
GOVERNOR, BANK OF CANADA
TO THE 46TH ANNUAL MEETING OF
THE CANADIAN CHAMBER OF COMMERCE
SASKATOON, SEPTEMBER 22, 1975

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When your President invited me early in the year to come to Saskatoon to address a luncheon gathering at this annual conference, I was very glad to be able to accept. The occasion has given me the chance to visit my native province again, which is always a pleasure, and it has given me a very welcome opportunity to hear views about our economic problems from many of your delegates and an even better opportunity to tell you how I feel about those matters that by virtue of my job are of particular concern to me.

Earlier this month the Bank of Canada announced an increase of 3/4 of one per cent in its Bank Rate, that is, from 8 1/4% to 9%. For several weeks prior to this announcement Canadian interest rates had been rising both in the short-term money market and in the bond market. Following the Bank Rate move the chartered banks and a number of other financial institutions announced increases in the rates that they charge for bank loans and mortgages and that they pay for savings and time deposits. There was also some further upward adjustment of market interest rates.

This recent increase in interest rates, and in particular the

Bank of Canada's part in it, has naturally attracted a good deal of attention. I would like to take this opportunity to review with you the reasons for our decision to raise our Bank Rate. That decision rests on two underlying propositions.

The first proposition is that it is very much in the public interest that the drift into deepening inflation in Canada be halted and reversed. A few years ago when the rate of price rise was relatively low there was a certain amount of debate about this proposition. However, now that we have been experiencing double-digit inflation there are few who would seriously question it, and very few indeed among those who have watched what has been happening in countries where the rate of increase in the price level has continued on up to figures such as 25 per cent a year. Nevertheless, I think that there is still a good deal of wishful thinking surrounding this matter and that there is an inadequate appreciation of the seriousness of the problem that we face. To put my first proposition another way, it is that the protection of the value of money is of prime importance to the future economic and social welfare of Canada.

The second proposition is that, whatever else may need to be done to bring inflation under control, it is absolutely essential to keep the rate of monetary expansion within reasonable limits. Any programme that did not include this policy would be doomed to failure. There is no way of preserving its value if money is created on an excessive scale. In this country the job of keeping monetary expansion within reasonable bounds is the direct

responsibility of the Bank of Canada. I do not want to pause here to describe the techniques that are used to do that but I want to assure you that although the degree of control over short-run movements is not precise, the means available to the Bank to do this job are broadly adequate.

I want to emphasize that control over the money supply cannot be maintained unless the central bank is prepared to allow interest rates to move. I know that this may be a difficult point to grasp, but it is crucial to an understanding of why we have just had an increase in interest rates in Canada. It is simply not possible for the Bank of Canada to control the rate of monetary expansion while at the same time trying to hold interest rates to some fixed level. The reason for this is that the Bank of Canada cannot control the demand for money. That depends on the state of the economy and people's views about the future. If the demand for money strengthens the only options open to the central bank are to allow interest rates to rise or to resist the upward pressure on them by taking action to permit a larger increase in the money supply than would otherwise have occurred.

This brings me to the recent situation. In the past few months the demand for money and credit in Canada turned stronger, with the current and prospective credit demands of borrowers -- including the very large requirements of governments -- threatening to outrun the supply of funds savers seemed willing to lend or invest at the then prevailing interest rate levels. At the same time the growth of the money stock accelerated to rates

in excess of 20 per cent a year -- rates which, if allowed to continue, would lead in due course to an acceleration of the rate of inflation in Canada. In these circumstances the central bank had no responsible alternative but to let market interest rates move upward in response to the pressure of credit demands, and to adjust its own lending rate accordingly. This, in essence, was why the Bank of Canada decided to act as it did three weeks ago.

I am aware that many people find it difficult to understand why higher interest rates should be regarded as anti-inflationary, since an increase in the cost of borrowing immediately increases the costs of doing business and higher mortgage rates immediately add to the cost of housing. These immediate effects are undeniable, but they are only part of the story and not the most important part. The most important part of the story is that to react to rising demands for credit by permitting excessive monetary expansion inevitably leads in due course to higher rates of inflation. Experience here and in other countries proves this point beyond any shadow of a doubt. After extended periods of very rapid monetary expansion the result, invariably, has been substantially higher rates of increase in costs and prices.

In coming to its decision to raise the Bank Rate, I can assure you that we in the Bank of Canada were well aware of those features of our present economic situation that might point in the direction of avoiding any increase in interest rates at this time, and we certainly were not inclined to dismiss them lightly. But we had to weigh these considerations against the consequences of giving up any serious effort to control the growth of the supply

of money. To some extent this was a weighing of immediate consequences against longer-term consequences, but it was by no means only that. A powerful force that is feeding the inflationary fires in Canada right now is a widespread expectation of continuing, and even accelerating, inflation. What would be the effect on this inflationary psychology if the central bank were seen to be unconcerned?

The only other direct comment that I want to make on the recent increase in our Bank Rate is a brief reference to its exact timing. At first financial markets seemed surprised at the timing, but I think that they have now come to see clearly what lay behind it. The Government of Canada was on the eve of decisions about both a large new market issue of Government securities and the new Canada Savings Bond campaign. Since we in the Bank of Canada were convinced that a change in our Bank Rate could not be long delayed, it seemed desirable that the Government's new financing should be brought to market after our action rather than before it. The date of the Bank Rate announcement, September 2nd, was about the latest date that allowed financial markets a reasonable period in which to react.

I would like now to say a few words about some other features of our present economic situation which we have kept in mind in conducting monetary policy.

It is clear to everyone of course that, like other industrial countries, Canada has been passing through a recession. So far this country has escaped with a shorter and milder fall-off in activity than most of its

trading partners, although at the moment our industries are operating for the most part at levels well below capacity. Both here and in the United States, if not as yet in many overseas countries, there is accumulating evidence that the worst of the recession may now be behind us and that production is beginning to recover.

Unemployment has risen in Canada. In recent months it has been recorded as about two percentage points higher than it was at the peak of the boom in 1974. Moreover, our history suggests that any substantial decline in unemployment can be expected to lag behind any general recovery in economic activity by several months. One can note that the current rate of unemployment in Canada is a full percentage point below that in the United States and that Canada's arrangements for providing compensation to the unemployed are among the most generous in the world, but the fact remains that no one welcomes unemployment. The only acceptable goal for Canada is sustained high levels of employment. The question is how best to pursue that goal. The present problems of recession and unemployment both here and elsewhere can be traced directly in very substantial part to the excesses of the recent worldwide inflationary boom. We cannot expect to achieve any lasting solution to these problems by setting off yet another round of inflation fueled by excessive monetary expansion.

New housing construction in Canada also continues to be beset with a variety of difficult problems, many of which reflect the distortions generated in the intense inflationary boom of 1973-74. The strong demand during that

period for houses and apartments greatly inflated both the cost of constructing new housing and the prices of existing housing. While rents have been rising persistently, they have not kept pace with the cost of putting new rental accommodation in place. The result has been to make the construction of new rental units economically unattractive, at least for the time being, and few such units are currently being constructed except under subsidized programmes. In spite of this the level of housing starts in recent months has been running at annual rates well in excess of 200,000 units. The demand for mortgage money has tended to exceed the supply of the term deposit money savers were willing to make available through institutional channels even at relatively high interest rates. But the main thing I want to say about housing is that many of the current problems arise from the extent to which recent inflation has distorted normal cost, price and rent relationships. That situation will not be remedied by allowing inflation to continue at existing or even higher rates.

There is another feature of our economic situation that I haven't said much about as yet, and that is the continued steep upward trend of costs and prices. There are admittedly some special factors in areas such as energy prices and food prices but even after making allowance for these the rate of increase remains much too high. The current wave of inflation was not initiated by a marked acceleration of wage and salary increases. It was the other way around. It was the short but intense boom -- more intense here than in the United States because of the relatively greater importance of primary

products in our economy -- that gave rise to demands for higher rates of increase in labour incomes. But that boom ended some time ago and new wage and salary settlements continue to be disturbingly large. They have been running for the past several quarters at around 18 per cent per year on average, a rate of increase that is far greater than would be consistent with any diminution of our rate of inflation. It appears that for the most part employers have been passing these increases on to consumers in the form of sharply higher prices, and that all concerned act on the assumption that they will continue to be able to do so.

If one reflects on this situation in the light of the present levels of unemployment and unused productive capacity, one cannot help but wonder what is going on here. In our economic system the basic control over the level of prices is and always has been the willingness of the market to pay them. It's obvious that improved productivity can offset very little of the cost of current wage and salary increases since the long-term average increase in output per worker in this country is only 2 1/2 per cent per annum. In many cases, in fact, those involved in both the private and public sectors seem to be incurring costs at rates that foreshadow an accelerating increase in inflation. How is this expected to work? Are fiscal and monetary policies being counted on to be sufficiently expansionary to accommodate an accelerating increase in costs and prices? Is the central bank expected to create enough money to finance whatever rate of inflation emerges?

Expectations of this sort are clearly quite inconsistent with any

possibility of good economic performance over time. I do not want to encourage their development by seeming to be unconcerned when the rate of monetary expansion in Canada tends to be excessive. Let me therefore say a further word about rates of monetary expansion in Canada.

Over a period of two years ending in the second quarter of 1973, a period in which unusually high rates of monetary expansion occurred around the world, the public's holdings of currency and demand deposits -- the main forms of money used for making payments in Canada -- increased at an average rate of no less than 15 per cent a year. By comparison, an average rate of no more than 5 per cent a year would have been high enough to accommodate the growth in production of goods and services in Canada at the long-term trend rate if the price level had remained stable.

The Bank knows perfectly well, of course, that over recent years an underlying rate of inflation has been built into our economy which is now much too high to be eliminated at all quickly by suddenly reducing the rate of monetary expansion to anything like such a low figure. The consequences for economic activity would be much too disruptive in the short run, so that whatever progress is to be made in moderating the rate of monetary expansion in Canada must be achieved gradually over time.

Some moderation has occurred. Over the two years to the second quarter of 1975, the average rate of growth of currency and demand deposits in Canada has been about 10 per cent a year. Since then the rate of money supply growth has bounced back up to unusually high figures but as I have

explained we have now taken the steps that we think will ensure that this excessively high rate does not continue.

When you look at the cyclical aspects of the current economic situation, those of you who have watched economic and financial developments closely for as long as I have must be struck as I am with a sense of déjà vu. We have been here before. On previous occasions we have generally ended up, for all sorts of plausible short-term reasons, by turning economic recovery into an inflationary boom. This time round, it seems to me, we would be well advised to take a long look backwards at where we have been making our mistakes, together with a long look forward at where we want to be two or three years from now -- and how we propose to get there.

The last time this country began to emerge from recession into recovery with a persisting problem of substantially escalated labour costs was as recently as 1970, only five years ago. In those days a policy aimed at trading off a bit more inflation in order to get a bit more employment was still the conventional economic wisdom. We now know what happened. Three years later we all found ourselves participating in the most virulent worldwide inflationary boom of living memory under peacetime conditions. The boom didn't last much more than a year before signs of spreading recession began to appear in one country after another even before the shock of oil prices. And now we find ourselves back at square one with higher unemployment rates, with higher underlying rates of cost and price inflation, and with higher interest rates.

For more than 20 years almost every country in the western world has given rapid growth and high employment much higher priority in its policies than the preservation of the value of money. This approach worked well for quite a while, but it won't work well any longer. The loss of confidence in the value of money that has resulted from these policies has now become so great almost everywhere as to threaten the effective functioning of our existing economic, social and political institutions. We now have no option but to contain inflation and inflationary expectations if we are to have any realistic hope of achieving sustained economic growth.

You will have realized by now that I am not offering to you views on all the things that can or should be done to grapple constructively with Canada's various economic problems. My primary responsibility is to try to get monetary policy right, and I've explained today what I think that means. You can be confident that the Bank of Canada will permit a rate of monetary expansion that by any reasonable standard is sufficient to meet the needs of a good economic recovery with some moderation in the recent pace of inflation. You can also be confident that we shall be on guard against rates of monetary expansion that reinforce inflationary tendencies. I know, of course, that many things other than monetary policy have also to be right before the economic system will work well. I hope that a sober appreciation by Canadians of the seriousness of our economic problems will call forth sufficient will to co-operate in their resolution.