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REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO THE FREDERICTON CHAMBER OF COMMERCE
FREDERICTON, N.B., JUNE 23, 1976

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Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to the
Fredericton Chamber of Commerce
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May I begin, Mr. Chairman, by saying that I am most grateful for the invitation to speak to the Fredericton Chamber of Commerce on the same day as the Board of Directors of the Bank of Canada is meeting here.

The Board usually holds its meetings at our head office in Ottawa but it has been our policy to arrange periodic meetings in other parts of Canada. Directors come from right across the country -- two from Ontario, two from Quebec and one from each of the other eight provinces. Other members of the Board are the Deputy Minister of Finance, the Senior Deputy Governor and myself as Chairman. Meetings like this one give the Directors of the Bank the opportunity to see and hear something at first hand of economic conditions in the various regions of Canada. I wouldn't, however, want you to think that back in Ottawa we are by any means totally ignorant of events in New Brunswick. Quite apart from other channels, our Director from your Province, Mr. John Burchill, sees to it at our Board meetings that we are well informed. We are indebted to him for the invitation

to meet in Fredericton and for many of the arrangements that have been made for us. We are delighted to be here and we look forward to talking with many of you. We expect to leave with a better understanding of your circumstances and problems, many of which are certainly matters of serious concern.

At the same time I should make it clear that the operations of the Bank of Canada, which are essentially directed at controlling the rate of expansion of the money supply in Canada as a whole, necessarily have an impact that is national in scope. The major way in which our activities can be helpful to your Province, or to any other region, is in the extent to which they ensure that its economic activities are carried out within the framework of a strong and expanding national economy.

Today I want to say something about the nature of the problems facing our economy and about the kind of public policies that we need in Canada, both to permit the current economic recovery to continue and to provide a sound basis for sustained growth in the future. In the course of my remarks I shall concentrate on monetary policy since that is the area in which the Bank of Canada has responsibility.

Let me begin by reminding you of some features of the economic situation in Canada as they were last summer. Prices were continuing to rise at rates appreciably in excess of 10 per cent a year.

Although the average increase in real output per worker is usually around 2 per cent a year, rates of pay were being inflated by increases averaging in excess of 15 per cent a year, with many settlements substantially above that figure. A gap of well over $4 billion a year had opened up between our spending on foreign goods and services and the export earnings we were generating to pay for them. Our national unemployment rate had risen to around 7 per cent of the labour force even though the downturn in economic activity from which Canada was just beginning to recover had been much less severe than in the United States and many overseas countries. At the same time Canada was entering the recovery period of the business cycle with a significantly higher continuing rate of inflation than that of its main trading partner.

There were a number of related reasons for anxiety about how these difficulties could be overcome.

One reason was that the standard policy prescription followed in past recessions in order to bring the economy back to more normal levels of production and employment was unlikely to work well in the situation we found ourselves in last summer. In previous recessions when people still had little experience of rapid inflation, the general policy approach followed in Canada and other countries had been for governments to increase their expenditures substantially without a corresponding increase in tax revenues and sometimes indeed with

tax reductions; meanwhile the central bank would expand the money supply fast enough to prevent this increase in government borrowing from pushing interest rates upwards. Looking back now, it seems clear that excessive reliance around the world on these highly expansionary policies in order to get quick results in the short run has been one of the main reasons for the rising trend of inflation rates over the longer run. By last year, with inflation running at double-digit levels, that approach involved far greater risks than ever before.

Such policies would certainly have increased the total amount of spending by Canadians, and no doubt some part of this additional spending would have encouraged higher levels of production and employment in Canada, at least for a time. The risk was, however, that much of this additional spending would simply lead to still higher costs and prices in this country and to still higher imports from abroad. This was particularly so at a time when Canadians generally had come to fear that rapid inflation was likely to continue or even accelerate, and were anxiously seeking to gain as much protection as possible from its impact through substantial increases in their own prices and money incomes.

Another reason for being concerned was that if costs and prices in Canada continued to rise at rates as high or higher than those we had already been seeing for some time, Canadian industry would soon

find itself in a steadily worsening position in terms of its ability to meet foreign competition both here in Canada and in export markets. This was not the first time in our history that more rapid inflation in Canada than in the United States had posed this particular danger, but invariably in the past we had not let a situation of this kind continue for long. This is the main reason why the external value of the Canadian dollar has remained as close to parity with the United States dollar as it has for so many years.

There is of course the possibility, in theory at least, that a continuing higher rate of inflation in Canada than in the United States could be accommodated by a movement over time of the exchange rate, but it would be a serious error to suppose that such accommodation would work smoothly. One has only to look at the experience of other countries to see how disruptive the movements in exchange rates can be between countries with appreciably different patterns of inflation. From the point of view of a country's foreign trade it is much more sensible to aim for at least as good, and preferably better, performance in domestic costs and prices than in the countries with which it trades. It is interesting, and in my view instructive, to observe that after all the movements of the foreign exchange rates of many countries in recent years, it is those countries with the best records of dealing with domestic inflation that have emerged as being in the strongest positions in international trade.

By far the most important reason for being alarmed about where we were heading, however, was that this particular upsurge of inflation was simply the latest and most severe of a number of such episodes, each of which had turned out to be more serious than the last. Only two or three years earlier few Canadians would have thought it possible that they would be witnessing double-digit inflation in 1975 in the midst of world-wide recession. If we continued to follow much the same sort of policies that had permitted episodes of this kind to occur in the past, what was to prevent the rate of inflation from reaching, say, 20 to 25 per cent a year in the next such episode? Given the degree to which confidence in the future value of money had already been shaken in Canada in recent years, how could our market economy possibly be restored to any kind of lasting health and vigour in the absence of convincing evidence that inflation not only could be but most certainly would be brought under firm control and kept under firm control in this country?

These, then, were in my view the main grounds for concern about the course that the Canadian economy seemed to be on last year just prior to the launching of the anti-inflation programme.

The programme is now well into its first year, and although it is still too early to judge what degree of success it will ultimately achieve, I believe that it continues to have a good chance of bringing

the rate of price increase down very substantially over the next year or two. Encouraging progress has already been made. At the absolute minimum, it is surely fair to say that the programme has already gone a long way towards calming the more extreme manifestations of the inflationary psychology that gripped Canada not so many months ago. At the same time the economy has continued to grow -- not as rapidly as in the early stages of past recoveries, perhaps, but then that was hardly to be expected in present circumstances.

As you know, the anti-inflation programme depends crucially on the fiscal policies of the federal and provincial governments and on monetary policy to keep the growth of public and private spending within moderate limits, while at the same time it supplements these policies by providing a mechanism for intervening directly in price and income decisions. I don't propose to say very much today about these other important elements of the over-all programme, but I would like to say something about the role of monetary policy.

Perhaps the place to start is to remind you that the main job of the Bank of Canada is to regulate the rate at which the total quantity of money in this country is increased over time. A growing economy needs a growing stock of money, but if the quantity of money in the hands of the public is allowed to expand too rapidly, sooner or later its value will fall. The value of money simply reflects the quantity of goods and

services that you can obtain in exchange for it -- that is, it is the obverse of the price level. When the price level goes up, the value of money goes down. The control of the quantity of money is therefore an essential element in the control of inflation.

The Bank of Canada has been making a determined effort to keep the money supply growing at a more moderate and steadier pace than in the past. The basic principle underlying the policy of the Bank has been to permit the money supply to grow at a rate consistent with continued economic expansion provided that this is accompanied by some slackening of the rate of inflation. For reasons which I have discussed elsewhere, the particular monetary aggregate whose growth rate the Bank of Canada has tended to regard as the most useful one to focus on for control purposes has been currency plus demand deposits at banks -- the main forms of money used directly for making payments in Canada.

Last autumn I gave some indication in public of the general range within which we were trying to keep the growth rate of the money supply during the current period dating from the second quarter of last year. I said that in our view it would be inadvisable for the time being to aim at reducing the trend rate of monetary growth below 10 per cent a year, but that on the other hand a rate of growth as high as 15 per cent a year would be much too high. In the event, it now looks as though the

growth of the money supply over the latest 12-month period measured to the second quarter of 1976 will be close to 10 per cent, that is, at the lower end of the range announced last fall. I regard this outcome as satisfactory, having regard both to the recent performance of the economy and to the need to make progress toward the achievement of the objectives of the anti-inflation programme.

Not everyone is impressed by the fact that for some time now the underlying growth rate of currency and demand deposits in Canada has been kept down to a figure of around 10 per cent a year. They point to the fact that the recent growth rate of currency and demand deposits in the United States has been only about half that figure, that is closer to 5 per cent a year. It should be noted, however, that a more accurate comparison of the growth rates of the main forms of money used for transactions purposes in the two countries requires the inclusion in the Canadian figures of chequable savings accounts on which interest is paid -- a form of money still widely used for making payments in Canada but one that is much rarer in the United States. On this basis the comparable Canadian figure is not 10 per cent a year but 7 per cent. There are other relevant differences between financial developments in Canada and the United States, and I do not regard recent U.S. experience as indicating that the rate of monetary expansion in Canada in the last year has been too high.

I would be the last to deny, of course, that the growth rate of the money supply in Canada on either of the definitions to which I have referred is still too high to be consistent both with a stable price level and with continuing real growth of the economy at its long-term trend rate of increase of close to 5 per cent a year. The trouble is that widespread expectations of rapid and continuing inflation are still reflected in many on-going arrangements and contracts in our economy, so that while inflation can be geared down gradually over a period of years, there is simply no way of bringing it to an abrupt halt without having a very disruptive impact on economic activity and employment in Canada.

A notional timetable for gearing down Canada's inflation rate was implicit in the Government White Paper issued last October outlining the main features of the anti-inflation programme. There the possibility was envisaged that the rate of increase in the price level in Canada would be reduced by roughly two percentage points a year over a three-year period. This would bring our inflation rate next year down to around 6 per cent, and in 1978 down further to around 4 per cent.

The possibility of slowing down inflation in Canada in accordance with this general timetable is neither an unrealistic hope nor an overly-ambitious goal. It is, in fact, about the minimum that we must and can achieve if our economy is to become healthy and prosperous

again on any lasting basis; and until it is achieved, it must in my view continue to have the highest priority. A programme that attempts to gear down inflation over a three-year period is bound to require a great deal of patience on the part of everyone. But the consequences of a demonstration of failure to deal adequately with our current problem of inflation would be most serious in terms of its effect on confidence and on expectations of future inflation. There is simply too much at stake in the effort to which we are now committed to allow it to fail. We are on the right course, and we must stick to it with all the patience and determination we can muster until we have achieved what we set out to do.

With the broad objectives and timetable of the anti-inflation programme in mind, what sort of monetary policy should Canadians expect over the period ahead?

First, we intend to press ahead with the gradual slowing of the pace of monetary expansion that is essential to the success of the anti-inflation programme as a whole. As I have already noted, the growth of the money supply in the form of currency and demand deposits has been kept down to about 10 per cent over the past year. Looking ahead it is clear that the limits of the target range for monetary expansion announced several months ago are becoming outdated and that before long a somewhat lower range should be regarded as the appropriate one to aim at. The announcement of a lower range should not necessarily be

regarded as signalling a change in the current setting of monetary policy. That would only be necessary if the trend rate of monetary expansion prior to such an announcement had been outside the new range.

The second point I want to make has to do with the implications for interest rates of the gradual slowing of the pace of monetary expansion in Canada that we are determined to see. I particularly want to question the tendency of some people to assume that progressively lower rates of monetary expansion must necessarily involve progressively higher rates of interest. This is by no means the case. It is true that so long as the pace of inflation fails to slacken sufficiently the Bank of Canada cannot take action to moderate excessively rapid monetary expansion without being willing to see temporary increases in short-term interest rates. We have faced up to difficult decisions of this kind in the past, and should the necessity arise in the future we would do so again. But to the extent that the rate of inflation in Canada falls, the money value of national income will rise less rapidly and so will the amount of money required to carry on business. It is therefore within the realm of possibility that receding inflation will permit a gradual moderation of money supply growth without the need for significantly higher interest rates than we have at present. Indeed, in an atmosphere of growing confidence that inflation was being brought under control and would be kept under control, interest rates could over time be expected to begin declining, especially long-term

rates which now clearly include a sizeable inflation premium. I am offering no forecast whatsoever of how interest rates will in fact move in the months ahead, but I do believe that over the longer run, lower rates of inflation, lower rates of increase in the money supply, and lower interest rates are mutually compatible objectives.

My third point has to do with concern that the economic recovery that is now underway in this country could falter as a result of the effort that is being made to moderate the trend of money supply growth.

In this connection I remind you that the Bank of Canada has no intention of cutting back the growth of the money supply at all suddenly or drastically. Given time, our economy can adjust in an orderly way to a gradual lowering of the rate of monetary growth through a gradual reduction in the rate of inflation. Hand in hand with receding inflation we can expect continuing increases in economic activity, with strong support coming from the economic expansion which is now being experienced by virtually all industrial countries. But if the rate of monetary expansion should begin falling away further or faster than we think the economy can safely adapt to, I can assure you that the Bank of Canada will be alert to the need for prompt corrective action.

I began my remarks today by referring to the need to pursue economic policies that will provide a sound basis for economic growth in

the future, and later on I spoke of the time and patience that this approach will require. It is of course very difficult to resist the temptation to seek quick remedies to our problems, even at the cost of building up more serious difficulties for ourselves in the future. But surely if there is one lesson to be learned from our experience in recent years, and that of other countries, it is that a longer-run approach to policy is essential, that we must keep an eye on the far horizon, on where we want our economy to be a number of years from now. I am encouraged by the signs I see that we are learning that lesson.