NOT FOR PUBLICATION BEFORE: 12:30 P.M. PACIFIC STANDARD TIME
NOVEMBER 8TH, 1978

REMARKS BY
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TO
THE MEN'S CANADIAN CLUB OF VANCOUVER
VANCOUVER, B.C.
NOVEMBER 8TH, 1978

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Remarks by
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Governor of the Bank of Canada
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I want to say a few words today about Canadian monetary policy and about the recent actions of the Bank of Canada in response to developments in the foreign exchange market. In the first part of my remarks I would like to explain how I view our basic economic problems and outline the general approach that we are following in our monetary policy in order to help resolve them. I shall then turn to one special manifestation of these problems, the story of the recent fortunes of the Canadian dollar. This will give me an opportunity to explain the recent activities of the Bank of Canada in this regard.

The root of the troubles that the Canadian economy has been experiencing in recent years can be traced back to the problem of inflation, and in particular to the bout of intense inflation that this country suffered earlier in the 1970s. Inflation in Canada reached a peak in 1975, with prices and wages rising at rates that were not only very high in absolute terms, but also substantially higher than comparable rates in the United States, our main trading partner.

We are still suffering from the legacy of this and earlier experiences of rapid inflation. This legacy included a persistent fear of

yet more inflation to come in spite of the current weakness of the economy, a high personal savings rate and a weak investment picture. It also included a serious impairment of our international competitive position, a large deficit in the current account of the balance of payments, and a falling off of foreign capital inflows into direct investment in Canada. These latter developments led in turn to a large downward adjustment in the external value of the Canadian dollar. I shall have more to say about this later on in my remarks.

We Canadians, then, have been faced with the need to extricate our economy from the grip of rapid inflation and repair the damage it has already done. We have wanted to do this in a way that would at the same time maintain a moderate rate of continuing economic growth, and even on the best of assumptions this was bound to be a lengthy and painful process. Our efforts towards this end have recently encountered two major hurdles -- the sharp bulge in food prices in the past two years and the direct impact on our price level of the adjustment that has occurred in our exchange rate. Nevertheless, we have made real progress against inflation in Canada: with the exception of food prices, there has been a continuing gradual moderation of our price and wage increases, which by and large are no longer running ahead of similar increases in the United States. Thus the most recent Canadian year-on-year increases in consumer prices other than food, in the GNE price deflator, in industry selling prices, in average

earnings and in new wage settlements are all close to or below the comparable figures for the United States.

Monetary policy has had an important role to play in this slowing of inflation in Canada. For more than three years the Bank has been operating within a framework of publicly-announced and gradually declining targets for monetary growth. These targets specify the upper and lower limits of a range within which the Bank will endeavour to keep the trend rate of increase of the money supply. The Bank's initial target range for monetary growth back in 1975 was from 10 per cent a year to something less than 15 per cent a year. As monetary growth and inflation have slowed over the intervening period, there have been three successive downward revisions of the Bank's target range to its current level of 6 to 10 per cent a year. The Bank had made it clear on numerous occasions that further gradual reductions in its monetary growth targets will be required over future years if monetary policy is to be consistent with the longer-run objective of ensuring a continuing gradual decline in Canada's rate of inflation.

In setting its targets the Bank's objective is to choose a range for the near-term growth of the money supply capable of accommodating a reasonable rate of economic expansion provided that this is accompanied by some continuing decline in the rate of inflation. The fact that we have been successful in meeting our targets for three consecutive years now provides, I hope, convincing evidence that we are serious about them.

If as we come out of the decontrol period the rate of inflation should not decline, or worse still, if there should be a renewed acceleration of the rate of increase of wages and prices, the Bank will not for that reason allow its monetary growth targets to be exceeded. In such circumstances interest rates would have to be high enough to prevent undue monetary expansion, and that in turn could lead to slower economic growth until inflation subsided again. That risk cannot be avoided unless monetary policy is simply to underwrite whatever rate of inflation turns up. Given more responsible wage and price behaviour, of course, economic growth need not suffer in this way. Indeed, if we do not let inflation cancel out the benefits of the recent exchange rate adjustment, our improved competitive position will itself provide fresh stimulus to economic activity in Canada.

The main point I want to make here is that the use of monetary targets to avoid excessive monetary expansion imposes a financial discipline on the economy that I trust all of the main participants -- business, labour and governments -- will recognize and observe. Financial discipline is not an end in itself, but is rather a means to other ends that are of great social importance, namely, sustainable high employment and rising living standards. No free society has found a way to achieve these goals without continuing financial discipline.

Over the period since the Bank first began to pursue publicly-announced monetary growth targets, the primary purpose of the interest rate adjustments that it has initiated from time to time has generally been to keep the rate of monetary expansion broadly on track. In recent months, however, the Bank has had to give special weight in its interest rate actions to the unusually disturbed state of the foreign exchange market. Most of the remainder of my remarks will be concerned with this aspect of our activities.

The recent substantial decline in the external value of the Canadian dollar is one consequence of our general economic situation. Like our domestic economic problems, our international payments problem largely reflects an earlier failure to control our costs of production adequately and we now have a very large current account deficit in our international payments which must be financed. With inflation running substantially higher in Canada than in the United States for several years, the cumulative effect was to open up a substantial gap between cost and price levels in that country and our own inflated levels of costs and prices -- especially labour costs, which bulk so large in our total production costs. This gap became too large to be corrected over a reasonable period of time by gradually reversing the relative increase of our costs, and it was apparent that a major downward adjustment of the exchange value of the Canadian dollar was bound to occur sooner or later.

The downward adjustment of the Canadian dollar from November 1976 to the early part of this year was reasonably orderly and was not a cause for particular concern. At the beginning of this year it seemed to me that Canada's underlying balance of payments situation was better than it had been for some time. A large downward adjustment in the Canadian dollar had taken place about as smoothly as could be expected, and this had much improved our competitive position in international trade. Our costs of production were no longer rising significantly faster than those of our main trading partner, as rates of increase in money wages had come back down to about the same range as in the United States. The expenditures of governments in this country had slowed considerably and the money supply was under good control. The merchandise trade surplus was increasing and prospects for a decline in our over-all current account deficit seemed reasonably good. Although rising U.S. interest rates in conjunction with a lowering of Canadian rates had reduced the incentive to borrow abroad and there had been a lull at times in the pace of foreign borrowings by provinces and corporations, it looked as though these forms of net capital inflow would come close to financing the current account deficit.

You are familiar with the main features of the exchange rate story over the last eight months or so. During that period the exchange value of the Canadian dollar fell from about 90 cents U.S. to a little below 84 cents U.S. briefly in early October, and has since recovered somewhat.

Among the various factors that contributed to this movement in the exchange rate I shall mention only three. The first is that throughout the period interest rates in the United States were rising fairly rapidly and were expected to continue to rise. The main reason for the increase in interest rates in the United States was that the level of economic activity in the United States was both high and rising rapidly. In these circumstances higher interest rates were necessary if the U.S. economy was to avoid a major acceleration of price inflation. But the economic situation was somewhat different in Canada; there was more economic slack in this country. This difference raised doubts in the exchange market about whether interest rates would rise as rapidly in Canada as in the United States, and if they did not, sufficient capital might not flow into Canada to finance our international payments deficit on current account, and the exchange rate would weaken further.

The second factor is that we got some very disappointing figures for Canada's international balance on merchandise trade for three months in a row, namely, for June, July and August. These figures were so far below the earlier trend that it was difficult to believe that they were not in large part an aberration, and this impression is supported by the recent very strong figures for September. But the poor figures for the three preceding months undoubtedly had a great influence on market views about the probable course of the Canadian exchange rate, and added greatly to the downward pressures on the rate from late July until the strong rally about two weeks ago.

The third factor is that the sustained decline of the Canadian exchange rate seems to have fed on itself -- to have engendered expectations (or fears) of a continuing decline. This became especially evident after the Canadian dollar had fallen below 90 cents U.S. A widespread bearish sentiment developed that tended to ignore the positive elements in the situation and accented the negative ones.

You are also familiar with the main features of public policy that were implemented to moderate the tendency of the exchange rate to move too fast and too far. They were foreign borrowing by the Government of Canada to finance exchange market intervention and increases in interest rates initiated by the Bank of Canada to prevent our interest rates from getting too far out of line with those in the United States.

The program of foreign currency borrowing by the Government of Canada was undertaken to provide assurance that there would be a continuing inflow of capital to Canada adequate to finance the country's current account deficit. This financing is usually provided by external borrowing by Canadian entities other than the Government of Canada, but the Government decided in the circumstances to take on to the extent necessary part of the job of raising capital abroad, and it took various initiatives to dispel any doubts about its ability to do so.

In respect of interest rates, the Bank of Canada recognized that it was necessary in the circumstances to keep a positive spread of

reasonable magnitude against interest rates in the United States. This necessity arose from the fact that Canada was running a large deficit in its international trade in goods and services and this deficit had to be financed by inflows of foreign capital. This need was reinforced by the fact that when there is a strong tendency for short-term funds to be switched out of Canadian dollars because of concern about the trend of the exchange rate, it does not make sense to encourage this movement further by allowing short-term interest rates in Canada to become lower than comparable rates in the United States. That is what would have happened if Canadian interest rates had remained steady while rates in the United States kept rising. Although we had to take into account what was happening south of the border, we were not aggressive in moving interest rates higher in Canada because of our concern for the domestic economic situation. That is why we raised the Bank Rate by only one half of a percentage point at a time except in mid-October when the increase was three-quarters of a percentage point. The Canadian dollar did not respond with sudden strength to these increases but that, I believe, is mainly because they occurred during a period in which interest rates were rising just as quickly in the United States, and usually at times when further increases were expected there.

In the economic circumstances that existed the Bank of Canada could not ignore the inflationary consequences of a very rapid rate of decline

in the exchange rate of the Canadian dollar. Once a currency begins to decline rapidly, there is a very real danger that the process will begin to feed on itself and go too far as exaggerated fears are aroused. If the exchange rate decline goes substantially further than underlying conditions warrant, no doubt it is true that at some stage it will tend to reverse, but when one looks around the world these days it is difficult to be confident that such a reversal would in fact occur before much avoidable inflationary damage had been done. That has been the Bank of Canada's basic concern about the course of events in the foreign exchange market in recent months, and the basic reason why it has acted as it has to cushion the decline of the currency.

The risk of setting off renewed inflationary pressures in Canada is very real. Over the past two years, a major downward adjustment of the external value of the Canadian dollar has substantially improved the ability of our export and import-competing industries to compete with foreign suppliers on a profitable basis, but it has at the same time pushed up the prices paid by Canadians for many of the things that they buy. The declining Canadian dollar has, for example, been an important element in reinforcing the sharp upward movement of food prices this year that was occurring for other reasons. And food prices are by no means the only area of consumer prices that have felt the impact of the exchange rate decline. Thus the wage-bargaining process is under intense pressure to provide

compensation for the recent upsurge in consumer prices at a time when the Anti-Inflation Board's activities are being phased out.

It has long been clear that a large exchange rate adjustment could restore our international competitive position on a lasting basis only if the feedback on the domestic economy from the higher prices of imports and export-related goods did not result in a fresh outbreak of large, leap-frogging wage and price increases in Canada. There are many examples of countries that have failed to control the inflationary effects of exchange depreciation and have fallen victims to the vicious circle of an initial depreciation followed by more inflation, then more depreciation, and so on.

I have heard a certain amount of unhappiness expressed because of a feeling that our interest rates are tied to those of the United States. My reply to this is that to the extent they are so tied it is at our own choice. After all, we have had the choice of not following U.S. rates up and thus allowing the Canadian dollar to fall faster and further, with the risks that I have just referred to. We always have the choice of ignoring movements in U.S. interest rates if we think we can live with the consequences; in some circumstances it may be wise to do so, but in others it is not. In a situation where we are heavily dependent on inflows of foreign capital and when confidence in the Canadian dollar is still rather fragile in foreign exchange markets, opportunities to be able to ignore movements in U.S. interest rates are likely to be limited.

Before I end my remarks I want to pause for a moment to emphasize what the Bank of Canada has not been trying to do over the past two years in connection with the exchange rate. It has not been trying to prevent a substantial downward adjustment of the exchange rate over time, the need for which was readily accepted provided that the movement did not go too far too fast. It has not tried to defend some particular level of the exchange rate at all costs. On the other hand, the Bank has certainly not washed its hands of any responsibility for the behaviour of the Canadian dollar -- there was too much at stake for that. The fact of the matter is that the Bank has been following a middle course between these two extremes through its market intervention as the Government's fiscal agent and through its interest rate policy in order to try to keep the pace and scale of the exchange rate adjustment within reasonable bounds.

I want also to say a few words about how the Bank of Canada's more recent increases in Bank Rate -- especially that of 3/4 per cent effective October 16 and that of 1/2 per cent effective on Monday of this week -- fit within the Bank's basic policy of seeking to achieve rates of monetary growth within the target ranges that it announces from time to time. When we adopted that basic long-term policy we recognized the possibility that we might on occasion decide that we had to give high priority for a time to immediate problems of overriding importance. This is such an occasion and we have, for reasons that I have outlined, decided that we must give priority for a time to the need to maintain confidence in the

Canadian dollar in foreign exchange markets. We do, however, regard this shift in priority as temporary, and we expect that if there should be any significant departure of monetary growth from our target range in the months ahead it will be of sufficiently short duration as not to affect materially the longer-term strategy that we are following.

I am very much aware of the concern that has been expressed over the fact that the present high interest rates, so long as they last, will have a negative impact on domestic economic activity, and I recognize that this is so, but one must also recognize that the large decline that has occurred in our exchange rate is having a substantial positive impact on activity. In my judgment the alternative of allowing the differential between interest rates in Canada and in the United States to disappear or to become negative would in current circumstances cause us much more trouble, and trouble of a more permanent character, since it would put further strong downward pressure on the Canadian dollar with the inflationary consequences already described.

I believe that the steps that have been taken to deal with the exchange rate situation were sensible in the circumstances. It is hardly to be expected that a major adjustment in the value of a currency is likely to occur smoothly, and without any overshoot, in a world of floating exchange rates and unsettled economic conditions. The policies that have been followed, including the Bank Rate increases and the foreign borrowings of the Government

of Canada, have not failed; the pace and scale of the exchange rate adjustment have been moderated and the danger of a serious overshoot in a downward direction, with its inflationary effects, has been greatly reduced.

Let me conclude by saying that, although we in Canada have been going through a difficult period of adjustment, we have been making real progress and this is not the time to relax our efforts. A large exchange rate adjustment has indeed occurred, and we are now in a position to show the rest of the world that we are once again quite competitive. If we can also demonstrate continuing moderation with respect to increases in our labour and other costs, despite the short-run impact of exchange rate depreciation on consumer prices, we can claim to be back in business to stay. Much patience and fortitude will be required for success in this endeavour but I have no doubt that this is the only lasting basis on which to build Canadian prosperity.