Statement prepared for the appearance of

Gerald K. Bouey

Governor of the Bank of Canada

before the

House of Commons Standing Committee

on Finance, Trade and Economic Affairs

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I am glad to have this opportunity to explain the recent actions of the Bank of Canada to this Committee.

I think I know why you want to see me. You are concerned about the high levels reached by interest rates in Canada. You are disturbed about the effect of these interest rates on borrowers, both individuals and businesses. You are also disturbed about the effects of these interest rates on the near-term prospects for employment and growth in the Canadian economy.

There is no question but that interest rates as conventionally stated are very high. In terms of our history they are at record levels. The interest rate charged by banks on demand loans to prime borrowers is 13 3/4 per cent; other borrowers pay more. Housing mortgages are in the 13 1/4 to 13 3/4 per cent range. The interest yield on long-term Government of Canada bonds is about 11 1/2 per cent. Savings depositors can obtain rates in the neighbourhood of 11 per cent. I am not surprised that these rates have aroused a good deal of comment and criticism. Certainly anyone who looks no further than the immediate impact of the high level of interest rates is bound to feel concerned about what has happened.

I would like first to comment directly on these concerns and then go on to talk more generally about the economic and financial situation as I see it and what the Bank of Canada is doing about it.

With respect to the level of interest rates I would first like to remind you that "it takes two to tango". If there is a borrower there must be a lender, and one needs to look at the situation from his side as well. Lenders are usually thought of as banks or other financial institutions but it is more accurate to regard those institutions as intermediaries. The true lenders are the savers, the Canadians who hold deposits with banks, trust companies, credit unions and caisses populaires, who have life insurance policies, who contribute to pension funds and who own bonds. To lenders, interest rates do not look all that high because they know that the interest they receive is in effect reduced by the declining purchasing power of the money they have loaned and will eventually get back. Of course borrowers know this too; they know that the real cost of borrowing is nowhere near as high as the level of interest rates makes it look.

What I am saying here is that the nominal level of interest rates must be set against the rate at which inflation is reducing the value of money to discover the level of real interest rates. It is real interest rates much more than nominal interest rates that affect people's decisions, and thus the way the economy performs.

One problem with real interest rates is that of knowing what they are at any moment in time. The real interest rates that affect economic decisions are those obtained by adjusting current nominal interest rates by the future rates of inflation that people expect to occur. Since it is not easy to measure people's expectations it is not possible to be precise about what real interest rates are at any given moment or indeed were in past periods. One can, however, arrive at an approximate estimate of the real rates that prevailed in the past by adjusting historical interest rate levels for the associated rates of inflation. During this century it can I think be said that real interest rates in Canada have typically been in the range of 2 to 5 per cent depending on the degree of risk involved in the loan and its term to maturity. During periods of inflation they have often been well below that range, and in recent years they have sometimes turned out to be negative -- a state of affairs that could not reasonably be expected to last because it imposed no real cost whatsoever on borrowers and penalized rather than rewarded savers. Interest rates in Canada at present are presumably seen as being positive in real terms, but I judge from observing how borrowers act that in real terms rates are not seen as being extremely high. Real interest rates in Canada have typically been somewhat higher than in the United States because Canada has long been an importer of capital. The argument that real interest rates in Canada are higher than usual in relation to U.S. rates depends on the view that the outlook for prices in Canada -- including energy prices -- is not nearly as bad as in the United States.

Let me turn now to the other concern that I mentioned in my opening paragraph, namely the effects of current interest rates on the near-term prospects for employment and output in the Canadian economy.

There is a problem here and it is very important to understand its nature. No one who examines the matter can fail to see that the prospects for economic activity and employment in the months ahead are less than ideal, in part because of a probable short-term slowdown in economic activity in the United States. If this were our only economic problem we could concentrate on it alone, but it is not. We have another problem, and that is the threat posed to the future growth of employment and output in this country -- and in many other countries -- by yet another resurgence of inflation. This is a longer-term problem and in my opinion it is a much more serious one. Nor am I the only one who thinks so. The threat of inflation to the world's future economic prosperity was in fact the major theme running through the statements of the major industrial countries at the annual meeting of the International Monetary Fund, which I attended earlier this month. Declining confidence in the future value of money is threatening the future performance of almost all market-oriented economies because economies that use money cannot work well when the future value of their currencies is in serious doubt. The gold market has recently offered dramatic evidence of the expectation and fear of inflation that has developed around the world and the sight of Canadians lining up to buy gold is not reassuring.

If the objective of public economic policy is to seek conditions in the years ahead that are favourable to economic prosperity, then inflation must be fought and public expectations of high inflation must be reversed. The experience of other countries shows that if inflationary tendencies are not fought earlier they have to be fought later and that the later the battle is joined the more painful it is bound to be. Whatever the merits in earlier periods of taking policy risks only on the side of inflation, that approach has now become far too dangerous. With that approach inflation accelerated during periods of economic expansion, paused on a plateau when the economy slowed down a little, and then accelerated again. If pursued continuously that course could only lead to economic and social breakdown. I believe that we have gone as far along that path as we dare.

For some time now the Bank of Canada has been trying to improve prospects for the functioning of the Canadian economy in the years ahead by following a monetary policy directed towards resisting any acceleration of inflation and encouraging its gradual reduction. That policy has meant resisting inflation coming from external sources through our international trade and our foreign exchange rate as well as inflation generated or accommodated internally by the growth of money and credit. I should like to discuss these two aspects of the situation, starting with our international trade and the exchange rate.

Canada's external payments deficit on current account has been widening again this year and now appears to be running at a rate of

around $7 billion a year. Among the major industrial countries this is the largest current account deficit in relation to GNP and it may even be the largest in absolute terms. This is both disappointing and worrying in view of the fact that we have already had a large downward adjustment in the external value of our currency. That decline in our exchange rate has re-established our competitive position in the world. However, in many of our export and import-competing industries business has increased to the point where they are now operating at or close to existing capacity and thus have no further scope at present to exploit their new opportunities. Efforts by these industries to increase their productive capacity are underway but this will take time. Until these increases in productive capacity are achieved we shall not be in a position to reap the full benefits of our improved competitive position.

In the meantime the current account deficit must be financed one way or another. If it is to be financed without a further significant depreciation of the Canadian dollar, interest rates must be high enough in Canada to attract an adequate inflow of funds into this country and to discourage capital outflows. There may be periods when flows of funds in response to other incentives, for example, investment prospects in energy development, may be strong enough to allow short-term interest-rate spreads to be unusually low or even, for a time, non-existent or negative. But in circumstances where interest rates abroad are rising as rapidly as they have risen in recent months and where doubts remain

about the ability and determination of Canadians to avoid further exchange rate depreciation, the scope for Canadian interest rates to lag behind foreign rates is necessarily rather limited unless we want to invite yet further substantial depreciation of the currency.

Some people have suggested that the Bank of Canada should not worry about these interest rate relationships, that it would be preferable to try to hold Canadian interest rates well below current U.S. rates and allow the Canadian dollar to fall in the exchange market to whatever level this might involve. It is important to recognize what the consequences of such a course of action would be. Even if the Canadian dollar declined sharply in value it would take a long time for that change to have any major effect on the size of the current account deficit for the reason that I have already mentioned, namely, that few of our industries have the existing unused capacity to take advantage of such a change. In the absence of an adequate inflow of capital attracted by interest-rate incentives and because of the outflows that would be generated by a lack of confidence in the value of our currency, the Canadian dollar would have to decline far enough to convince investors that it had clearly become undervalued, at which point a short-term capital inflow could be expected to emerge and to check the decline. Meanwhile the price level in Canada would have been pushed even higher by the fall in the dollar and unless Canadians were prepared to accept the resulting decline in their living standards this in turn would

lead before long to a further acceleration of the wage-price spiral and a further weakening of the exchange rate. Once started, this vicious circle of exchange depreciation and rising inflation could be expected to continue until interest rates rose sharply enough to stop it.

In short, our internationally exposed industries are already in a strong competitive position and in present circumstances a significant further depreciation of the Canadian dollar would do much more harm than good. It would worsen our inflation problem and prejudice our economic prospects. I invite you to reflect on the fact that the countries displaying the best economic performance in the world today are those countries with strong currencies.

If you look over the record of the past two or three years I think you will agree that the Bank of Canada has not taken an extreme view of the need to resist exchange rate depreciation or of the need to maintain wide interest rate spreads against the United States. On the contrary we have already had a very substantial downward adjustment in the exchange value of the Canadian dollar, most of which had become necessary owing mainly to the relatively high rate of inflation experienced in Canada earlier in the decade as compared with countries like the United States.

I turn now from the external aspect of our economic situation that makes us highly vulnerable to a further worsening of inflation to the internal aspect. As I have said, the Bank of Canada has had both very much in mind in its recent conduct of monetary policy.

The year-on-year rate of increase in the Consumer Price Index in Canada has now reached 9.6 per cent even with a lull in the steeply rising trend of food prices. We still have to face up to the need to bring domestic energy prices much closer to world levels and for some time wage settlements have clearly been on the rise again. While in recent months we have certainly been experiencing strong upward pressure on our price level from external sources, this is by no means the whole story.

I have noted that an important factor in our economic situation is the fact that many of our industries are operating uncomfortably close to capacity. In present circumstances we are much closer than is generally recognized to a situation in which most firms and industries, because they can readily sell just about all they can produce on a profitable basis, see little risk in incurring large cost increases or in posting large price increases. I am aware of the possibility that these demand pressures on capacity may begin to moderate over the period ahead and that, as markets become more competitive, firms will be under greater pressure to hold down their costs and prices. But in some degree this is precisely what has to happen if inflation is to be checked -- and it has not happened yet.

The inflationary potential in the present situation is greatly increased by the fact that Canadians have become highly sensitized to fears or expectations that inflation cannot or will not be held in check for long and is therefore bound to get worse. The danger is that these inflationary expectations will be reflected in the price and wage behaviour of Canadians and thus will turn out to be self-fulfilling. This would give us the worst of both worlds -- rising unemployment caused by rising inflation.

There are of course other aspects of our internal economic situation that have an important bearing on our current and prospective rate of inflation. There is the special problem of energy prices but on the other hand there is also the prospect that some slowing of the near-term pace of economic activity in the United States -- and to a lesser extent in Canada -- will moderate somewhat the recent degree of inflationary pressure. But with due allowance for all the possibilities there does not seem to me to be any justification for public policy to take any risks on the side of inflation in the foreseeable future.

This view seems to me to be confirmed by what is going on in the area for which I carry direct responsibility, namely, in the field of money and credit. The growth of money and credit in Canada has been remarkably strong and persistent for more than a year and would no doubt have been even more rapid had it not been for the steep rise in interest rates during this period. The trend rate of increase of the money supply on the narrow definition, currency and demand deposits (or M1), has averaged

about 9 per cent a year since mid-1978 as compared with the Bank's target range of 6 to 10 per cent. Broader measures of the money supply have been increasing at higher rates both in absolute terms and by comparison with their rates of growth through much of last year. So far this year the chartered banks' general loans have risen at an average annual rate of around 25 per cent, with the business loan component rising even faster. While at the time balance of payments considerations played an important role in the successive increases in the Bank Rate since the spring of 1978, it has now become clear from subsequent experience that a substantial rise in interest rates was also needed in order to contain the rapidly expanding demand for money and credit in the domestic economy.

To sum up, it is my view that the actions taken by the Bank of Canada constitute a reasonable and prudent response to the potential inflationary damage that would be inflicted on the Canadian economy by a failure to resist both further exchange depreciation and the continued rapid expansion of money and credit.

This brings me to the end of what I have to say in explanation of the Bank's recent monetary policy but before I conclude I would like to deal with a number of matters related to our actions that seem to puzzle many people.

First, as I have become very much aware, it is not generally understood that when money and credit are in strong demand there are no

means open to the Bank of Canada within its existing powers to limit their expansion which do not involve at least a temporary rise in interest rates. This is because a slower expansion of the supply of money and credit in these circumstances will not of itself do anything to produce a correspondingly slower growth in the demand for money and credit; interest rates must therefore adjust to higher levels to bring the demand down into balance with the reduced supply. The sequence in which these adjustments occur -- whether the central bank restrains the growth of money and credit with the consequence that interest rates rise or brings about a rise in interest rates with the consequence that the growth of money and credit slows -- can run either way. It is necessary, however, to recognize that these two developments are inextricably linked.

This still leaves the question -- could a way not be devised for controlling the expansion of money and credit which did not involve higher interest rates? As is true for all goods and services, the main alternative to allocating credit by price (interest is the price of credit) is some form of direct controls. Such a system would require detailed decisions as to which classes of borrowers should be able to obtain funds from which financial institutions and for what purposes and in what amounts. Measures would also have to be taken to ensure compliance. Moreover, steps would have to be taken to make sure that savers and investors did not divert funds to foreign markets to earn a better return and this would involve a comprehensive system of foreign exchange controls. Direct

controls on consumer credit and exchange controls have been used on occasion in Canada, mainly during World War II, but experience with such controls has led Canadian governments to avoid them if possible and, for my part, I would be opposed to proposals to use them in current circumstances. A major problem with direct credit controls is that they would not help to ensure an adequate inflow of capital into Canada, which requires sufficiently high interest rates to attract the needed funds; indeed, because such controls would require restrictions on capital outflows, they might well have the effect of discouraging capital inflows.

Another question that frequently arises is how can a rise in interest rates help bring down the rate of inflation when the higher rates themselves obviously add to the costs of doing business? The answer is that this effect is only part of the total effect of a rise in interest rates on costs and prices in Canada and by no means the most important part. A rise in interest rates discourages borrowing and spending. This brake on spending causes markets for goods and services to be less buoyant and more competitive than they would otherwise be with the result that businesses find it more difficult to raise their prices. The rise in interest rates thus increases the pressure on business to hold down its other costs of production, including labour costs, as well as its profit margins and prices. These same influences should also operate in turn in the direction of causing employees to moderate their demands for higher money incomes. In addition, the rise in interest rates helps to maintain the foreign exchange value of the Canadian dollar and it therefore helps to protect business firms and others from the higher

prices and costs of internationally-traded goods that would result from a lower exchange rate. It is because of all of these influences that one must look beyond the immediate impact of higher interest rates on business costs to understand their restraining effect on the rate of inflation.

I want to conclude my remarks by reminding you that our main job at the Bank of Canada is to exercise control over the quantity of money and credit supplied to the Canadian economy through the operations of our banking system. The performance of this monetary control function sometimes involves courses of action which are neither easy nor pleasant. That is certainly the situation we have been faced with in recent months. However, Parliament did not establish the Bank of Canada with the expectation that it would avoid unpopular decisions. The Bank was given a considerable measure of independence so that it would not succumb to the pressures of the moment but would rather be guided by the longer-term interests of the economic life of the nation.

Mr. Chairman, we are at a crucial stage in the fight against inflation. I think it can be said that we have reached a crisis of credibility in this matter. Do we continue the battle or do we forget about it for a time because we fear a period of slower economic growth? If we continue the battle we must be prepared to do those things that are necessary to restore the faith of people in the future value of our money. That can be done if we have the will to do it. That path will not at times be easy, but I assure you with confidence that it will not be nearly as unpleasant a path

as we shall quite soon find ourselves traversing if we decide to try to opt out of the battle against inflation. If we stay with it we have a very good prospect of emerging from a period of slow growth with a solid basis established for an efficient non-inflationary, highly competitive economy -- with high employment and a strengthening external position. These are the conditions that will allow interest rates to be considerably lower than they are now. These are the objectives that the Bank of Canada is pursuing in its area of responsibility.