NOT FOR PUBLICATION BEFORE: 1:30 P.M. IN WINNIPEG 2:30 P.M. IN OTTAWA
APRIL 8TH, 1980

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REMARKS BY
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GOVERNOR OF THE BANK OF CANADA
TO
THE CANADIAN CLUB OF WINNIPEG
WINNIPEG, MANITOBA
APRIL 8TH, 1980

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to
The Canadian Club of Winnipeg
April 8th, 1980

Each year my Annual Report to the Minister of Finance is published about the third week in March. Since that report is mainly devoted to an up-to-date account of the monetary policy that the Bank has been following, I do not usually feel the need to comment further on the subject for some time. However, this year is different. A great deal has been happening on the monetary scene since my report was written in the latter part of February and I am glad to have this opportunity to explain what we have been doing in recent weeks. But to provide a background to these most recent developments I will begin by summarizing briefly the main themes of my Annual Report.

In 1979 there was a marked intensification of inflationary pressures on the Canadian economy. In part these pressures were of external origin. Inflation was on the rise in most of the world's main trading countries, and the rise was very pronounced in the United States. This had extremely unsettling effects on expectations -- as evidenced in no uncertain terms in world markets for precious metals and other commodities -- and it spilled over into Canada through our foreign trade,

notably through a 15 per cent annual rate of increase in the costs of the goods we import. We could not do much about other countries' domestic inflation, but we tried to guard against allowing a further substantial decline in the external value of the Canadian dollar since that would magnify the effect of rising prices abroad on our own cost and price performance.

In part the increase in inflationary pressures in Canada in 1979 was of domestic origin. The domestic economy was hard pressed to keep up with the demands for goods and services that were being placed upon it. Unusually high operating rates in relation to existing capacity were characteristic of a broad range of our industries. Total employment in Canada grew very rapidly indeed across all segments of the labour force and labour markets tightened in most parts of the country, above all for skilled workers. These conditions greatly weakened any effective resistance to the spread of cost and price increases across markets and across industries; indeed, they added to the inflationary pressures coming from external developments.

In this climate, the Bank came to the view in the second half of 1979 that there was no responsible alternative to sizeable increases in short-term interest rates in Canada. The monetary aggregate on which the Bank puts the primary emphasis, currency and chartered bank demand deposits or M1, was growing vigorously after a brief pause early in the year. Credit demand was persistently very strong throughout 1979, as

were the rates of expansion of the broader monetary aggregates. The concern generated by these signs of the strength of demand for money and credit was strongly reinforced by the downward pressure exerted on the Canadian dollar by the sharp increases in U.S. short-term interest rates that began in July. In these circumstances the need for higher short-term interest rates in Canada was very obvious. Not to have acted, and acted promptly, would have meant running a serious risk of further worsening an already dangerously inflationary situation. At the same time we were concerned that the rise in Canadian interest rates be no sharper than required. In the event, short-term interest rates rose somewhat less in Canada during this period than corresponding rates in the United States, and traditional interest differentials between similar instruments in the two countries narrowed or disappeared completely.

All this is spelled out in my Annual Report. But even as that report was being finished in the latter part of February it was apparent that the somewhat steadier conditions that had emerged in U.S. financial markets around the end of 1979 had come to an end. The astonishing sequence of interest rate increases in the United States that we have witnessed in recent weeks got underway in some areas of the market well before the second half of February. Bond yields in the United States rose steeply through January and most of February and here in Canada the bond market moved in much the same way. Except in financial markets these

developments did not seem to attract much attention in Canada, perhaps because they involved no press releases, no announcements of Bank Rate or prime rate increases. It is clear, however, that they were of cardinal significance, representing a fundamental shift of attitudes about economic prospects.

The drastic rise in U.S. bond rates was a direct reflection of rapidly spreading pessimism in that country about the prospects for any early relief from steadily worsening inflation. A troubled international situation, the prospect of increased defence outlays and larger budget deficits, an economy that in any case seemed virtually impervious to the measures of financial restraint already taken the year before -- all these factors combined to strengthen the view that longer-term interest rates were simply too low to be realistic in relation to what lay ahead. Strongly held fears and expectations of higher inflation to come already appeared to characterize the behaviour of U.S. consumers. They had for some time sharply curtailed their willingness to accumulate new financial savings in the face of inflation rates that outstripped the return they could hope to get on their savings and that made it a good bet to buy earlier rather than later. It might be added that the increasingly widespread vogue of multiplying one month's price increase by twelve to get an annual inflation rate has not helped matters. On this basis, the exaggerated notion that the basic trend of U.S. inflation has gone up to almost 20 per cent a year has unfortunately gained widespread currency.

Since mid-February U. S. short-term interest rates have again risen explosively. The spiral started on February 15th with an increase in the discount rate of the Federal Reserve System from 12 per cent to 13 per cent. By February 19th major U. S. banks had raised their prime rates from 15 1/4 to 15 3/4 per cent. But that was just the beginning. Increase followed increase in short order: on February 22nd to 16 1/4 per cent; on February 29th to 16 3/4 per cent; on March 3rd to 17 1/4 per cent; on March 7th to 17 3/4 per cent; and on March 13th to 18 1/4 per cent. On March 14th the U. S. Administration and the Federal Reserve introduced a set of additional fiscal and credit measures designed to offer increased resistance to inflation. The fiscal measures were mainly aimed at eliminating the budget deficit while the package of controls on credit and other financial transactions was chiefly directed towards reining in consumer spending and speculation financed by credit. On March 18th, with financial markets coming under continued pressure, the prime rate moved up to 19 per cent. On March 28th it moved to 19 1/2 per cent and on April 2nd to 20 per cent. At that point it had jumped by almost 5 percentage points in six weeks.

At bottom, this chain of developments was the result of a widespread erosion of confidence in the future value of money which resulted in vastly increased uncertainty in U. S. financial markets. Since no one could be sure how strong the inflation psychology had become no one could be sure how high interest rates would go.

Some Canadians are tempted to sit back and regard the situation in the United States with some detachment. After all, they say, has not our recent consumer price performance been distinctly better than theirs? The fact of the matter is that this impression of inflation in Canada being less severe than in the United States is more apparent than real; there is not much in it when account is taken of the much greater extent to which the United States has adjusted to higher energy prices and of certain peculiarities in the treatment of housing costs in the U.S. consumer price index. Furthermore, neither industry price nor labour cost statistics suggest that Canada's trend rate of inflation might be below that of the United States. Surely no one would assert that our public sector finances or our balance of payments position are in better shape. If our performance in controlling inflation was believed by investors to be much better than that of the United States, the Canadian dollar would be much stronger than it is.

I now want to address in some detail the market situation faced by the Bank of Canada at the beginning of March. For some time previously we had been getting by with short-term interest rates that were no higher and quite often lower than those in the United States. For example, the prime loan rate of the Canadian banks had been 15 per cent since October -- whereas the prime rate of American banks had risen to 15 1/4 per cent by mid-February and to almost 17 per cent towards

the end of that month. But the Canadian dollar had nevertheless shown unusual strength in exchange markets for a number of weeks up until early March partly because of an unusually favourable trade performance but also because of a strong inflow of capital related to investment in our resource industries. This was apparently due in large measure to the enhanced prospects for major oil discoveries off Newfoundland. How long this inflow would continue and how strong it would be was of course completely unpredictable. What was sure was that it would vary with rumours and progress reports on drilling by the oil companies concerned.

To those uncertainties were added others. It had been indicated in advance that fiscal and credit measures aimed at redressing the situation in the United States would be introduced before long, but one did not know the precise timing of these measures, their nature, or what impact they might have on financial markets. The foreign exchange market in particular was being affected by these uncertainties. Indeed, it seemed impossible to pick a Bank Rate that could be counted on to be appropriate in relation to foreign exchange and money market conditions for more than a very short period.

In this extraordinarily fluid situation the Bank of Canada came to the view that it needed to be able to react to developments more quickly, and with more flexibility, than was possible with a fixed Bank Rate

system. To set a Bank Rate that we could at least have hoped would remain unchanged for some weeks would have meant fixing it very much higher. On Monday, March 10th, the Bank of Canada announced that the Bank Rate would be allowed to float, that is, that it would be set each week at 1/4 percentage point above the latest average rate established in the weekly auction of 91-day Treasury Bills issued by the Government of Canada. This new system went into effect on March 13th when the next Treasury Bill auction was held.

The advantages of having a floating Bank Rate in periods like the one we have been passing through recently were demonstrated rather clearly in the first week of the new system's operation. On the basis of the results of the Treasury Bill auction on March 13th the Bank Rate moved up slightly from its earlier fixed level. But barely more than an hour after the bids were submitted a major U.S. bank announced a further 1/2 percentage point increase in its prime rate to 18 1/4 per cent and during the next day this new higher level became general. In the face of the associated rise in U.S. money market rates the exchange value of the Canadian dollar began to weaken, particularly at the start of business on Monday, March 17th. With the flexibility of a floating Bank Rate it was possible for the Bank to permit a prompt rise in Canadian money market rates, including the Treasury Bill rate, to stem the downward pressure on the Canadian dollar. Under the previous fixed Bank Rate regime

this change could not have been effected so promptly nor so flexibly since it would have implied a decision to move to a new, higher Bank Rate that could be expected to remain in effect for at least a few weeks.

Although the move to the floating system has been regarded by some people as an effort on the part of the central bank to minimize its share of responsibility for the level and movement of short-term interest rates, the fact of the matter is that the Bank of Canada acknowledges every bit as much responsibility for short-term interest rates under this new system as under the former one. This was stressed in the press statement accompanying the announcement of the new system. What we do not answer for is the state of the world. A prime rate of 20 per cent in the United States was not brought about by the Bank of Canada and it is not our responsibility. We do, however, accept full responsibility for the way in which we are trying to cope with the problems that confront this country in the world as it is these days.

The particular way in which the Bank Rate is set is not an important factor in our present difficulties. Our real and immediate problem is not one of technique. It is that short-term interest rates in the United States have risen far above ours. Sometimes it is charged that Canadian monetary policy is made in Washington. It is not. But Canada has not severed its connections with the outside world either, and if U.S. interest rates rise to extremely high levels there is no point in

pretending that we remain unaffected in any way. There are no restrictions on the flow of funds across our border. If interest rates in the United States are so much higher than ours that funds are attracted or diverted from Canada the result will be downward pressure on the exchange value of the Canadian dollar. The lower the Canadian dollar, the higher will be our import costs, over and above the rise in these costs due to soaring prices in the United States. This, while unwelcome, is only part of the real danger. The real danger, one that it would be folly to ignore in present conditions, is that strong additional price pressures from this source would have a pervasive and cumulative impact on inflationary expectations and on wage and price behaviour in Canada. They would give fresh impetus to the inflationary spiral. Instead of merely trading off a lower Canadian dollar in exchange for lower interest rates, we would quickly find ourselves faced with more rapid exchange rate depreciation, more rapid inflation, and before long with even higher interest rates; in short, our economic problems would quickly get worse. To believe otherwise is merely wishful thinking.

I know the argument that the risk of higher inflation from a lower Canadian dollar is a risk that has to be taken in the interests of improving the competitive position of Canadian industry. However, by any reasonable standard most of our industries are already in a strong competitive position internationally. As discussed in detail in my Annual Report, the actual situation of Canadian industry is much more

clearly one of needing additional capacity to produce than one of needing more exchange depreciation to enhance its price and cost competitiveness. Thus any potential benefit to our balance of payments from a lower Canadian dollar would likely be at best small and delayed. By the same token its impact on our domestic prices and costs would be correspondingly large and quickly felt.

The Bank of Canada is aware that sharp increases in interest rates are painful to many Canadians, including mortgage borrowers, farmers and small businesses. It is also aware, of course, that interest rates which are not high enough to compensate for inflation are painful to the even larger number of Canadians whose savings provide the funds for borrowers to spend. The Bank has been trying to steer a course through an extraordinary and highly unpredictable situation in a manner that is designed to minimize the increases in interest rates required to curb inflation in Canada. We are not operating monetary policy on the basis of some preconceived view of the appropriate relationship of interest rates in Canada and the United States. We are aware that there are some other flows of funds that are not particularly sensitive to interest rates that may help us, in the same way as the strong inflow of capital related to the oil industry helped us up to a short time ago. We may see a resumption of that kind of inflow and other inflows as well. Foreign investors who take a long-run view of the Canadian economy, which

because of its energy and other resources looks to them like one of the most favoured places on earth, may provide some underlying support for the Canadian dollar so long as they retain confidence in the way we manage our affairs. Even in the present difficult period there has been evidence of investment by foreigners in long-term as well as short-term Government of Canada Canadian dollar bonds. Moreover, U.S. interest rates may not stay at such extremely high peak levels for long and this should give pause to those who are tempted to take a strong position against the Canadian dollar. These are some of the cross-currents in the troubled waters through which we must steer.

Within the possibilities available to the Bank of Canada in these difficult circumstances, I do not know of a better course than the one we are pursuing. I know that it is unpleasant, but I hope that Canadians will take some encouragement from the probability that the present extraordinary situation will be short-lived and from the fact that facing up to unpleasant decisions now is the road to lower inflation in Canada in the months to come.

I conclude my remarks by reminding you that it is inflation that poses the greatest threat to our society at the present time. Whatever problems each day brings we must never forget that. Because inflation is so harmful to the nation as a whole we must think of the welfare not only of particular groups of borrowers but of all 23 million Canadians.

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