A Statement by
Gerald K. Bouey
Governor of the Bank of Canada
At a Meeting of the
Federal and Provincial Ministers of Finance
Ottawa, Ontario
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I welcome the opportunity to be present at this Federal-Provincial meeting of Ministers of Finance and to respond to any questions you would like to raise about the monetary policy that is being followed in Canada. Before doing so I thought a brief introductory statement might be helpful.

My statement falls into two parts. The first part addresses the immediate problems posed for Canadian monetary policy over recent weeks, as a result of the very steep run-up of short-term interest rates in the United States and the associated downward pressure on the Canadian dollar. The second part deals more broadly and in longer term perspective with the basic policy being pursued by the Bank of Canada.

Over the past two months short-term interest rates in the United States have shot up. The prime lending rate of U.S. banks, which was 13 1/2 per cent on October 16, rose in rapid steps to 17 per cent on November 21 and to 21 per cent yesterday. Money market rates in that country are approximately double the level of last July.

The recent upsurge of short-term interest rates in the United States to extremely high levels is part of a pattern of extraordinary interest rate volatility in that country during 1980. No doubt you will recall that U.S. rates shot up to much the same extremely high levels last spring, and then plunged with equal rapidity to extremely low levels early in the summer. I welcome the determination of the U.S. authorities to fight inflation but such wide interest rate gyrations in the United States, whether to extremely high or to extremely low levels, pose very difficult choices for monetary policy in Canada.

In the present case, the rapid run-up of U.S. short-term rates to such high levels is bound to have a major impact on Canada through increases in interest rates here or through a fall in the foreign exchange value of the Canadian dollar, or some combination of the two. The problem does not originate in Canada and the Bank has no way of dealing with it that will not affect either the level of interest rates or the exchange rate or both. The Bank of Canada could, if it chose, try to resist firmly the upward pressure on Canadian short-term interest rates exerted by steeply rising interest rates abroad and accept the inflationary repercussions on our own economy of a sharp decrease in the foreign exchange value of the Canadian dollar as investors responded to the widening gap between interest rates in this country and the rates obtainable south of the border. On the other hand the Bank of Canada could, if it chose, firmly resist any downward

pressure on the Canadian dollar by ensuring that short-term interest rates in this country rose as fast and as far in relation to rates abroad as might prove necessary for the purpose. In fact the Bank of Canada has chosen a course of policy which lies between these two extremes. Canadian short-term interest rates have risen considerably, though not nearly as fast or as far as comparable rates in the United States. Back in July short-term rates were roughly 2 per cent higher in Canada than in the United States; currently they are 3 to 4 per cent lower in Canada than across the border. So much for the allegation that it is Bank of Canada policy to force Canadian interest rates to move in lock-step with U.S. interest rates. Over the same period the foreign exchange value of the Canadian dollar has declined from around 87 1/2 cents U.S. to as low as 82 1/2 cents yesterday morning. So much for the allegation that Bank of Canada policy is to keep the Canadian dollar at some predetermined level.

The reason why there is a very real limit to how far the Bank of Canada can prudently go in present circumstances in insulating the Canadian interest rate structure from steeply rising interest rates abroad and accepting the exchange rate consequences of such a policy is the danger of making our already severe inflation problem considerably worse. It would not be safe to assume that the consequent decline in our dollar, or the high U.S. interest rates that precipitated it, would be quickly reversed. We could expect the domestic prices we have to pay for our

imports and for the export-related commodities we consume here in Canada to rise before long by a substantial proportion of the percentage decline in the foreign exchange value of the Canadian dollar. In Canada's current environment of highly-charged fears and expectations of worsening inflation, a substantial jump in prices that raised our present double-digit inflation rate even higher would be likely to trigger off a further escalation of wage increases. Thus whatever competitive advantage our export and import-competing industries might gain from further depreciation of the Canadian dollar could quickly be eroded by a further escalation of their on-going labour costs. The risk of such an outcome may be somewhat lower now than it was a year ago when most of these industries were pressing against the limits of their productive capacity, but it is still very real. The end result, in all probability, would be to compound our inflation problem with little or no lasting benefit to our near-term growth prospects.

I believe that the course of action followed by the Bank of Canada in response to the recent upsurge of U.S. interest rates has been both moderate and responsible in all the circumstances. The day is long past for running serious inflationary risks in our economic policies here in Canada. If the only responsible options left to us are ones that are both unpleasant and unpopular, we had better face up to that fact.

This brings me to the second part of my introductory comments. For several years now the basic objective of Canadian monetary policy has

been to moderate gradually over time the pace of monetary expansion. This policy approach is based on a conviction that whatever else needs to be done to reverse the drift into ever-deepening inflation, no strategy for doing so will succeed unless it is supported on a continuing basis by firm control over the process of monetary expansion.

How has this policy approach worked out in practice? The trend rate of increase of the money supply and of total spending has indeed been moderating, although at times the pace of progress in this direction has been less steady and more gradual than intended. Over the past one and a half years money supply growth has been in a range of 5 to 9 per cent (annual rates), well below the rates of increase seen earlier in the 1970s which at times reached 15 per cent a year. Total spending in the economy (that is, the dollar value of gross national expenditure) has risen by about 9 per cent over the past four quarters, a rate of growth well below that of the previous four quarters and much below the rates of up to 20 per cent a year seen earlier in the decade. To date our inflation rate, however, has not moderated correspondingly. After falling back for a time a bit below the double-digit rates reached a few years ago, as measured by the Consumer Price Index, it has since turned upwards again and over the past twelve months has been in excess of 10 per cent.

The fact that our inflation rate is still as high as it is in spite of the moderating trend of money supply growth and total spending

in the Canadian economy is interpreted in some quarters as evidence that the monetary policy approach we have been following is not working. I believe this view to be mistaken. It seems to me that what has happened is that the mild and gradual downward pressure on prices stemming from our efforts to moderate monetary growth and spending has been exceeded for the time being by the strength of upward pressures on costs and prices from a number of other sources. Although a temporary reverse of this kind can happen, and seems to have happened, I am confident that firm persistence with the monetary policy we are pursuing will help to offset the impact of these particular pressures on the over-all price level, and will lead in time to a renewed decline in our over-all inflation rate.

Some of the sources of recent strong upward pressure on the price level that I have referred to are not difficult to identify. Over the past year or two much higher rates of price inflation in the United States and abroad, taken in conjunction with the recurrent weakness of the Canadian dollar, have resulted in rates of increase in the prices we pay for a wide range of export-related commodities and imports (other than subsidized oil imports) well in excess of those for most other goods and services. The special problems of world energy and food supply and prices in relation to the trend of prices in Canada are well known; they have also worsened considerably over the past year with no early relief in sight. The fact that the output capacity of the Canadian economy, like that of most other industrial countries, has not been growing nearly as fast

as it used to because of the slowdown in productivity helps to explain why many of our industries began to press against the limits of their productive capacity in 1979 and to generate larger and persisting price and wage increases. These particular sources of upward pressure on the price level have been reinforced by fears and expectations that inflation is out of control and bound to get worse -- fears and expectations that feed directly into wage and price-setting behaviour and that in the short-run tend to become self-fulfilling. These are some of the powerful forces working against the anti-inflationary influence of gradual monetary restraint.

What moral should be drawn from the experience we have had with monetary policy over recent years? First, I believe that we could have made more progress against inflation, in spite of these upward pressures on the price level, if the monetary policy followed had been less gradual -- if the pace of monetary expansion had been brought down more promptly and steadily and if, to this end, interest rates had been allowed to rise faster and further at an earlier stage. An important corollary to this conclusion is that an easier monetary policy than the one actually followed would have resulted in a still higher rate of inflation than we are now experiencing. Another conclusion that might be drawn with the benefit of hindsight is that it would have been useful to reinforce the monetary policy that was actually in place with stronger anti-inflationary action in other areas of public policy to the extent that this was feasible. We must recognize that if inflation is to be brought under control demand management policies,

including monetary policy, must be pressed to the point where markets for goods and services are not buoyant enough to allow prices to be raised rapidly even though this may mean, at least for a time, more slack in the economy than we would like to see.

The problem of reducing the rate of inflation in Canada has turned out to be more difficult than I had hoped five years ago that it would be, and in that sense I am disappointed. But insofar as monetary policy is concerned, Canadian experience underlines the necessity of continuing firm restraint, and that is the policy that the Bank of Canada intends to follow. We welcome all the help that we can get in the struggle against inflation. The most effective form of help is for all other groups in the community, including governments, to conduct their own affairs in ways that help to reduce cost and price inflation.