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REMARKS BY
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TO
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Remarks by
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to The Empire Club of Canada
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When I appeared before the Standing Committee of the House of Commons on Finance, Trade and Economic Affairs two weeks ago I was impressed by the fact that there are advantages in a forum where the speaker replies to questions because he can then be confident that at least some of his audience are interested in what he has to say. That format helps to deal with the problem of relevance that all speakers face. It avoids the pitfall into which economists have long been accused of falling, namely, answering questions that no one has asked. The risk is, of course, that the speaker may find himself faced with questions that he doesn't quite know how to answer. It has occurred to me that at this luncheon of The Empire Club perhaps I could go some distance towards a Question and Answer format, but with typical central bank caution I myself am going to choose the questions from among those that are frequently asked that I would like to answer today. That seems fair enough to me! So let us proceed.

The first on the list of questions I am asked these days is: Why are interest rates so high? Answer: The basic reason why

interest rates are so high is that current and expected rates of inflation are so high. If you make allowance for the current rate of inflation, interest rates are not in fact unusually high. If you deduct the percentage increase in the Consumer Price Index over the last twelve months, 10.7 per cent, from current interest rates in order to obtain an approximation to "real" interest rates, what you get is 4 to 5 per cent on mortgages, 3 to 3 1/4 per cent on prime commercial bank loans and about zero to one per cent on short-term savings instruments. Interest rates are thus not so high as to provide savers with a large real return before taxes or in many cases with any real return at all after taxes. They are not so high as to discourage borrowers who expect continued high rates of inflation. I am, of course, aware that they are painful to other borrowers who did not expect to have to pay such high rates.

Another question is: Why doesn't Canada have a more independent monetary policy so that interest rates here don't have to move so closely in lock-step with those in the United States? I am inclined to answer that one with another question: Haven't you noticed what has happened this year? Even a cursory comparison of the movements of interest rates in the two countries shows that they have followed quite different paths at times. This year money market interest rates have sometimes been over 4 percentage points higher in Canada than in the United States and at other times over 3 percentage points lower. In recent weeks they have been 1 to 2 percentage points lower. More often than not in the past year the banks' prime lending rate in Canada has been lower than that in the

United States. The Canadian prime rate has ranged from 1 3/4 percentage points higher to 3 percentage points lower than the U.S. rate. At the time these remarks were prepared it was 1 1/2 to 1 3/4 percentage points lower. Spreads between bond yields in the two countries have also varied considerably. Thus Canada is by no means the 13th Federal Reserve District. If further evidence is desired, ask yourself what Federal Reserve District has experienced a decline in the value of its currency relative to other Districts of some 17 per cent in the last four years. I do not mention that particular piece of evidence with any pride, but it is convincing.

The real issue here is not how much interest rate movements in Canada can diverge from those in the United States but how much they should diverge. The exercise of policy independence in this area involves a price. Where on balance does the Canadian interest lie? That is the question. This year the Bank of Canada has felt that the Canadian interest was best served by more moderate swings in interest rates than those that have occurred in the United States; even so, interest rates here have still been quite volatile for much the same reason as in the United States, namely, because the public's views about the inflation outlook have fluctuated so widely in response to the latest news about the economy. The extent to which the Bank of Canada feels that it should moderate these upswings in interest rates is limited by its concern about the inflationary consequences of further significant depreciation of the Canadian dollar and excessive monetary expansion.

What I have said so far will not prevent people from asking the question: Why is the Bank of Canada so concerned about inflation rather than unemployment when the economy is in a period of recession or slow growth? The answer is that the Bank's concern about inflation arises directly out of its concern for unemployment and real incomes. We in the Bank believe that the greatest threat to future economic welfare and employment growth in this country is inflation. We must not jeopardize our longer run chances for growing employment and output by putting aside our concern about inflation in the period immediately ahead. This point was made rather well by the Managing Director of the International Monetary Fund on September 30th when he addressed the annual meeting of that institution. May I quote a couple of excerpts in which he discussed two possible scenarios that the IMF had studied.

> "Assume first that industrial countries persist in their fight against inflation. Given the present very high rates of inflation in quite a few of these countries, this implies that they accept for some time a reduction in the growth of their nominal demand. It may be expected, on this hypothesis, that inflation in the industrial world gradually decreases, that the average rate of growth of real GNP advances from a low level, and that the recycling problem proves manageable. This scenario is certainly not ideal, as it would entail an increase in economic slack. It would, however, restore by the mid-1980s an environment conducive to sustained long-run growth..."

> "Our second scenario supposed that demand management policies make an early shift toward expansion. Growth rates might improve markedly for a year or two, but inflation would flare up again and upward pressures on the price of oil

> would intensify. A new shift toward severe restraint of demand would probably then occur, bringing about a fall in rates of economic growth. Those countries with weak external positions would see them deteriorate even further and, toward the middle of the decade, recycling problems would become very serious. Several years would have been lost in the fight against inflation, and inflationary expectations would become even more deeply entrenched..."

The remarks of the Managing Director are related to another question and this time it is one that I want to ask you. Inflation did not used to be a problem in peacetime. What was it that controlled inflation then? Before anyone jumps up to respond to that question I will, as promised, answer it myself. In the past inflation was controlled by the discipline of market forces working in an economic environment where the pressure of demand in markets was only rarely so strong that prices of goods or services could be raised easily and rapidly. What prevented rapid inflation was the fact that any typical business that raised its prices significantly risked the loss of business to its competitors. If they were to survive employers simply had to keep their costs -- including their labour costs -- from rising, and employees could not press too hard for wage increases if they expected their employer to stay in business and their jobs to continue to exist. That is what controlled inflation. That's all there ever was outside of very brief periods of price and wage controls. That's what keeps inflation from getting worse now. This is not to say that no steps could be taken to raise the level of activity at which the Canadian economy can operate without generating higher inflation, and I will

come back to this point. It simply means that inflation will never be controlled as long as the over-all level of spending in the economy is allowed to grow so rapidly that markets can readily absorb large price and cost increases.

The statement that I have just made is really the answer to my next question: Where does monetary policy come into the picture? Monetary policy is mainly a matter of controlling the rate of monetary expansion and thereby affecting the over-all level of spending on goods and services in the economy in an impersonal way. The link between the rate of monetary expansion and the over-all level of spending is interest rates. Interest rates are determined by the interplay of many economic forces including the rate at which the Bank of Canada permits monetary expansion to proceed. Higher interest rates tend to discourage spending; lower interest rates tend to encourage it. Changes in the over-all level of spending in turn give rise to some combination of change in real output and change in the price level.

The extent to which a change in the level of spending is reflected in a change in the price level depends heavily on the level of activity in the economy relative to its effective productive capacity. What level of activity and employment in the economy is compatible with a declining trend rate of inflation? The answer depends fundamentally upon the responsiveness of prices and costs to changes in the over-all level of spending,and that responsiveness depends in turn upon the flexibility of the existing arrangements and practices for setting prices and costs. The more unresponsive price and cost increases are to a moderation of spending pressures in the

economy, the lower the level of activity must be for inflation to subside. Thus anything that can be done to make prices and costs more sensitive to a moderation of spending pressures is very desirable because it will reduce the adverse short-run impact of anti-inflation policy on real output and employment. Indeed a country that depends heavily on market-oriented policies such as monetary and fiscal policies has an obligation to concern itself with how well its markets work.

What are the factors that tend to make cost and price increases unresponsive to a slower growth rate of total spending? There are many such factors. The one that I would put at the top of the list is expectations of future inflation. Strong inflationary expectations reduce the responsiveness of price and cost increases to slowing growth of the over-all level of spending and thereby reduce the level of output and employment unnecessarily during the transition to lower inflation. That's why the need to grapple with inflationary expectations is such an important aspect of anti-inflation policy. That is why it is so important that public policy, including monetary policy, be firmly committed, and be seen to be firmly committed, to reducing the rate of inflation.

There are other factors that also reduce the sensitivity of prices and costs to a moderating trend of total spending. There are sectors of the economy that public policies have largely insulated from market discipline and other sectors where in practice free and keen competition does not prevail. There is also the matter of general attitudes. There is the danger that we come to believe not only that everyone ought to be compensated for increases in

consumer prices, but also that we are all entitled to a better standard of living whether or not it is earned. The fact is that this year the Canadian economy is not producing enough to maintain average real incomes per capita, let alone provide for an increase.

Because in practice the use of monetary policy to moderate excessive spending pressure in the economy involves a temporary slowing of the growth of output and employment, some observers feel that the cost is simply too high to accept and they therefore ask the question: Why does the Bank of Canada persist in its present policy? Sometimes the question is put another way: Why doesn't the Bank bring down interest rates? In either form, what the question must mean is, why doesn't the Bank of Canada permit more rapid monetary expansion and thus more rapid inflation? I believe that many who ask this question do sincerely wish to see inflation controlled, so that in asking it they give evidence of a certain amount of confusion about what is involved.

I say confusion because the fact is that no strategy for dealing with inflation will succeed unless it is well supported by firm and continuing control of the rate of monetary expansion. That proposition is as well established as any general proposition in the whole field of economics, and its acceptance is a basic requirement for any useful debate on how to control inflation. It should not be stretched, however, to include the idea that controlling monetary expansion can by itself deal with inflation in a way that ensures good all-round economic performance. That is not a claim that the Bank of Canada has ever made. Other policies and arrangements in the

economy are also very important. The essential point here is that no matter what measures are adopted in areas such as fiscal policy, or what have come to be called supply-side policies, or even in the unusual case of price and income controls, a key element that must be included in any combination of measures for achieving good economic performance is the avoidance of excessive monetary expansion.

Although I believe that this view about what a central bank should do to control inflation is unassailable, I readily acknowledge that there is room for differing views about the details of monetary policy within this broad framework. I want to discuss this matter but since this is a Question and Answer format I must first find a question with which to begin. One that will serve the purpose and has in fact been asked is: Are the Bank's policies based on oversimplistic monetarist theories?

There does seem to be an impression around that a few years ago some of us in the Bank of Canada were struck down on the road to inflation by a blinding light -- the word "blinding" is sometimes emphasized -- and experienced a sudden conversion to a new far-out religion called monetarism. I have to confess that I was there at the time and that nothing quite so dramatic happened. It is true that we had not been satisfied with the past operation of monetary policy and that we were looking for ways to improve it. It is also true that we have adopted monetary targets to help us in keeping the trend rate of monetary expansion within prudent limits. Monetary targets were adopted because our research work revealed a reasonably systematic relationship in Canada between the trend of M1, a measure

of the money supply narrowly defined to include currency and demand deposits, and the trend of over-all spending in the economy. The use of monetary targets necessarily involves formulating monetary policy with a view to a medium-term time horizon. Adopting this approach therefore meant acknowledging that the time lags between monetary policy actions and their effects on the economy are too long to make it sensible to respond to every short-term fluctuation in economic activity. This was also an important element of change in our approach to the conduct of policy. But that is about all that was involved in our conversion. I assure you that we do not look at the trend of monetary expansion in isolation and that we continue as before to make use of any available indicator in continuously assessing our policy.

I suppose that our adoption of monetary targets made it inevitable that we would be described as monetarists. I was first called a monetarist after a speech I made in 1975 in which, after noting that it was very much in the public interest that the drift into deepening inflation in Canada be halted and reversed, I went on to say that, "Whatever else may need to be done to bring inflation under control, it is absolutely essential to keep the rate of monetary expansion within reasonable limits. Any programme that did not include this policy would be doomed to failure. There is no way of preserving its value if money is created on an excessive scale". That, you will have noted, is very much what I have said again today. I continue to believe it. Does that make one a "monetarist"? If it does, there must be few among us who are not

"monetarists" these days. But at times the "monetarist" label seems to be used to mean something else. Next time you see or hear the word "monetarist" used, ask yourself what the user means. Beware of the use of labels: the world of ideas about economic policy is not as sharply divided between monetarists and Keynesians as you may sometimes be invited to believe.

The Bank of Canada does not follow an entirely rigid money supply policy. Not only is our target band relatively wide but we would in fact be prepared to see the money supply move outside the band for a while if we believed that there were good and sufficient economic reasons for doing so, in which case we would feel obliged to explain the reasons. Moreover, within the broad framework set by our monetary targets we see no reason not to give some weight in the short-run to resisting unwelcome developments in the foreign exchange market and to moderating extreme movements in domestic money market interest rates. Over the longer run movements in the exchange value of the Canadian dollar need to be consistent with the achievement of our monetary targets, but in the short-run we do not feel that we should be precluded from resisting movements that threaten to make the subsequent achievement of those targets more difficult. In certain circumstances, for example, a significant decline in the exchange value of the Canadian dollar brought about by unusual interest rate relationships between Canada and the United States would not only add almost immediately to the upward pressure on prices and spending but would also, before long, threaten to put increased upward pressure as well on negotiated wage settlements and thus on our on-going costs of production. I know that some monetary

theorists are uneasy about remarks like this, believing that the trouble with central banks is that they try to ride three horses at once -- the money supply horse, the exchange rate horse and the interest rate horse. It would be easier to agree with them if the money supply always closely followed a highly predictable course but since in its relationship to total spending it tends to wander a bit at times from one side of the track to the other I don't think it a bad idea at least in the short-run to keep a weather eye on those other horses as well.

The battle against inflation is never easy. It has not been easy over the five years during which we have been pursuing monetary targets, and I confess that I am somewhat disappointed with the results to date. I am quite clear in my own mind, nevertheless, that the results would have been even more disappointing if we had allowed even more monetary expansion to take place than we in fact did. In retrospect, given some of the largely unpredictable economic and financial developments that occurred over that period, it might have been better if the moderation of excessively rapid growth since 1975 had been less gradual so that the moderating effect on inflation would have been greater. The fact is, however, that the rate of monetary expansion is now very much less than it was five years ago and I believe monetary policy will have a stronger impact on the trend of total spending and hence on our inflation rate in the period ahead than in the recent past.

It is my basic conviction that a central bank should achieve and maintain firm control over the rate of monetary expansion and that it should muster the patience and resolution to proceed in

that way for as long as may be necessary. A lot of patience will be required. The world economy is highly inflationary and beset with many problems, including the dangerous situation in the Middle East and the serious problems of payments imbalances among countries resulting from the last oil price shock. There are some inevitable price increases ahead that we must absorb without a further lasting escalation of our over-all inflation rate. These seem likely to include food price increases for the next year or so and energy price increases for years to come. It is clear that the battle against inflation cannot be won quickly and this brings me to my final question: Will the Bank of Canada be able to muster the patience and resolution to stay the course? The answer is that it has no other choice. It is not free to give up the fight because that would violate the mandate given to it in the Bank of Canada Act by Parliament "to regulate credit and currency in the best interests of the economic life of the nation". That is our duty, and that is what we intend to do.