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

Thursday, October 30th, 1980

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In his letter about my appearance to-day before this Committee your Chairman asked me to discuss interest rates, money supply and the role of the Bank of Canada in the Canadian Economy. I have therefore prepared a statement touching on these matters which I would like to present to open the discussion.

I shall begin by reminding you of Parliament's view of the role of the Bank of Canada in the Canadian economy. This view appears in the preamble to the Bank of Canada Act, and it is that the Bank of Canada is "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion".

That is Parliament's instruction to the Bank of Canada. It is a very good instruction to a central bank, and that no doubt is why it has not been changed since the Bank of Canada Act was first

passed by Parliament in 1934. We in the Bank treat that Parliamentary instruction very seriously indeed. We are fully committed to regulating credit and currency in Canada in the best interests of the economic life of the nation.

What action by the central bank is appropriate to promote the country's economic welfare varies with the economic circumstances. For quite a few years now the nature of the major threat to the future economic welfare of the country has been unusually clear. That threat is inflation. The idea that some inflation is on balance helpful to the performance of an economy, that inflation is benign -- an idea that was never more than superficially plausible but was nevertheless quite popular -- is now thoroughly discredited. What has discredited it so effectively is not economic theory but economic experience. The experience of the world economy and the widely-varying experience of its national members have shown beyond reasonable question that inflation is malignant. The matter is no longer seriously debated.

The critical question, then, is not whether to fight inflation but how. Debate on how best to fight inflation rages all around the world.

In trying to pick one's way through the complexity of that debate there is one proposition that must never be forgotten, and that is the proposition that in a free society no strategy for dealing with inflation will succeed unless it is well supported by firm and continuing control of the rate of monetary expansion in the

society. That proposition is, I assure you, as reliable as any general proposition in the whole field of economics. Every central banker in the world knows it to be true, and I doubt that any serious and experienced student of financial affairs would question it. It is a very firm proposition indeed, and anyone who wants to participate responsibly in the debate on how to deal with inflation would be well advised to keep it uppermost in his mind.

This proposition should not be stretched to include the idea that controlling monetary expansion can by itself deal with inflation in a way that ensures good economic performance. Other policies and arrangements in the economy are also very important. But no matter what policies are adopted in such areas as fiscal policy, or what have come to be called supply-side policies, for example, or even in the unusual case of direct control over prices and incomes, one element that must be included in any combination of policies that can succeed in controlling inflation is the avoidance of excessive monetary expansion.

What I am saying, then, is that if you are a central banker with a duty to promote the economic interests of your country and you are operating in an environment as strongly inflationary as has existed in recent years it is not difficult for you to know the outlines of what you should do. You should achieve and maintain firm control over the rate of monetary expansion in your country, you should take great care to ensure that the rate of monetary expansion is not so great as to prevent the rate of inflation in your country

from subsiding, and you should muster the patience and resolution to proceed in that way for as long as may be necessary.

You will need a lot of patience because you will not be able to tell in advance how long it will take to bring inflation in your country under control. If inflationary practices and inflationary expectations have become firmly established in your country, as they have in many countries including Canada, you will know that it will take many years to turn them around unless the society experiences a very severe deflationary shock. You will also know that the speed of the reaction of an ecomomy to monetary restraint will also depend very much on what supporting action your monetary policy receives from the actions of governments, the business community, the trade unions and other groups in your country. If these groups all co-operate in the anti-inflationary program progress will be made toward a less inflationary society with the minimum of economic and social strain. But if any large groups see themselves as immune to the adjustments required in the transition of the society to non-inflationary practices progress will be slow, there will probably be periods of backsliding and there will certainly be all sorts of economic and social strains. In that event your patience and resolution will be severely tested, but you will not be free to give up because to do so would violate your responsibility "to regulate credit and currency in the best interests of the economic life of the nation".

In the interests of completeness I should perhaps add that you as central banker will know that if your country trades

extensively with other countries its progress towards lesser rates of inflation will probably be appreciably helped on occasion and appreciably harmed on occasion by developments in the economies of its trading partners, and you will have to do what you can to adjust to those external influences without getting blown off track.

The advice that I have just offered to "you as central banker" is of course a statement of how I see my own position and it is advice that I am trying to follow. It is advice that I must follow because of the responsibility the Bank of Canada Act places on the Bank.

Let me turn now to be a bit more technical about what we in the Bank have been doing. As you know we have been working to reduce gradually the rather high rate of monetary expansion in Canada. To this end the Bank has followed the practice of trying to keep the trend rate of monetary expansion within notional upper and lower limits which have gradually been reduced over time. The Bank is able to operate within this broad framework of longer run monetary growth targets while still retaining considerable latitude to respond in the short run to erratic developments in financial markets or in the foreign exchange market.

At the outset about 5 years ago the target band for the growth of the money supply, defined for this purpose as currency and demand deposits, was set at 10 per cent to 15 per cent a year and it has been gradually reduced to the current 5 to 9 per cent. This gradual approach to reducing the rate of monetary expansion was

adopted in order to avoid the severely disruptive effect on economic activity that would flow from a rapid reduction.

The linkages whereby the rate of monetary expansion affects the rate of inflation are rather complex, but the process can be summarized fairly accurately by saying that the rate of monetary expansion influences interest rates, interest rates influence both the foreign exchange rate and the level of spending in the economy, and both the foreign exchange rate and the level of spending in the economy influence the rate of inflation.

The last link in that chain, the influence of the foreign exchange rate and the level of spending in the economy on the rate of inflation, arises mainly from the fact that in a market economy changes in the level of spending in the economy and in the exchange rate cause markets at home and abroad for Canadian-produced goods and services to be more buoyant or less buoyant than they were and make it easier or harder for prices and incomes to be raised. What level of activity and employment in the economy is compatible with a declining trend in the rate of inflation depends fundamentally upon the responsiveness of the arrangements and practices in the economy that determine prices and incomes to changes in the level of total spending. The more unresponsive they are the lower the level of activity in the economy must be in order for inflation to subside. Thus anything that can be done to make prices and costs more responsive to changes in the level of spending in the economy is very desirable because it will reduce the adverse short-run impact of anti-inflation policy on real output and employment.

The responsiveness of prices and costs in the economy to changes in the level of total spending is reduced by any widespread view that inflation will be allowed to continue at high rates or even accelerate. That is 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.

In considering the interplay of the rate of monetary expansion and the rate of inflation it is important to recognize that the tendency of the two to move together is subject to a good deal of variation. Short-term fluctuations around the central tendency are commonplace and from time to time there are shifts in trend that are essentially unpredictable. The rate of inflation is higher today than one might reasonably have expected in the light of the M1 growth that has actually occurred.

The experience of the past few years appears to have led some observers to conclude that the Bank's approach to reducing inflation has failed. If they mean that progress in reducing inflation is less than the Bank hoped, I agree with them. But if they mean, as I think some of them do, that the Bank's approach was misconceived, then they have misread the history of the period. What they should conclude is that given the economic and financial developments over that period, many of which were unpredictable, it would have been better if the slowing of monetary growth had been

less gradual so that it would have had more impact on inflation. That is the moral that should be drawn. In this connection I would point out that the rate of monetary expansion today is very much lower than it was five years ago and although we have arrived at this position through a very gradual process the impact on total spending can be expected to be much firmer from now on than it was when we started on this path.

I now want to say something about interest rates because I know this is a subject of considerable interest to members of the Committee.

The basic reason why interest rates are so high is because 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. They are not so high as to provide savers with a large real return before taxes or in many cases with a real return at all after taxes. They are not so high as to discourage borrowers who expect continued high rates of inflation.

The extraordinary volatility of interest rates in North America over the past year has been disturbing to many people. It has been disturbing to the Bank of Canada as well and much of our activity has been directed towards moderating extreme fluctuations. This volatility is a sign of how sensitive the public has become to the outlook in respect of inflation and of how sharply they react to each bit of news that seems to cast any light at all on that outlook.

In the past year there have already been three major swings in interest rates in North America -- strongly upward to a peak in

April, then sharply downward for about two months, and since then upward again. These swings arose much more from developments in the United States than in Canada, but it would be an error to suppose that the uneasiness of financial markets about the inflation outlook is significantly less in Canada than in the United States. The Bank of Canada regarded the speed and magnitude of the interest rate swings as excessive, and we succeeded in tempering them a good deal in Canada.

Canada's interest rate experience in recent months demonstrates that the view that Canada does not have an independent monetary policy but is rather forced to move lock-step with the United States is simply wrong. Even a cursory comparison of the different movements of interest rates in the two countries shows that clearly. In the past year money market interest rates have sometimes been as much as 4 per cent higher in Canada than in the United States and at other times almost 4 per cent lower. In recent weeks they have been 1 - 2 1/2 per cent lower. More often than not in the past year the prime lending rate in Canada has been lower than that in the United States. The Canadian rate has ranged from 1 3/4 per cent higher to as much as 3 per cent lower. This morning it was 1 3/4 per cent lower. Spreads between bond yields in the two countries have also varied considerably. 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 independence in this area involves a price. Where on balance does the Canadian interest lie? That is the question.

We in the Bank gave a good deal of attention to this question, and we came to the conclusion that the Canadian interest was best served this year by seeking a slower and smaller movement of interest rates in Canada. In the economic circumstances that existed this middle-of-the road approach softened the impact of interest-rate developments in the two countries on the exchange rate between their two currencies and it reduced the danger of Canada being blown off-course in the pursuit of its money-supply target. It was to gain some flexibility to follow this approach that we moved last March from a so-called "fixed" Bank Rate to a floating Bank Rate.

What the trend of interest rates will be in the future will depend to a very considerable extent on how prices and costs respond in an economy that is not overloaded in terms of its physical capacity to produce goods and services and in which the growth of real output seems likely to be relatively slow for a time. If in these conditions inflation remains high, or even tends to accelerate, reasonable monetary growth will not accommodate the inflated level of total spending in current dollar terms without high or even higher interest rates. On the other hand, if the rate of inflation subsides, the prospects for lower interest rates and for more real growth will improve. The only sure road to lower interest rates is via lower inflation rates.