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REMARKS BY
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TO THE BUSINESS OUTLOOK CONFERENCE
OF THE SASKATCHEWAN CHAMBER OF COMMERCE
MOOSE JAW, SASKATCHEWAN
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Remarks by
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to the Business Outlook Conference
of The Saskatchewan Chamber of Commerce
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I am particularly pleased to be able to participate in this business outlook conference of The Saskatchewan Chamber of Commerce although I am not going to forecast the path of the economy over the near-term future. It is not my practice to make public economic forecasts and in any event you have others on your programme who are doing that for you. What I do want to talk about is monetary policy, that is, about the control of the money supply and about interest rates, factors which are bound to exert an important influence on the future course of inflation and economic activity in Canada. I will volunteer one forecast, however, which is that interest rates are unlikely to decline significantly until there are some signs of progress being made in reducing the rate of inflation.

In saying that, I am well aware that high interest rates are difficult, even painful, for many of you in carrying on your business activities. I can assure you that the Bank of Canada has no wish to create unnecessary problems for you. My connection with this part of the country is very close and I understand the many difficulties already faced by farmers and businessmen in Saskatchewan, operating in an economy that can be severely buffeted by the whims of both weather and world markets. At the same time I am very much aware that inflation can also cause a great deal of trouble for you because of its impact on the prices of machinery and equipment and other costs of production. What we at the Bank of Canada wish to see is both a declining rate of inflation and lower interest rates, for it is only with a significant moderation of inflation that it will become possible to have significantly lower interest rates.

Interest rates have just recently risen to record levels. They are even higher than last December's peak levels which at the time seemed so extraordinary that they were then regarded as most unlikely to last for very long. Why has this happened? The main reason is that interest rates have come under further upward pressure from the strength of the credit demands that have been generated in Canada by the combination of a strong rate of growth of output and the worsening of inflation and expectations of inflation. This upward pressure on interest rates has been reinforced by the relatively weak performance of the Canadian dollar relative to the U.S. dollar in the foreign exchange market.

The real growth of the Canadian economy has been surprisingly strong over the past three quarters, much stronger than seems to be generally realized. Indeed there seems to be a widespread but erroneous view abroad in this country that the Canadian economy is severely depressed and barely growing at all. The truth of the matter is that after growth resumed at a moderate pace in the third quarter of last year, real output surged ahead at an annual rate of more than 8 per cent in the fourth quarter and probably at an annual rate of as much as 4 to 6 per cent in the first quarter of this year. These rates are far above any realistic estimate of the growth of output that can be sustained by the Canadian economy. An important factor in the expansion of economic activity over this period has been the strong performance of the Canadian economy in international trade. Our trade picture reflects a much improved international competitive position as a result of the massive exchange rate adjustment that took place a few years ago. The recent strong rate of real growth in Canada has been coupled with a high and rising rate of price increases. The resulting growth in total spending has been accompanied by a persistently strong demand for credit which in turn has been a major source of continuing upward pressure on Canadian interest rates. The pressure has been reinforced by heavy borrowing to finance real estate acquisitions and corporate takeovers and by the large cash requirements of governments.

The weakness of the Canadian dollar relative to the U.S. dollar in the foreign exchange market has also been a factor in the disposition of Canadian interest rates to rise. The persistence of this weakness must be regarded as disappointing in view of the fact that at least until a few days ago interest rates in Canada have been sufficiently higher than in the United States to be relatively favourable to the inflow of capital into Canada. Moreover, as I have already indicated, our international trade balance has been much better than in recent years. Yet in spite of these positive factors the Canadian dollar has not recovered very much ground from its low point of late last year. It would seem necessary to look elsewhere for an explanation of why this should be so -- to the view one frequently hears expressed that, because Canadians have so many unresolved internal differences at present, the attractiveness of Canada as a country in which to invest has lost some of its former appeal.

The various forces at work in the Canadian economy that I have just pointed to as reasons for the recent tendency of Canadian interest rates to rise were forces that the Bank of Canada had to take into account in considering to what extent it would be wise to resist the tendency. Let me recapitulate them: the strength of the current economic rebound in Canada; high and rising inflation and serious fears of still worse inflation to come; a continuing strong demand for credit even with interest rates at levels that normally would have discouraged domestic borrowing; and a persistent weakness of the Canadian dollar that was adding to the upward pressures on costs and prices in Canada. In these circumstances there was not a convincing economic case for preventing an upward movement of Canadian interest rates, and no economic case at all for a decline in interest rates. The last thing a country in Canada's present dangerously inflationary situation needs is to step up the process of money creation in a short-sighted attempt to hold down interest rates, one effect of which would be a further decline in the exchange rate. Anyone who doubts that the inflationary psychology now gripping this country has reached alarming proportions should meditate on the current phenomenon of a booming residential housing market in many of our major cities despite mortgage interest rates of 16 1/2 to 17 per cent a year. We had all better face the fact that this country really does have a very serious inflation problem on its hands.

It may help you to understand why the Bank of Canada has responded to the current situation in the way that I have described if I try to explain in some detail how I view the problem of inflation and the role of the Bank in dealing with it.

Only twenty years ago the rate of inflation in Canada was less than two per cent a year. Over the intervening period inflation in Canada has not only become chronic but has surged ahead repeatedly to reach its present level of around 12 per cent a year. Thus the disease that this country has contracted is not just high inflation, but escalating inflation. Doubts about the ability of this country to rid itself of this cancer of growing inflation have spread throughout our society and are clearly apparent to-day in almost every aspect of our economic behaviour.

I continue to believe, however, that Canada's serious inflation malady can and must be brought under control and eventually cured. I also believe that whatever else needs to be done to effect a cure, the key element must be the restoration of a greater degree of realism, responsibility and continuing discipline in public financial policy than we have had for many years and the acceptance of that discipline by the general public. Price and cost pressures cannot be contained in an economy in which the over-all level of spending is repeatedly fed increasing doses of fiscal and monetary stimulus, with only belated and short-lived attempts to cut back on the dosage when the economy begins to overheat and the rate of inflation to spurt ahead. We will never master inflation so long as we insist on trying to keep the Canadian economy operating at levels of capacity utilization and labour market tightness that are manifestly incompatible with moderation of the trend of price and cost increases.

The Bank's approach to monetary policy follows directly from this view of Canada's inflation problem and what needs to be done to overcome it. The policy is based on two fundamental propositions, both of which I regard as unassailable.

Proposition I is that Canada has no option but to contain and reduce inflation. Quite apart from the obvious unfairness of inflation and its progressively debilitating effects over time on the ability of the economy to function effectively, any attempt to tolerate it will simply make matters worse. Experience around the world has shown that in the end inflation is always resisted: the only questions are at what stage and how. The higher the rate of inflation is allowed to go before the battle is undertaken seriously, the more painful and arbitrary the measures to combat it tend to become.

Proposition II is that whatever else is done to control inflation, it will never in fact be controlled unless the growth of the money supply is kept within prudent limits. And that is our job. I hasten to add that we have never claimed that firm control of the money supply is all that is required to bring down inflation and at the same time ensure good economic performance. But it is a necessary part of any effective economic policy directed towards those objectives.

I might note in passing that the idea that inflation cannot be controlled if growth in the money supply continues to be excessive is not a new one by any means. In fact as economic propositions go it is a very old idea. In recent years we have adopted the practice of establishing target limits for monetary growth but that is a matter of technique and it does not turn this long-held, basic proposition into some new-fangled economic theory.

In spite of our emphasis on the control of the money supply when we talk about monetary policy, it is natural for people to look at monetary policy in terms of interest rates instead. I have yet to hear of a potential borrower going into his bank and asking how the money supply is doing before he discusses a loan and the rate of interest on it. And neither, of course, do we expect him to. The difference in focus between ourselves and the individual borrower or lender comes about because of our responsibility for over-all monetary management. If we are going to limit monetary expansion we cannot afford to have any strong preconceptions about where interest rates should go. Certainly the actions we take in financial markets for the purposes of containing monetary expansion do have an effect on interest rates, but when all the dust has settled what actually happens to interest rates is the joint outcome of these effects and all the forces at work in the economy that are affecting the demand for money and credit.

Over the past six months the rate of monetary expansion in Canada, though considerably lower than in recent years, would still have been more than enough to accommodate considerable real economic growth with much lower interest rates than those we now have -- but only if the price level had been rising much more slowly. The reason interest rates are now as high as they are is primarily because inflation has greatly increased the demand for money and credit. Indeed by far the largest component of the present level of interest rates is the inflation premium, by which I mean the additional interest required by savers in order to compensate them for purchasing power they stand to lose as a result of inflation. The remaining component of the interest paid by borrowers and received by savers -- the amount by which the interest rate exceeds the expected rate of inflation -- is often called the "real" interest rate.

For most of the past decade interest rates were unusually low in relation to the inflation rate and savers did not get a sufficient return to compensate them for the loss of purchasing power caused by inflation. At the same time the cost of credit to borrowers, particularly on an after-tax basis, frequently turned out to have been exceedingly low in real terms since debts were being repaid with much cheaper dollars. In these circumstances inflation tended to worsen.

Monetary policy has now become firmly anti-inflationary. The target that we set for the money supply (defined for this purpose as currency and demand deposits at banks) has recently been lowered to an annual rate of growth of 4 to 8 per cent. This will help to ensure that interest rates are at levels capable of exerting a moderating influence on the rate of growth of total spending, and thereby on the rate of increase of prices and costs.

There would be more support for a policy of monetary restraint if the role of interest rates were better understood than it is now. A popular view is that a rise in interest rates is itself a cause of inflation because it adds to the costs that borrowers incur in doing business. That interest rates have some effects in this direction cannot be denied, but this is far from being the most important part of the story. If it were, you could push the argument to the absurd conclusion that the way to bring down inflation would be to have zero interest rates, absolutely free money. The role of rising interest rates in limiting inflation is quite opposite to their effects on costs. For one thing, they help to maintain an adequate value for the

Canadian dollar and thus keep down the Canadian dollar equivalent of prices that are determined outside our country. The major impact, however, comes from the fact that interest rates affect total spending in the economy. Interest rates have to be sufficiently high to keep the demand in markets for goods and services from being too buoyant so that market discipline is strong enough to make it difficult to raise prices and costs rapidly without suffering losses of sales and employment.

If we are to control inflation we must return to this kind of market discipline. It is what we relied on in past periods of price and cost stability. As we move toward the restoration of that kind of market discipline interest rates can decline. That is the objective of the Bank of Canada -- declining rates of inflation and declining interest rates. Only then will there exist a basis for the kind of economic performance this country is capable of achieving.

Let me say in conclusion that it would be foolish to ignore the fact that Canada is face to face with a very serious problem of inflation. It would be equally foolish to suppose that a painless solution is available, or that procrastination will help. The sooner the country faces the facts the better. Firm and continuing restraint on the rate of monetary expansion is one essential element in the cure. Whatever the other elements may be there can be no serious debate about the essentiality of the monetary element. Since that element is the Bank of Canada's responsibility our duty is clear.