Extra. B-250

NOT FOR PUBLICATION BEFORE: 1:30 P.M. EASTERN DAYLIGHT SAVING TIME
MAY 26TH, 1981

STATEMENT PREPARED FOR THE APPEARANCE OF

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GOVERNOR OF THE BANK OF CANADA

BEFORE THE

STANDING SENATE COMMITTEE

ON NATIONAL FINANCE

TUESDAY, MAY 26th, 1981

Statement prepared for the appearance of Gerald K. Bouey, Governor of the Bank of Canada, before the Standing Senate Committee on National Finance, Tuesday, May 26th, 1981.

In the last year or so I have said so much about what the Bank of Canada has been doing that I doubt that there is much need for me to say anything on that score to the Committee at this time. My last Annual Report, published in March, reviewed the rather dramatic events of 1980, and in a speech on May 6th delivered in Moose Jaw I brought the story up to date, with particular attention to current economic developments. In addition, my colleagues in the Bank and I have made many statements to the press or to others on the role of monetary policy in the present circumstances.

Events this month have once again given the activities of the Bank a high profile. There has been a lot of discussion of our actions -- which we welcome -- and a good deal of confusion about them -- which we regret. I hope that the proceedings here today can help to clarify some of the matters at issue. I would like to make some opening remarks on two of the most basic questions, namely,

(1) how much concern is warranted by the current trend of inflation in Canada? and (2) if serious concern is warranted, what can be done about it?

How Much Concern about Inflation is Warranted

There are a number of measures of the rate of inflation, but if one considers them he will I think be forced to conclude that the current rate of inflation in Canada must be put at above 10 per cent per year, at say 11 or 12 per cent. He will also observe that the rate of inflation in Canada has been rising over the past few years and that it appears to be continuing to rise. He will probably also agree that, insofar as it is possible to generalize about people's expectations for the next year or so, they seem to be that the rate of inflation is more likely to rise than fall. Finally, he will probably agree that the current rate of inflation is somewhat higher in Canada than in the United States, and that it is generally regarded as more likely to rise here than there.

The Canadian dollar has been weak vis-à-vis the U.S. dollar and further significant weakness would add to inflation in Canada.

What should one think about this state of affairs? Everyone who is interested in my views knows that I think it warrants grave concern. The reason for my concern is the effect of inflation

on the future performance of the Canadian economy. It is a concern rooted in the welfare of Canadians. I do not think it is realistic to suppose that an economy like ours will work well under conditions of rising inflation. Rising inflation is a recipe for stagnation not for prosperity. My dispute with people who disagree with that view is not about ends -- I am as deeply concerned for the future welfare of Canadians as they are. The dispute is about means. I am sure that failure to face up to the problem of inflation will compound our economic problems and increase the economic pain involved in resolving them.

You are of course aware of those people who say, "Yes, of course we must deal with inflation but first let somebody devise a painless way of doing it". Until that happens, they sometimes add, the cure is worse than the disease. Painless cures are a nice idea but people who hope to find a painless cure for inflation know little about the disease. They are dreaming pleasant dreams and it is too bad to have to try to wake them up.

Then there are others who say that it will be easier to learn to live with inflation than arrest it. What do these people think is involved in living with inflation? Do they assume that the present inflation rate would stabilize if public policy turned to learning to live with inflation? What could be more unlikely! Nothing stimulates inflation like indifference to it. History

affords us examples of societies that have seemed to try to learn to live with inflation, but at some rate of inflation -- 20 per cent, or 100 per cent, or in a few cases 1,000 per cent or more -- they have had to give up and start the long hard road back. In a number of cases democratic government was a casualty of the process.

Being relaxed about inflation simply will not work. Sooner or later a society has to grapple with the erosion in the value of its money. What are the means available to do that?

In a free society many elements of public economic policy have, or can have, a bearing on the trend in the value of money, that is, on the rate of inflation. There are the two so-called "big levers" for influencing the level of total money demand -- fiscal and monetary policy. Then there are a host of more specific policies affecting the way that individuals, businesses, trade unions and others operate in markets. These can be called supply policies or competition policies or micro policies or regulatory policies and they include what is involved in terms like industrial strategy, industrial relations policy, income maintenance policy, regional policy or sectoral policies like transportation policy or energy policy. Finally there are the various direct controls like wage and price control and credit control. How an economy operates over time and what happens to the purchasing power of its money are affected by the interaction of all of these policies. Let me say a little about how some of these policies affect the outcome.

1. Monetary policy is the task of the Bank of Canada, and I accept responsibility for it. That makes it easier for me to talk about it. The other policies are the direct responsibility of the Government of Canada or the provincial governments, and insofar as I have advice to offer to the Government on those policies it is my practice to give it in private.

Monetary policy has basically to do with the rate of monetary expansion however defined. The rates of interest that exist from time to time are the results of the interplay between the rate of monetary expansion and the demand for money and credit generated by the activity in the economy. The way that the Bank of Canada influences interest rates is by varying the rate of monetary expansion.

In respect of the influence of monetary policy on the rate of inflation, the central point is that if the Bank of Canada permits more monetary expansion than the economy needs to operate at a reasonably high level with price stability prices will rise. There will be inflation. This is what has happened for many years. In that sense the Bank has accommodated inflation. But for some years now the Bank has been reducing gradually the trend rate of monetary expansion. This is essential if the rate of inflation is to decline. This is the proper contribution of monetary policy to anti-inflation policy. It is essential, and it is being provided. The Bank intends to continue providing it.

The current high levels of short-term interest rates are the fall-out from the interaction of this monetary restraint and the very high current demand for money and credit in the economy associated with the relatively high levels of economic activity and the high rate of inflation and expectations of inflation. A distressing number of people appear to believe that these interest rates are working on balance to raise the rate of inflation rather than to lower it. This proposition, we are told, is common sense because interest costs are an element in production costs. But this proposition will not stand critical examination any better than the common-sense proposition that the world is flat because it looks flat. What an individual first sees in both cases is not the true story. High interest rates operate to reduce total spending in the economy from what it would otherwise have been, and this eases the upward pressure on prices from what it would otherwise have been. No proposition in economics is more certain than that a move of the Bank to allowing significantly higher rates of monetary expansion in an effort to lower short-term interest rates would increase the rate of inflation. This would in turn feed back in a little time to generate higher interest rates. That policy would be a prescription for surrendering to inflation, high interest rates, and economic stagnation.

It is true that high interest rates can have a quite uneven impact across the economy on different groups of individuals,

different industries and different businesses within an industry. If inflation is to be subdued with a minimum of stress it is therefore desirable that other public economic policies also have an anti-inflationary thrust.

2. Fiscal policy, like monetary policy has an important influence on the rate of increase in total spending in the economy. There can be no doubt that in our present inflationary difficulties, with demand in the economy running as strongly as it is and with expectations of inflation so intense, the extent to which governments engage in deficit finance must be a major policy consideration. From the viewpoint of moderating the demand for goods and labour and the pressure of borrowing requirements on financial markets it is the case that the smaller the deficit the less strained the situation will be. On those grounds I have welcomed the recognition by the Government of Canada of the need to reduce its deficit over time.

Over the long run the case for limiting deficit financing depends on one's view of the degree to which national economic welfare is served by governments diverting private savings from the capital markets to support government activities. The merits of channelling savings to finance government depend fundamentally on the value that is placed on the use government makes of the savings as opposed to how they would have been used otherwise.

I have discussed the position of the government sector in terms of its deficit, not in terms of its over-all size as measured by its total outlays. This is because I have taken the view that Canadians can have as large a public sector as they are willing to pay the taxes to support. I would add one caveat, however. It is essential that taxpayers really be prepared to pay the costs of governments including transfer payments -- that is that they be willing to forego the real income that might otherwise have been available to them and not seek compensation for increased tax bills by demanding larger increases in money incomes than are possible without generating inflation.

Before I leave fiscal policy there is one issue I want to clear away and that is whether Government deficits are financed by "printing money". In Canada they are not. The goals of monetary policy are set independently of whatever size the Government's borrowing requirements happen to be. Thus the public debt is financed in the market at market interest rates, and the Bank of Canada participates in that market only to the extent that its money supply policy permits. Increases in Government borrowing requirements have much the same effect on the level of interest rates as increases in private borrowing.

3. Other policies. My comments on other types of government policies that can operate in an anti-inflationary direction will be

very brief, not because they are not important but because they are far outside my area of responsibility. One set often mentioned these days involves the pursuit of policies to deregulate and decontrol markets in the interests of a more productive and efficient economy. I have nothing specific to say about this approach except that I think the broad public interest lies in taking a skeptical view of the value of restraints on the functioning of markets and on the rate of supply of particular goods or services. This would be true even if inflation were not a problem but it is doubly so given our difficulties. I can be still briefer regarding another approach, that of direct controls. Some forms of temporary controls can sometimes be useful in circumstances where events have got out-of-hand but they are not a substitute for sound financial policies.

Some people might add to the above list of public policies that have, or can have, an effect on the purchasing power of Canadian money what is sometimes called exchange-rate policy. I am not inclined to do so for when a country's foreign exchange rate is floating as it is in Canada that rate is affected by all the other policies, that is, by the total circumstances of the economy relative to other economies. It can be influenced by a change in monetary policy or fiscal policy or regulatory policy or by direct controls. If, for whatever reason -- by rising external interest rates, for example -- forces operating in the exchange market threaten to

depress the exchange rate when that is not needed to preserve a reasonably competitive position for the country's international trade and when it would add to the upward pressure on prices internally, effective anti-inflationary policy would seek for some policy adjustment to neutralize the threat. That adjustment could be in monetary policy, which through interest rates can have an immediate impact on capital flows, but in some circumstances it could also be partly in debt management policy, or fiscal policy, or in regulatory policy.

4. Bank of Canada responsibility. Looking over the current situation one could say, if one wanted, that it would be nice if events in the United States had evolved differently and the Americans were not now experiencing such high and volatile interest rates. One could add, if one wanted, that it would be nice if things had evolved differently here in various ways. However, saying what would be nice doesn't get you very far. It is always necessary to look forward, to focus on what can in fact be done in the light of the conditions that prevail.

The Bank of Canada's responsibility lies in the monetary field and what it has to work with is the control of the money supply, not the tools of fiscal policy, regulation, or direct controls. The Bank has to use its powers in the world as it finds it, and to face up squarely to the implications of what it finds there for the integrity of the nation's money. In present circumstances there is no good reason for avoiding a monetary policy that provides strong resistance to inflation.