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REMARKS BY

GERALD K. BOUEY

GOVERNOR OF THE BANK OF CANADA

TO THE

MEN'S AND WOMEN'S CANADIAN CLUBS

OF CALGARY, ALBERTA

SEPTEMBER 23RD, 1981

Remarks by Gerald K. Bouey
Governor of the Bank of Canada
to the
Men's and Women's Canadian Clubs
of Calgary, Alberta
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Today I want to talk mainly about interest rates.

Interest rates are extremely high. They are much higher than I ever expected to see them. They are causing a great deal of stress and strain in this country among home owners, farmers, small businessmen and others. I hear about these problems in very specific detail every day through telephone calls, letters, visits, the media and contacts with financial institutions. I assure you that there is no lack of awareness in the Bank of Canada of the difficulties caused by high interest rates. Lack of awareness is not the problem. The problem is what the Bank of Canada can do about the situation that will not in the end do more harm than good.

Before one comes to a conclusion on that question it is useful to reflect on the factors that have contributed to the extraordinary rise in interest rates in Canada.

The main contributor to the present level of interest rates in Canada is the rate of inflation that exists

and that is expected in Canada. Inflation of costs and prices increases the amount of money that people need to borrow, and expectations of rising inflation increase their willingness to borrow it. Unless the Bank of Canada is prepared to accommodate whatever rate of inflation turns up, no matter how high, it must keep the rate of money creation under control. The interaction of the strong spending pressures and the strong demand for money on the one hand and restraint on the growth in the money supply on the other is what has caused short-term interest rates to rise.

With inflation as high as it is interest rates are bound to be high. How high? Well, certainly well above the inflation rate. You may recall what interest rates were like in earlier periods when we had no inflation. In those post-war years when inflation was very low or zero, when the general fear or expectation was of a reversion to the depression era rather than rising inflation, and when fiscal policy was relatively strong, the prime lending rates of banks were generally in the 4 1/2 to 5 1/2 per cent range while mortgage rates were somewhat higher. These were "real" interest rates in the sense that virtually no allowance had to be made for inflation or expected inflation. For anything like the same "real" interest rates now, you have to have interest rate levels well above the current and expected rate of inflation. I do not want to be at all precise about how much above for there are other factors

that must also be taken into consideration. But I think you can see that until progress can be made in bringing inflation down in Canada, interest rates will have to be high in this country. They will fluctuate around a high level. That would be true even if we were not living in a world in which interest rates, particularly in the United States, are now very high.

But we are attached to the rest of the world. Money is free to flow in and out across our borders in response to interest rates and other incentives. This does not mean that our interest rates must move exactly like U.S. interest rates. Over the past eighteen months our short-term interest rates have sometimes been 4 per cent lower than theirs and sometimes, as in recent months, as much as 4 per cent higher. But it does mean that the level of interest rates in the United States has an important influence on the situation here.

There are a number of reasons why our interest rates are now higher than American rates. Canada normally runs a deficit on current account in its international payments and we must attract enough foreign capital to cover that deficit. This year that deficit has been growing. Our problems in this area have been exacerbated by the dispute over energy prices which, while it lasted, increased the need for imported oil and had some adverse effect on capital movements as well. On top of that an additional burden has been placed on our balance of

payments, at least in the short and medium terms, by the unusual scale of takeovers of foreign companies operating in Canada that have occurred this year. In the last several months takeover activity has had a major influence on both the exchange rate and the level of interest rates.

There is one more important element in the difference between Canadian and U.S. interest rates. If the rate of current and expected inflation were appreciably lower in Canada than in the United States interest rates here could be no higher, perhaps even lower, than in the United States despite our balance of payments situation. But the current and expected rate of inflation is higher in Canada than the United States and this tends to increase the difference between interest rates in the two countries.

As a result of all the factors I have mentioned -- our serious made-in-Canada inflation, our current account deficit and other special factors that increased the need for an inflow of capital -- interest rates have risen well above those in the United States. A few weeks ago the prime lending rate of Canadian banks reached a peak of 22 3/4 per cent compared with 20 1/2 per cent in the United States. Some money market rates were more than 4 per cent higher than in the United States. I am glad to be able to add that interest rates in both countries have come down a little in very recent weeks.

What in these circumstances were the alternatives for monetary policy? What would have happened if, in spite of our own serious inflation problem and our balance-of-payments difficulties, we had tried to keep our short-term interest rates significantly lower by increasing the rate of monetary expansion? One immediate result would have been a sharp fall in the exchange value of the Canadian dollar. One cannot tell with any assurance how far the Canadian dollar would have dropped, but if the authorities of a country experiencing marked domestic inflationary pressures fail to offer resistance to a decline in that country's foreign exchange rate you can be sure that the decline will be large. Past experience would indicate that in the end the market, with confidence seriously damaged, would have pushed the rate to the point where the authorities would have been forced to react strongly, and the reaction would likely have involved interest rates that were higher than ever.

In the circumstances that existed there would have been no worthwhile benefit from a significantly lower exchange rate. Canada was already competitive internationally because we had already had so much exchange depreciation, and further exchange depreciation would in the circumstances have fed through quickly to increasing the rate of price and cost inflation in Canada. Do not be misled by estimates that one sees from time to time that a fall of 1 per cent in the exchange value of the Canadian dollar results in only a 0.3 per cent

increase in our prices. That is an estimate of the first round automatic increase that results from the effect on the general price level of the increase in Canadian dollar prices of internationally-traded goods. But in a highly inflationary environment there is no reason to believe the increase would stop there: it would spread through the economy as one group after another attempted to obtain compensation for these cost increases. That is why in the present world environment we see every industrial country trying to avoid or limit exchange rate depreciation. Exchange rate depreciation is not part of a solution to our problems. It is itself inflationary, and inflationary solutions to inflation do not exist. In our situation the last thing we should want is a prolonged slide in the foreign exchange value of the Canadian dollar.

I think I have said enough to demonstrate that it is wrong to suppose that our interest rate difficulties have come mainly from abroad. While we cannot avoid being influenced by U.S. interest rates, given our inflation and our balance-of-payments difficulties it must be conceded that our present interest rates have a large made-in-Canada content.

For the reasons I have outlined the Bank of Canada has in recent months given a high priority to the exchange rate situation in its monetary policy operations. The move to higher interest rates was not triggered by an excessive expansion of

the money supply by the measure to which the Bank has paid particular attention -- M1, or currency and demand deposits at chartered banks. If one tries to see through the distortion of M1 caused by the post office strike, it seems for the time being to be running under the lower boundary of the current targeted rate of increase of 4 to 8 per cent a year. Experience has shown, however, that it is wise to be fore-handed in controlling monetary expansion; that it is better to resist strong downward pressures on the exchange value of the Canadian dollar at the time they are taking place rather than wait until the money supply begins to be affected by the price increases that follow a sharp fall in the dollar.

What I have been aiming to do in my remarks to this point is to explain why interest rates have risen to such high levels. In doing this I am not intending to suggest that the situation we are now in is satisfactory. It is profoundly unsatisfactory.

How are we to move to a situation where the general level of interest rates can be significantly lower? I propose to say a few words about each of the factors that have contributed to the present situation -- our own domestic inflation, U.S. interest rates and the spread or margin that has been required above U.S. interest rates -- but in the reverse order.

First the margin above U.S. interest rates. Some steps have been taken recently that should help us. One of them was the request made of banks by the Minister of Finance to reduce their lending to finance takeovers that involve outflows of capital funds from Canada now or later on. This was a welcome move in the circumstances I have described and whether because of it or not the rate of such takeover financing appears to have slackened. More recently, the agreement reached by the Government of Canada and the Government of Alberta on energy pricing and taxation has done much to clear away the uncertainty that existed on the direction Canada might take in this area, and the elimination of the earlier oil production cutbacks will be a tangible benefit to our trade performance over the near term. On the other hand, we continue to have a large current account deficit in our balance of international payments, we continue to encourage some further Canadianization of oil and gas resources, and we have a higher rate of inflation in Canada than in the United States. In those circumstances we cannot reasonably expect to escape having higher interest rates in Canada than in the United States.

I shall not try to predict the future of interest rates in the United States. Financial markets in that country seem to have taken the view that much depends on how large the fiscal deficit of the U.S. government will turn out to be. What Canadians should worry about, I believe, is the possibility that

even if U.S. inflation is brought under better control, and there are some signs of that happening, and if then U.S. interest rates decline, we will not be able to take full advantage of that development because of failure to control our own inflation.

As I indicated at the beginning of my talk our own inflation is the fundamental cause of our high interest rates. What this means is that although Canadian interest rates have declined over the last three weeks, the room for further downward adjustments in the present general level of interest rates will not be great until there are clear prospects of a significant decline in the rate of inflation in Canada. To believe otherwise would be wishful thinking.

I have emphasized that an attempt to bring down interest rates through a rapid expansion of the money supply cannot contribute to a solution of our economic problems and I want now to give equal emphasis to the fact that many policies other than monetary policy can have an important influence on reducing interest rates because they can contribute to reducing inflation. I am pleased to see growing evidence that both these points are well understood by many Canadians.

Policies and practices in other fields should certainly be reviewed to see if they could not be modified in

the direction of generating lesser inflationary pressures and lower interest rates. However, I occasionally come across a version of this view that puzzles me greatly. It is the argument that the first thing to do is to have a sufficiently rapid acceleration in monetary expansion to reduce interest rates appreciably and only then to look around to see what other things can be done to prevent an acceleration of inflation. If the advocates of that argument are really concerned about inflation the questions for them are -- what other things have they in mind? and, why not proceed with them before changing monetary policy? To the extent that other initiatives are effectively anti-inflationary they will reduce the upward pressure on interest rates without any change in monetary policy, that is, without a move to rapid monetary expansion. Surely the sensible way to proceed is to get on with them. Monetary policy claims no monopoly in the fight against inflation, but it is anti-inflationary in a situation which cries out for anti-inflationary policies. Why weaken it before something better is in place? If there has been excessive reliance on monetary policy to contain inflation the thing to do is to improve the balance by strengthening the other components. To proceed otherwise is to put the cart before the horse.

Of course policies other than monetary policy matter in the pursuit of economic prosperity with stability and

I welcome enthusiastically all efforts to explore the contributions they can make. I have referred to these other policies myself on a number of occasions in the past. The Minister of Finance, as the time for another budget draws near, has made it clear that he is concerned about the contribution fiscal policy can make. But the list of such other policies is much longer than just fiscal policy. It includes all the policies and practices of governments, of business, of marketing associations and of trade unions that affect economic efficiency and the flexibility and responsiveness of the economy to changes in the economic environment. The better these policies and practices are the better will be our economic prospects and the less we will be burdened by high interest rates. But insofar as they are inflationary there is no effective way of offsetting this by more monetary expansion.

Since the battle against high interest rates is inescapably the battle against inflation, it is heartening that the current situation is giving rise to so much interest in the various ways in which the resistance of the Canadian economy to inflation could be strengthened through public policy. I have never accepted the idea that Canadians should have to tolerate as their lot a drift into ever increasing inflation, and I am glad to be reassured that most Canadians feel the same way.

My responsibility in all of this is to try to ensure that monetary policy makes the most constructive contribution possible to the resolution of our national economic problems and to explain the nature of that contribution. I make no apology for repeating over and over again that good monetary policy is a necessary condition for good economic performance but it is not a sufficient condition. In the present economic circumstances the consequences of good monetary policy are high interest rates. I am not at all happy about that, but my unhappiness does not alter the facts. Few will be more relieved than I when the circumstances warrant a much lower level of interest rates in Canada. But the Bank of Canada cannot by itself create those circumstances and at the same time ensure good economic performance. That will take a lot of co-operative action by a lot of people. The sooner that is recognized the sooner it will happen. Since I believe that understanding of these matters is growing, I can conclude these remarks on an optimistic note.