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MONETARY POLICY AND INTEREST RATES

NOTES FOR REMARKS BY
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TO THE MEN'S CANADIAN CLUB OF OTTAWA,
OTTAWA, ONTARIO, APRIL 6TH, 1982

Notes for remarks by
Gerald K. Bouey,
Governor of the Bank of Canada,
to
The Men's Canadian Club of Ottawa,
Ottawa, Ontario, April 6th, 1982

To make a public speech to an audience of Ottawa people is a pretty rare thing for a Governor of the Bank of Canada to do, so rare that I cannot find any record of it ever having happened before. Speeches have been made to groups that come to Ottawa for meetings but that is not the same thing. Why have Ottawa people been singled out for this treatment, or lack of treatment? Could it be that you have already heard more about the activities of the Bank than you want to hear? I hope not.

There was a time when I felt there was little point in making a speech anywhere just after the release of my Annual Report. After all, my main story is in that Report. But I have come to realize that the readership of the Report is rather limited and that the references carried by the media are very brief. So today I want to take advantage of the opportunity to concentrate on the main message in the Report and to comment on a few of the reactions to it that I have noted.

The most important point in the Report is that the Bank of Canada, like others, wants interest rates to be lower and that it is doing what it can to get them down. What the Bank of Canada can do to get interest rates down and to keep them there is to help reduce the rate of inflation by restraining the rate of monetary expansion. That is what we are doing. A decline in the rate of inflation is the only sure route to a lasting decline in interest rates. We know that the process of reducing inflation is painful and costly, but we also know that the cost of failing to deal with inflation would turn out to be much greater.

I might note that this view is the basis for monetary policy in other countries as well. Almost every country in the world is trying to deal with inflation as the best way of establishing a solid foundation for the sustained growth of employment and output. Inflation and unemployment are no longer regarded as separate and unrelated problems.

While I believe that the Bank's position on interest rates is convincingly argued in our Report, I cannot say that everyone has been convinced by it. You would not think so either if you had followed press reports as closely as I have or if you had listened to the comments and questions from members of Parliament that I had to deal with the other day in a session of the Standing Committee of the House of Commons on Finance, Trade and Economic Affairs. There are,

of course, various possible reasons for this. One is that the argument advanced by the Bank is not clearly understood. Another is that it is understood but not agreed with. Still another is that people don't question the argument but just don't like the conclusions.

It is easy to understand the cool reception of the Bank's message if you think of the problem of interest rates from the point of view of those who are suffering most from them. In the Bank we know about this. We hear a great deal about it everyday. To give you just one example, I have received telephone calls that begin with words like these: "This is the day I am going out of business and I want you to know that it's your fault". So we know about bankruptcies, lay-offs and other problems from direct contact with the public as well as from many other sources. Many farmers, small businesses, large businesses, and home mortgage borrowers are facing interest rates that are extraordinarily high by historical standards and they are having a very rough time.

To many of these people their problems appear to have been caused by the policy of the Bank of Canada, a policy they believe the Bank could easily alter substantially any time it chose without causing serious damage to the economy.

Others who find themselves in similar circumstances understand the policy problem but still find the situation difficult

to accept. Recently I had a call from an owner of a small business who, after discussing in a very reasonable manner what would happen if the Bank of Canada tried to push interest rates down sharply and quickly through rapid monetary expansion, told me, "I think you may well be right not to try it but it might let me stay in business for another six months". One must have a great deal of sympathy for people caught like that.

I can well understand why many people desperately want to believe that there is some way for the Bank to bring down interest rates sharply and quickly. That is why we have to explain why that is not practical.

In a free society interest rates have a role to play and their level cannot be fixed arbitrarily. They arise from the real productivity of capital and they provide a return to those who save for the future. In the normal course of events they are positive when the value of money is stable, and they are above the general tendency of inflation when there is inflation. Periods where they have been low relative to the rate of inflation have typically been followed by an acceleration of inflation.

When one looks at current Canadian interest rates in this light there is nothing particularly unusual or exaggerated about them. Certainly they are high by historical standards but so is inflation. When, twenty to thirty years ago, we had very little

inflation, interest rates were appreciably higher than the rate of inflation and no one thought this to be odd or unreasonable.

The basic point is that, given the current rate of inflation in Canada, interest rates in Canada are not far from where one would expect them to be. If inflation was much lower, interest rates could also be much lower.

While this is the fundamental situation, interest rates have moved up and down a lot over the past two years or so. Part of the reason for the upward tendency was that inflation and inflation expectations worsened in Canada over most of that period, and in those circumstances there was strong pressure on interest rates to rise. But much of the volatility of Canadian interest rates around their central tendency has been due to the fact that short-term interest rates in the United States have been particularly volatile, with unwelcome but unavoidable effects on Canada.

On several occasions in this period the Bank of Canada has acted to moderate the effect on Canadian short-term rates of sharp movements in corresponding rates in the United States and has allowed some of the pressure to be taken by the exchange rate. Anyone who believes that interest rates in Canada have simply moved in lock-step with those in the United States has not bothered to look at the facts. Over the past two years short-term interest rates in Canada have been everything from some 4 percentage points below to some 5

percentage points above those in the United States. For a while in February of this year we were able to manage with short-term interest rates that were slightly lower than those in the United States.

Let me say here that I very much hope that the United States will be able to conduct its affairs in a way that will bring about significantly lower and more stable interest rates in that country. Such a development would give us somewhat more room for manoeuvre in conducting our monetary policy.

The fact that short-term interest rates in Canada in the recent past have on occasion been below those in the United States does not mean that such a relationship is available on a continuing basis unless the relative inflation performance of the two countries were to change greatly. Our inflation is at present significantly higher than in the United States. It would be extraordinary to believe that in this situation Canadian short-term interest rates could be pegged arbitrarily well below U.S. rates by means of whatever monetary expansion it would take without generating a sharp decline in the exchange rate. How far would the Canadian dollar fall? If the authorities of a country experiencing marked domestic inflationary pressures, as Canada is, were perceived as following a policy that promoted depreciation, market confidence in the currency would be sharply eroded and the decline would be very great. Experience in such cases indicates that the market would push the rate down so far that the authorities would feel themselves forced to

take strong measures to establish order, and these measures would certainly have to involve a substantial rise in interest rates. In any event, significant depreciation would add substantially to the rate of inflation in Canada and put strong upward pressure on interest rates. In the end interest rates would almost certainly have to be higher than they would otherwise have been.

Those who take the view that if our interest rates were pushed down several percentage points the exchange rate decline would be only moderate reveal among other things a serious lack of understanding of the psychology of exchange markets. They seem innocent of what I recently saw well described as "the relentless way the markets pounce upon currencies perceived as losers".

I have been talking mainly about interest rates and now I want to turn to a more general discussion of what is required to bring inflation down. One part of what is required is an economic climate that will restrain it. This we now have, partly as a result of the onset of an international economic recession. The other, and equally important part, of what is required is a flexible response to that climate by business, labour and the public sector. Our markets for goods and services both at home and abroad are no longer conducive to rapid price and wage increases. It is now in the interests of both business and labour that they respond by moderating price and income increases in order to protect employment and output. Businesses that are not able to be competitive will generate

neither profits nor jobs. In those sectors of the economy that are not directly exposed to market pressure what is required is that they do not lag the exposed sectors in restraint on increases in income. The public sector must recognize its share of responsibility for keeping Canada's costs competitive. So far one sees much more evidence in the United States than in Canada of realistic responses to the facts of the real world as they are today.

One hears much these days about the need of various groups for catch-up. The hard fact of the matter is that Canada is not currently producing enough in real terms to play the catch-up game in either profits or income. To assume that everyone is entitled to at least the increase in the consumer price index, and to more if some group somewhere else in Canada is thought to be better paid, is to assume that the world owes us our notions of a suitable living no matter how we perform in terms of real output. That assumption cannot be taken seriously.

Having indicated that in this matter of bringing down inflation it takes "two to tango" -- anti-inflation policies plus a flexible response to them -- I would like now to pose the question of what a central bank should do if the economy does not respond well to the emergence of a less inflationary climate.

There are many reasons why an economy may not react flexibly to a less-inflationary climate. Maybe people's expectations of future inflation are so deeply ingrained that they simply do not believe that an anti-inflationary financial climate will be permitted to continue. They think that the central bank or the government or both will lack the will to persist in the face of the inevitable strains involved in reducing inflation. Or maybe there are particular business and labour groups in the economy that believe that they can safely ignore general market pressures either because the market for their product or services is protected by one means or another or because they can control the supply of their goods or services sufficiently well to insist on inflationary price and income increases. To the extent that there are reactions like this an anti-inflationary climate will generate cut-backs in production and increases in unemployment rather than better cost and price performance.

What should a central bank do then? What can it do? Its power is essentially one-dimensional. It can increase or reduce the rate of monetary expansion. If the economy does not respond well to market pressures the central bank should not try to paper over the cracks in the economy by printing money. It should not give in to the very real temptation to try to play some residual role that might permit increased activity temporarily but would in the end only lead to higher inflation. If we have practices in our private and public

sectors that tend to promote inflation, let alone inefficiency, they will have to be tackled in a direct manner. They must not be used as an excuse for abandoning reasonable financial discipline.

I raise these difficulties about the response of the economy to anti-inflationary policies partly because they are relevant to a question I am sometimes asked. The question is, how high does the rate of unemployment have to go, how many more bankruptcies have to take place, how many foreclosures have to occur before the Bank will give up its policy of monetary restraint. Since surrendering to inflation is no answer to our problem one might better ask, how long will it take Canadians to respond realistically to the financial discipline our situation requires in order to avoid sacrificing businesses and jobs?

I want to conclude by touching on another question that is sometimes directed to me. It is, what hope can you give us? Is there any light at the end of the tunnel?

The answer is that of course there is hope for an improvement in economic performance although we may still have a difficult period to go through. The international economic recession is still on, and for the same reasons that apply here most other countries do not feel that they have room for major stimulative policies. Nevertheless recessions do generate self-correcting forces and they do come to an end. Many believe that the U.S. recession is

about over and most observers look forward to some recovery in both the United States and Canada during the second half of this year. The question for Canadians is not so much whether there will be an economic recovery in the world as whether Canada will be able to get its house in good enough order to participate fully in that recovery. We are making some progress in getting inflation down but we need to make a good deal more.

It is customary in speeches like this one to end on a high note by pointing to the great future that awaits Canadians as a result of our rich endowment of natural resources. But we seem to be able to get into considerable trouble even with those resources. Perhaps we should look less at our resources and more at ourselves. Are Canadians really incapable of pulling together to build a dynamic, non-inflationary, highly competitive economy. I don't believe that for a minute, and I don't think you do, but we had better get on with it.