Introductory Remarks
by Gerald K. Bouey
Governor of the Bank of Canada
in an appearance before the
Standing Senate Committee
on National Finance
Tuesday, March 23, 1982

Introductory remarks
by Gerald K. Bouey
Governor of the Bank of Canada
in an appearance before the
Standing Senate Committee
on National Finance
Tuesday, March 23, 1982

As you know, my latest Annual Report was published a few days ago. I understand that copies have been made available to the Committee.

In that Report I reviewed Canadian economic and financial developments over the past year. I sought to put them in the perspective of developments in Canada and abroad over a longer period. Much of the Report was devoted to a discussion of the monetary policy pursued by the Bank of Canada in the context of those developments. I tried to describe the nature of the interest rate problem that we have in Canada and to explain why it could not be greatly eased by a change in the policy of the Bank of Canada.

I understand that one aspect of these matters that is of particular interest to this Committee is the one that might be described as the issue of "made-in-Canada interest rates". Accordingly, I shall concentrate the remainder of these opening remarks on that particular topic.

Let me begin with a question. How does anybody recognize made-in-Canada interest rates when he sees them? To what extent is it possible to have a useful definition of made-in-Canada interest rates in an economically interdependent world?

In a free society interest rates are not a wholly arbitrary element in the economic system. 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.

When one looks at current Canadian interest rates in this light there is nothing particularly unusual or exaggerated about them. Certainly interest rates 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. No one argued that interest rates above that low rate of inflation were not made in Canada.

The basic point is that, given the current rate of inflation in Canada, interest rates in Canada are in the range that one would expect them to be.

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. This tendency was particularly noticeable for medium and longer term interest rates as savers became more wary of committing funds at fixed interest rates for extended periods. 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. The most recent occasion was in the period from late in 1981 to date. U.S. short-term interest rates moved up quite strongly but Canadian short-term interest rates stayed relatively steady. The impact on the Canadian dollar of the disappearance for a time of the differential by which Canadian short-term interest rates exceed those in the United States was cushioned by the general belief that the rise in U.S. rates would be temporary.

This is a current instance of the unavoidable fact that shifts in financial conditions in the United States affect the Canadian situation, causing reactions in our interest rates or our exchange rate, or both. The Bank of Canada's response has typically been to smooth and to spread the impact to the extent feasible -- seeking to avoid abrupt movements in interest rates or the exchange rate that did not seem warranted by Canadian economic conditions. But this does not mean that the central tendency around which interest rates in Canada have fluctuated was inappropriate to Canadian economic conditions. As I have said, the broad trend of our interest rates is what one would expect in the light of our rate of inflation.

We should bear in mind that interest and exchange rate strains do not originate solely in events outside our borders. There is certainly a very large made-in-Canada content in our current high rate of price and cost inflation. And we are capable of generating our own shocks to interest rates and the exchange rate. About the middle of last year the Canadian dollar came under extraordinary downward pressure and short-term interest rates in Canada rose sharply. This was not attributable to any change in U.S. conditions but was caused by developments originating in Canada. The mounting wave of Canadian takeovers of foreign-controlled businesses in Canada had a sharp impact on the exchange market in the month of July. Despite a sharp upward movement of Canadian short-term interest rates the Canadian dollar went down three per cent in the space of three weeks. The rise in interest rates was initially a domestic market reaction to the extraordinary slide in the Canadian dollar, but in the circumstances the Bank of Canada had no responsible alternative but to accept it.

The extreme pressures to which the Canadian dollar has been subjected from time to time in recent years, whether the result of swings in U.S. interest rates or of shocks originating in Canada, have required prompt responses from monetary policy. Our reactions were not motivated by a fixation on maintaining any particular exchange rate. They stemmed rather from a desire to avoid aggravating an already highly inflationary situation through exchange rate instability and loss of confidence in Canada's will to control inflation.

Once lost, confidence in the will and determination of public policy to combat inflation is not easily regained. The effects on financial markets of an erosion of confidence can be rapid and devastating, with very serious consequences for output and employment. Our inflation is at present significantly higher than in the United States. It would be extraordinary to believe that in such a situation Canadian short-term interest rates could be pegged arbitrarily below U.S. rates by means of whatever monetary expansion it would take without generating a sharp decline in the exchange rate. This in turn would lead to still more inflation in Canada, a bigger gap against U.S. inflation, and still further exchange rate pressure. At some point policies would need to be changed to retrieve the situation and what we would finish up with is interest rates higher than they were in the first place.

At the same time, I need hardly say 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. Failure to make good progress in getting the inflation rate down in Canada would, however, severely limit our prospects of achieving a similar decline in Canadian interest rates.

Before I conclude these remarks on made-in-Canada interest rates I want to recognize that some of the concern that I have heard expressed about the influence of U.S. interest rates on Canadian rates is more related to fears about the future than to the current situation. Some forecasts that one sees about the future movements of U.S. interest rates are certainly startling but I believe they are based on overly pessimistic assumptions about how the U.S. situation will develop. I do not think that it is reasonable to expect the kind of dramatic rise in U.S. interest rates that some extreme forecasts show.

Let me end by saying that I am deeply aware of the difficulties, frustration and anger caused by interest rates. I know that there is a great yearning for some easy way out of our current economic problems. But we shall do better if we choose realism over wishful thinking. The goal of the Bank of Canada is to get interest rates down by the only way that can keep them down -- that is, by lowering the rate of inflation in Canada. Monetary policy has responded to developments that pose a threat to that objective, whether the disturbance originates in Canada or abroad. I regard that as made-in-Canada policy to serve Canada's economic interests.