IB-280
Extra

NOT FOR PUBLICATION BEFORE 2:15 P.M. EASTERN DAYLIGHT SAVING TIME
SEPTEMBER 21, 1982

NOTES FOR REMARKS BY

GERALD K. BOUEY

GOVERNOR OF THE BANK OF CANADA

TO THE 53RD ANNUAL MEETING OF

THE CANADIAN CHAMBER OF COMMERCE

O T T A W A

SEPTEMBER 21, 1982

Notes for remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to the 53rd Annual Meeting of
The Canadian Chamber of Commerce
Ottawa, Ontario
September 21, 1982

In this, my opening statement, I am going to try to respond to your invitation to provide some background for the discussion on monetary policy. I am going to do this within a two-part framework. I am first going to make some general comments on the nature and role of monetary policy in a market-oriented industrial society such as we have in Canada, and how in such a society interest rates and the foreign exchange rate get determined and their relationship to inflation rates. I shall then turn to some comments on the economic scene that exists in Canada at the present time and I shall try to put that scene in some perspective.

Let me start by making explicit what you all know, namely, that the process of economic decision-making in the Canadian economy is widely dispersed. The overwhelming mass of the decisions about what to produce, how to produce it, where, when, to whom and for how much to sell it, what use to make of the income generated in the process of production and distribution -- most of these decisions are taken by individuals or private groups related to each other by markets. In a

society like ours public economic management relies mainly on influencing the framework within which markets operate. It relies to only a rather limited extent, or exceptionally, on direct intervention. In light of this, you will not be surprised when I tell you that the powers given to the Bank of Canada by Parliament are designed for a central bank operating in such a decentralized, market-oriented economy.

A developed market economy needs many financial services. In our society these too are provided largely by private initiative. But if these arrangements are to work well over time there must somewhere in the system be some way of managing the supply of the nation's money. This is done by monetary policy. Monetary policy is by its nature a public responsibility, and it is typically conducted by central banks.

In Canada monetary policy is the direct responsibility of the Bank of Canada. So the Bank's principal objective is to achieve a pace of monetary expansion in Canada that best serves the needs of the Canadian economy.

I will not go into any detail on the Bank's technical powers, but I assure you that they are adequate for this purpose. Problems related to the machinery of control are at most of secondary importance. The primary problem for the Bank of Canada, and in fact for any central bank, is that of understanding the whole complex economic and financial process well enough to be able to chart a course for monetary expansion that will in fact best serve the economic life of the nation.

I do not believe that there can be any serious argument about what should be the basic objective regarding monetary expansion. Monetary expansion for a country should proceed at a pace which assures reasonable stability in the value of the country's money, or, in other words, reasonable price stability. That generalization might have been regarded as controversial a decade or two ago but few people would challenge it today. The damage generated by inflation is now too serious and too evident to ignore. Market economies do not and cannot work well without a money that can be trusted. A commitment to maintaining the value of money must be at the root of the conduct of monetary policy.

I am very aware that the path back to a better price performance is proving a very difficult one after the serious inflation that we have suffered. An immediate return to price stability is not of course a reasonable target in a country where inflation and expectations of inflation have become as ingrained as they have in Canada. Those circumstances pose a special set of transitional problems to which I want to return in the second part of this statement.

Before I do that, however, I want to say something about how interest rates and the exchange rate get determined in our society. It is not uncommon to hear people talk as if they believed that the Bank of Canada determined both and could cause either to move in any way that it wanted. That is a serious misunderstanding.

Both interest rates and the exchange rate are determined essentially by the interaction of market processes. In any given economic circumstance, with given public economic policies and private practices, including a given rate of monetary expansion, the resulting decisions affecting financial markets, by borrowers and lenders, producers and consumers, residents and foreigners will work themselves out in a pattern of interest rates and a foreign exchange rate. These rates will change with any significant change in the economic circumstances even if the rate of monetary expansion remains unchanged. They will also change if there is a change in the rate of monetary expansion. The Bank of Canada can therefore have an influence on these rates by altering the rate of monetary expansion. But the extent of that influence is subject to important practical limitations.

Let me elaborate that idea a bit with respect to interest rates. If in the current situation, and with nothing else happening, the Bank of Canada were to set out to achieve a major decline in interest rates in Canada by stepping up sharply the rate of monetary expansion, what would happen? Interest rates would probably fall at first, but the decline, except perhaps in the case of extremely short-term rates, would only last for as long as it took the financial markets to recognize what the central bank was doing. As soon as the markets realized what was happening they would act in the expectation that a sharp acceleration of monetary expansion would lead before long to a sharp acceleration in the rate of inflation. In Canada the acceleration of inflation would be facilitated and indeed would be pushed further by a decline in the foreign

exchange value of the Canadian dollar, one that could be extremely difficult to control. Before long nobody would be willing to lend money at lower, or even the same interest rates, and interest rates would rise. The central bank's initiative would turn out to be counter-productive.

The market reactions that I am talking about are not theory but practice. They are happening all the time. The prevailing levels of interest rates and the exchange rate are always being tested in terms of what the market participants think is going to happen in the Canadian economy in the foreseeable future. If you want interest rates or the exchange rate to come out much differently you have to convince the people who undertake commitments in those markets that events will in fact develop differently than they are supposing.

So much for background generalizations. Let me now turn to some comments on the current economic scene in Canada.

It is a very unhappy scene. The level of national output has been falling for a year and is now some 6 per cent below that of a year ago. Unemployment has risen sharply and is now over 12 per cent, the highest since the 1930s. And the rate of inflation, while below its earlier peaks and falling, is still of the order of 10 per cent. There is reason for great dismay in all of that.

In the course of the past year interest rates in Canada reached extremely high levels. The prime lending rate of the Canadian

banks reached a high of 22 3/4 per cent a year ago following a sharp decline in the exchange rate. Interest rates in Canada are now well below these peaks. The prime rate is now 15 1/2 per cent, having declined by almost 3 percentage points in recent weeks. Money and credit measures in general have tended to slow, although the interpretation of short-term developments in the money supply is complicated by the kinds of financial shifts and reshuffling that I have referred to in some detail on other occasions.

The Bank of Canada, like others, would like to see a further decline in interest rates but the scope for lower rates depends mainly on two factors: domestic inflation and external interest rates. Recently a decline in U.S. interest rates, although now partially reversed, has helped to make it possible for Canadian rates to come down. There may be further room for current Canadian interest rates to fall relative to the inflation rate, given favourable external developments, but that room is not great. No major decline in interest rates in Canada can be sustained without a substantial decline in the rate of inflation in Canada.

It is worth elaborating on this. In the conduct of monetary policy the Bank of Canada has to pay attention to the unavoidable impact on Canada of movements in U.S. interest rates. On a number of occasions over the past three years or so 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. Thus the spreads between

U.S. and Canadian rates have in fact varied over a considerable range. As regards the basic trend of interest rates in Canada, this is mainly determined by what happens to inflation in Canada, and at present inflation here is appreciably higher than in the United States.

If one looks into the present difficult economic situation in Canada he finds that business is caught in a severe squeeze between weak markets for its output on the one hand and high and rising costs on the other. This is true of virtually all businesses, large and small, including farmers. This is the situation that is causing rising unemployment and an increasing number of business failures.

Although Canadian monetary and fiscal policies in recent years have been directed toward producing an anti-inflationary environment, a major cause of weak markets for Canadian products is now the world economic recession. Because of the strained fiscal positions of the federal and provincial governments in Canada and difficult financial market conditions, there is very little room for increased public spending to strengthen demand in Canada. I have already referred to the constraints that exist on a decline in interest rates in Canada to strengthen demand.

What can be done to relieve the squeeze on business in Canada, and its fall-out on employment, is to slow the rate of increase in total costs. Profits have already responded to the weak market situation by falling sharply. By the second quarter of this year they had fallen 44 per cent from the first quarter of 1981. What would be most helpful

now would be a slowing in the rate of increase in labour costs. This would in turn allow the rate of inflation and the level of interest rates to decline.

If our economic system is to function properly the rate of increases in incomes must respond to a slowing of total spending in the economy. Despite the pronounced slowing in total spending that Canada is now experiencing the response of income demands has so far been quite inadequate. This is not saying that any particular group was responsible for the development of the high rate of inflation in Canada. I want to make that very clear. Increases in average wage rates did not lead inflation in recent years. But labour costs amount to about two thirds of total costs in the economy as a whole and therefore the rate of inflation cannot come down substantially and stay down without a slowing of the rate of wage and salary increases in both the public and private sectors of the economy. This does not mean that real incomes have to reflect the slower growth in nominal incomes. Nominal income increases and the rate of inflation would tend to come down together. In time the total amount of goods and services produced in this country will be greater at significantly lower rates of inflation and the trend of real income in the country will be higher rather than lower.

Perhaps a few numbers would be helpful in illustrating the direction in which income increases must move. If, for example, the inflation rate in Canada is to come down to the U.S. level, which by next year may be as low as 5 per cent, wage settlements will have to decline

one way or another from around 12 per cent (ex. COLA) where they have been recently to something like 5 or 6 per cent, depending on the trend in productivity. This is simply the arithmetic of our situation. So long as matters do not develop in this way we will continue to have problems with inflation, interest rates, output and employment, and our balance of payments. I am relieved to see some signs that income increases are now beginning to respond to the economic situation.

I think that it is of great importance that Canadians see the country's current economic plight in broad perspective because that will help them to act in a way that will reduce the current economic pain. Canada is not alone in its economic troubles. The world economy is going through a transition that is much more profound than anything that it has experienced since the period of economic reconstruction following the Second World War. The current world scene has many of the features of the business-cycle recessions that have been experienced periodically in the last 30 years, but there are some important differences. One major difference is that world-wide inflation picked up so much momentum in the 1970s that public confidence in most countries in the future value of money is now severely eroded. Because of that the kind of expansionary public financial policy used by governments and central banks to stimulate their economies during earlier periods of recession is no longer available to anything like the same extent. That medicine has lost its effectiveness because events have shown, and detached observers have recognized, that it produces inflation, not prosperity. That is why nearly all the governments and central banks in the free world have acted, and are

acting, with much more restraint than they would otherwise have shown. They have come to see that, in the interests of future economic prosperity, the threat of inflation must be beaten back. In the interests of future economic prosperity confidence in the value of money must be strengthened.

That is what is going on today in the international-trading world. Canada is a part of that world, and Canadian prosperity has in the past depended, and will in the future depend, on its capacity to compete effectively in that world. We won't succeed in doing that unless we first face up to such adjustments as are needed to allow the Canadian economy to produce at high levels without inflation, as it used to be able to do.

I am well aware that there is nothing in what I have said that will ease immediately the strain and pain that is being felt today by so many people across this country. I know this and I very much regret it. But the more resistance there is to the mounting world pressure to improve productive efficiency and to slow the rise in costs the more extended, the more wrenching and the more painful the adjustment will be.

Things do not have to work out that way. Canadians can, in their own interests, respond to the current difficult economic situation by controlling their costs and lowering the rate of inflation. They can get through this difficult transition phase more quickly and open the way to an earlier and stronger economic recovery.