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Notes for remarks by

Gerald K. Bouey

Governor of the Bank of Canada

to the

Investment Dealers Association of Canada

Toronto, Ontario

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[The event at which the Governor spoke was a dinner organized by the Investment Dealers Association of Canada in honour of Douglas Humphreys, a Deputy Governor of the Bank of Canada who was retiring after a long career with the Bank of Canada during which he had had many close associations with the IDA and many of its members. The Governor took advantage of the occasion to make some remarks about economic and financial developments along the following lines.]

I am glad to have this opportunity to discuss economic and financial developments with a group whose activities in mobilizing and distributing savings are vital to the economic health of this country.

In the course of the past year there has been a very great improvement in our economic situation. Production and employment have risen substantially, unemployment has declined and the rate of inflation has come down significantly. The track along which the economic recovery has been progressing is promising, and there are grounds for hoping that we are emerging not only from a deep recession but from a decade of unsatisfactory economic performance.

How solid the grounds for that hope are depends very much on how clearly we have grasped the fact that the main lesson of that decade in respect of economic policy is to avoid inflation. The idea that this is a time to stop worrying about inflation and to concentrate on fighting unemployment reflects a dangerous misreading of the economic process. The practice of regarding employment and price stability as having separate priorities to be weighed against each other is a serious mistake. No one is in favour of unemployment. The argument here is not about ends; it is about means. What the experience of the last ten years reveals so clearly is that we will not succeed in achieving and maintaining high employment if we are tolerant about inflation. That will lead only to a resurgence of inflation and then, in short order, the need to go through something like the recent recession all over again. Who wants that?

As a result of past experience fears of a resurgence of inflation are widespread and persistent. We will not allay these fears if we accept the idea that a rate of inflation of 5 per cent in Canada in 1984 is good enough. It is not good enough. We are still at a stage of the economic expansion where there ought to be a continuing improvement in cost and price performance. We need a continuing improvement in cost and price performance for external as well as domestic reasons. The United States and most of our other major trading partners are doing better on inflation than we are, and we need a continuing improvement in cost and price performance to help us to compete successfully with them in international markets.

The appropriate objective of monetary policy in present circumstances is a rate of monetary expansion sufficient to accommodate increasing utilization of our economic resources in a context of increasing price stability. That is what the Bank of Canada has been trying to achieve, and in my judgement the rate of monetary expansion this year has been consistent with that objective. The Bank will continue to pursue the same objective.

By its nature monetary policy cannot do more than influence the rate of growth in total spending in the economy. It cannot determine the extent to which any increase in total spending calls forth an increase in output as opposed to an increase in prices. The responses of the various groups in the economy determine that. A monetary policy designed to help to move the economy in the direction of rising output with increasing price stability will not result in good economic performance if business and labour determine prices and wages on the basis of a view that inflation will not be reduced. On the other hand, wage and price decisions that reduce inflation will generate lower interest rates, higher investment, more efficiency and the growth of employment and output. Monetary policy can hold open the path to sustainable non-inflationary prosperity but it cannot ensure that the economy chooses that path.

Both the conduct and explanation of monetary policy are easier if that policy can be expressed in terms of some indicator of monetary expansion, that is, some particular monetary aggregate. For a number of years we were able to make use of published targets for one such aggregate, M1, defined as currency and demand deposits, but as you know we have had to discontinue that practice because innovations in financial services provided by deposit-taking institutions made it an unreliable guide. In the period that we made use of published targets we always checked the trend of M1 against the information available from all other financial and economic indicators to guard against being misled by it. The fact that we do not now have a precise monetary aggregate target has not therefore fundamentally altered the analysis and the judgement involved in monetary management.

The movements in Canadian monetary aggregates over the past year have been quite unusual. The growth of M1 was very rapid from late 1982 through to the middle of this year, and some of you may wonder how I can regard that growth as consistent with the kind of monetary expansion I have been talking about. Let me reassure you. What happened was a temporary development, one well recognized by monetary economists. It reflected a substantial rebuilding of chequable balances following the large decline in interest rates. These balances had been run down earlier when very high interest rates made it extremely costly to hold such deposits. Since the high growth rate of M1 resulting from this adjustment in holdings of transactions balances was temporary it did not signal an acceleration in the trend rate of monetary expansion. Indeed M1 growth has slowed significantly over the past few months as the process of adjustment to current levels of interest rates appears to have come to an end. At the same time, however, the process of financial innovation appears to have been reactivated. Our new monetary aggregate, which is called M1A and which includes a broader range of chequable balances than M1, is being increased by shifts from non-chequable accounts, and this limits its usefulness for the time being as a measure of monetary expansion in Canada. The broader monetary aggregates provide a better indication of the movement over the past two years to more moderate rates of monetary expansion that has taken place but the slowing in their growth rates has been exaggerated by a reduction in the share of total public and private credit that has been provided by the banking system.

I have been speaking about the broad strategy of monetary policy. Now let me turn to recent developments in financial markets.

After a sharp decline from mid-1982 into the first quarter of this year, short-term interest rates have remained almost unchanged. The Bank Rate has moved within a very narrow range. Long-term bond yields edged up in the second quarter and have changed little since then. The exchange value of the Canadian dollar in terms of the U.S. dollar has remained relatively stable over the past twelve months.

The fact that the exchange rate has been stable does not mean that interest rates in Canada have followed exactly the same path as interest rates in the United States. The trend of money market rates in Canada has been flat since last spring while comparable U.S. rates have moved up. Government bond yields have not risen here as much as in the United States. Mortgage rates have continued to decline. Consumer loan rates are now about as low as they have been at any time in the last twenty-five years, and are lower than in the United States.

A question is often raised as to why, given our continued progress on the inflation front, have interest rates not come down further this year? The basic answer lies in concerns about future inflation and future interest rates.

The economic recovery has been stronger than was earlier expected. With large budget deficits predicted in the United States for some years to come, a clash for funds between the private and public sectors in that country appears as a danger to many people if nothing is done about the size of the deficit. Other countries, including ours, have somewhat similar deficit problems but attention is focussed on the United States because of the strong influence of U.S. developments on the rest of the world. It is in the nature of financial markets that interest rates move as fears of a collision develop -- they do not wait for the actual event to occur.

So far the level of interest rates has not prevented vigorous economic recovery. At the same time Canadian financial markets have been able to accommodate a large volume of borrowing by governments. The numbers are quite impressive. Over the past fifty-two weeks the amount of Government of Canada securities outstanding has risen by $27 billion -- $13 1/2 billion in Treasury Bills, $7 billion in

Canada Savings Bonds and $7 billion in market bonds. This public sector borrowing has occurred in a period when the demand for credit by business has been very weak. It has, nevertheless, provided an impressive demonstration of the strength of the placing power of investment dealers.

The current narrow differences in interest rates between Canada and the United States, in the face of an inflation performance which is still substantially better in the United States, restrict the scope for interest rate declines in Canada. Our balance of payments circumstances are a good deal better than in recent years and this has given us more room to manoeuvre without risking a large exchange rate decline. But the room is limited, and any major depreciation of the Canadian dollar at this time would be much more likely to damage than to help our economic situation in that it would be strongly inflationary in an environment where confidence that inflation is under control is still so fragile.

One way of looking at interest rates that is mentioned frequently these days is in terms of "real" interest rates. Typically commentators subtract the current rate of inflation from medium- or long-term rates and conclude that the resulting "real" rates of interest are high compared to past experience. But the "real" rates of interest that matter are the calculations made by potential investors and potential borrowers when they subtract their expectations about future inflation from the interest rates they expect to receive or pay in future years. To the extent that expectations of inflation of borrowers and lenders remain rather pessimistic, "real" rates of interest for them are not as high as the usual calculations would suggest. This is just another way of saying that pessimistic expectations of inflation by borrowers and lenders work to keep nominal interest rates up.

I hope that such expectations can be changed and that room for somewhat lower interest rates will develop. Such an outcome will require a continuation of our improving inflation performance and policies that contribute to confidence that inflation will be well controlled.

Confidence in price stability will also contribute to less volatility in interest rates. To a group that has had the disagreeable experience of having to operate in recent years under conditions of extreme interest rate volatility I hardly need stress the connection between reasonable price stability and well-functioning financial markets.

One dark cloud that hangs over us these days is the international debt situation but I believe that with the strong leadership of the International Monetary Fund this problem is being handled well. The IMF has received the co-operation of governments, central banks, the Bank for International Settlements, and of the commercial banks, including Canadian banks, who have put up most of the funds required. This co-operation has posed some difficult problems for banks that already have substantial exposures in debtor countries but it has been essential for the well-being of those countries, for the international financial system and for the world economy. Progress in dealing with the international debt situation will require a continuation of this co-operation and it will also require both continuing strong efforts by the debtor countries to bring about the necessary adjustments in their economies and an expanding world economy that will provide those countries with the export markets they need in order to service their debts. I believe that the international debt problem can be resolved but it will take a lot of effort spread over a number of years.

In concluding I want to repeat that I think we now have a chance to achieve a better economic performance than we have managed over the last decade. There are of course problems but it is encouraging that a number of countries, including ours, have moved a long way toward price stability and that world economic recovery is underway. It is also very encouraging that there is a much greater awareness on the part of the various sectors of our community of the need for prices and costs to respond to economic realities if we are to achieve sustainable growth in output and jobs. In framing monetary and other policies we must ensure that we bolster confidence that we are not going to undermine our prospects for growth in employment and output with a renewed outbreak of inflation.