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Luncheon Address by

Gerald K. Bouey

Governor of the Bank of Canada

on the occasion of a

Meeting of the Board of Directors

of the Bank of Canada

in Charlottetown, Prince Edward Island

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You will not be greatly surprised to hear that the main subject of my remarks today will be the rise in interest rates in Canada and the decline in the exchange value of the Canadian dollar that have occurred in recent months. Both of these developments have been of serious concern to Canadians including, I am sure, residents of Prince Edward Island. The Bank of Canada has certainly not wished to see either of them. The pressures behind these unwelcome events have come from outside Canada. The task of the Bank of Canada has been to respond to them in a way that moderates as much as possible the impact on our prospects for good economic performance.

Let me provide some background to my comments by reminding you how our economy has fared during the past year or so in recovering from the recession of 1981/82. Our situation improved greatly during 1983. We have had a substantial recovery in the level of real economic activity in this country. Production has risen by about 8 per cent from the fourth quarter of 1982 to the first quarter of 1984. Employment is up by about 3 1/2 per cent over the same period. And we have made major progress in bringing down our inflation rate. The rate of increase in consumer prices was about 10 per cent in late 1982, now it is under 5 per cent. We have also managed to move into substantial surplus in our balance of trade with other countries over the course of the past two years. Rapid economic growth in the United States has been an important source of stimulus both in Canada and the rest of the world.

The rise in interest rates in recent months however has generated understandable unhappiness in Canada. The economic recovery has yet to return us to anything like satisfactory levels of production and employment. In the early months of this year the recovery has shown some signs of slowing and our already high unemployment rate has risen. With these economic conditions, and given the progress we have made in reducing inflation, the increase in interest rates has certainly not been what anyone would have liked to see. Even so, the rise in rates in Canada has not been sufficient to prevent a significant decline in the exchange value of the Canadian dollar to the point where it presents a new risk to our progress on inflation.

The main source of these pressures in our financial and exchange markets has been events in the United States. Economic activity in the United States has been expanding rapidly -- indeed too rapidly to be sustainable. The margin of unused resources in the United States has been greatly reduced. The large American budget deficit has been absorbing savings and adding to the demands on the U.S. economy at a time when private sector spending is expanding strongly. In these circumstances, interest rates in the United States have been rising since 1983.

There has, I believe, been too great a tendency in industrial countries in recent years to rely on monetary policy to restrain inflation pressures. That has been true even at times when fiscal situations have been clearly in fundamental imbalance, thus providing yet another reason for corrective fiscal measures. And given the extremely rapid economic expansion in the United States, the case for prompt fiscal action there is greatly reinforced.

Indeed, there is no substantial disagreement in the United States on the need for action to reduce their budget deficit. The disagreement is on the way to go about it. What combination of expenditure cuts and tax increases should there be? This is a question on which reasonable people can disagree. However, delay in taking fiscal action, even if this is because of disagreement on <u>how</u> rather than <u>whether</u> to attack the deficit problem, does worsen the situation. It leads to high interest rates in the United States which also affect the rest of the world.

I would not want this emphasis on the United States to obscure the very real issues facing Canadians over time in the management of government finances in this country. However, because of the size and importance of the U.S. economy, the essential problem from a global perspective is the fiscal situation and prospects for the United States. Because of high interest rates, investment needed to ensure future growth in the world economy is being inhibited. The situation of developing countries trying to extricate themselves from the burdens of international indebtedness is being impaired. And the ability of all countries to pursue the mix of fiscal and monetary policies appropriate to their domestic circumstances is being impeded.

For Canada the increases in U.S. interest rates have entailed strong upward pressure on Canadian interest rates and downward pressure on the international exchange value of the Canadian dollar. Canadian short-term market interest rates have risen by about 2 1/2 percentage points since late last year. The prime lending rate at banks is up from 11 to 12 1/2-13 per cent. Mortgage rates have risen some 2 1/2 percentage points. The Canadian dollar, which had remained relatively stable at levels just above 81 U.S. cents for much of 1983, has been trading in the last few days at levels below 76 1/2 cents, a decline of about 6 per cent.

The Bank of Canada has not wanted these interest rate increases nor has it wanted to see a lower Canadian dollar. What the Bank could do in these circumstances was to try to moderate the pressures on Canadian interest rates and on our exchange rate, and that is what we have done. Had we taken stronger action to forestall the rise in our interest rates, the initial burden of adjustment to the external situation would have fallen still more on the exchange value of the Canadian dollar. Alternatively, greater resistance to exchange rate depreciation would have required still higher Canadian interest rates than we now have.

One criticism of monetary policy has been that we have got our priorities all wrong. It is sometimes contended that instead of consistently resisting the weakness in the Canadian dollar in the way we have, we should have bent all our efforts towards holding down Canadian interest rates, or indeed driving them down further, while letting the exchange rate float "freely". In this way, it is argued, Canadian interest rates would indeed be "made in Canada" and the exchange rate would come to rest at what is asserted would be its "natural" level.

Such a view is high in rhetorical content and emotional appeal but must be dismissed as a policy option. This policy has never succeeded where it has been tried because it is based upon a fundamental misunderstanding of the nature of financial markets and what drives them. A nation's exchange rate does not float in a vacuum. It can only float and find its level within the context of policies and perceptions of policies. A prescription for monetary policy of the kind I have described would bring the Canadian dollar under intense downward pressure once it became evident that there was no policy concern about the Canadian dollar and the impact of any decline on inflation. In a situation where Canadian policy was perceived to be oriented towards repeating the inflationary mistakes of the 1970s, the exchange rate decline would have no evident limit. Interest rates would in fact rise sharply rather than fall as investors sought to get out of assets denominated in a currency that was only headed in a downward direction and as financial markets came to be dominated by the unpleasant prospect of much higher inflation rates. The Bank of Canada's actions have been directed towards avoiding such a disastrous outcome. Its actions do not provide any support for the view that the only direction for the Canadian dollar is down.

I observed earlier that Canada is by no means the only country whose interest rates and exchange rate have been affected by the high level of U.S. interest rates. Other industrial countries have felt the impact as well. But Canada is more affected than most because our direct economic and financial links with the United States are greater than those of virtually any other country in the world. That is why the U.S. dollar exchange rate is so important to us. Other countries' currencies have depreciated a great deal against the U.S. dollar in recent years but since trade with the United States is for most of them a small fraction of their total trade, their overall exchange rate relationship has altered a great deal less than their bilateral relationship with the U.S. dollar. Since Canada's situation is so different we really have to focus our attention on the U.S. dollar relationship.

As I have indicated, interest rates in Canada have not risen high enough to prevent some depreciation of the Canadian dollar against the U.S. dollar for the time being. Some prices in Canada have already risen as a result. The longer the lower level of the Canadian dollar persists, the more prices in Canada will react to the changed exchange rate. These price rises can have the benefit of providing a stimulus to export industries and to those industries which compete with imports. But that stimulus exists only so long as Canadians accept the higher prices without demanding compensating increases in their wages, salaries and other prices. If Canadian costs do rise, any advantage is eroded.

It is because of the substantial inflationary risk involved that I have never favoured depreciation where it could be avoided or at least limited. The record has not been good; our past experience with exchange rate depreciation has been that all too often it has led, not to a sustained improvement in our competitiveness, but to additional inflationary momentum as Canadians attempted to protect their incomes against the loss of purchasing power. The end result has then been more inflation rather than more economic activity.

We cannot afford today to take any major risks with inflation. The scars have by no means disappeared after our recent encounter with severe inflation and the recession that inevitably followed. If we let inflation get away on us again, even just for a while, the path back to price stability will be even more painful than it has been during the last few years. Who will then be willing to believe that the authorities are serious in their desire to return to a stable price level? And without a relatively stable price level we will not succeed in achieving the sustained economic expansion that we all desire.

We cannot avoid dealing with the international environment that confronts us. We cannot wish away the outside world because it is not always favourable to us. That reality is, I believe, becoming more widely recognized in Canada. But what we can and must do is ensure that our responses to higher external interest rates are as constructive as possible. Certainly being tolerant of inflation, in particular by not resisting exchange rate depreciation, will only aggravate rather than ease our adjustment to the external situation. The lower our inflation rate, the better we are able to cope with external shocks without setting off fears of a resurgence of inflation and a scramble by Canadians to protect themselves against rising prices and a declining currency.

I would like to take a moment here to dispel fears anyone may have that the current rise in interest rates could lead us again to levels in excess of 20 per cent such as we encountered in 1981. At that point our inflation rate was around 12 1/2 per cent and interest rates were at levels that reflected the demand by savers to be compensated for the rapidly declining value of their money and the need to provide a measure of restraint to bring down that inflation rate. We are not in such circumstances now. Our inflation rate, as well as those of our trading partners, is much lower now and has on balance been declining. I see nothing in our current economic situation that is likely to bring about the repetition of such drastic financial conditions.

The most constructive response we can make to the effects of the high international interest rates is to look to whatever means we can to improve our basic competitive position in the world. That includes continuing to moderate our income increases even when it implies absorbing without compensation any price increases coming from depreciation. It also includes making the maximum effort to keep our production as efficient as possible so our costs will be as low as possible. If, through an increase in our competitiveness, we can expand our sales of "made-in-Canada" products, we can help to sustain our economic expansion and make progress in bringing down our high unemployment rate even in these difficult times. And it is not unreasonable to hope that some reversal of the high external interest rates will occur before too long and enable us to make more rapid progress.