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Statement Prepared for the Appearance of Gerald K. Bouey

Governor of the Bank of Canada

before The House of Commons Standing Committee

on Finance, Trade and Economic Affairs

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My latest Annual Report was published some weeks ago; I hope you have had an opportunity to look at it. I propose today not to summarize the Report but rather to underline and to elaborate on some of the important points contained in it. I would also like to bring you up to date on exchange rate and interest rate developments.

The first point I want to draw to your attention is the importance of viewing developments in the Canadian economy in a longer perspective than one year. The progress made in 1984 in expanding output and employment and in lowering inflation was a further advance towards the better economic performance that we all seek after the inflationary experience of the 1970's and early 1980's. The Annual Report provides a reminder of how much our economic recovery has been hampered by the legacy left by high inflation. The severity of the 1981-82 recession and the heavy debt burdens of many businesses and individuals are part of that legacy. Moreover, the way in which inflation was eventually fought around the world placed too much reliance on monetary policy and high interest rates and not enough on fiscal restraint. High interest rates have added to the burdens of debtors, making

the process of redressing financial positions more difficult and prolonged, and have left both individuals and businesses cautious about undertaking new spending commitments that would contribute to recovery.

My Report has been criticized for being too concerned about inflation and not sufficiently concerned about unemployment, which is still distressingly high. But inflation and unemployment are not separate concerns -- if we take risks with inflation and let it get away on us once more, our overall economic performance will again suffer. Let me also remind you that, despite our progress, the inflation rate in 1984 was still higher than in virtually every year between 1952 and 1972.

While the over-riding objective of monetary policy must be price stability, this does not mean that monetary policy cannot help support and sustain economic expansion. Indeed, because there was scope for reinforcing spending in the economy during 1984 without undermining our progress on inflation, the objective of the Bank's policy operations, as I indicate in the Report, was to encourage a lower level of interest rates. In the event, however, that objective was not achieved because of interest rate and exchange rate pressures coming from abroad. Those pressures have been frustrating and difficult to cope with.

We describe in the Annual Report the role of the U.S. fiscal deficit in contributing to the increases in interest rates in the United States and to the extraordinary strength of the U.S. dollar. As a result of the ensuing distortion of international exchange rates, the Canadian

dollar has appreciated substantially against other currencies while depreciating on balance against the U.S. dollar. With these exchange rate divergences, there is no way that we can have an exchange value for our currency that is reasonable in terms of our overall competitive position, in which the relationship with the U.S. dollar is by far the major element, and at the same time have a good competitive position with our trading partners overseas. This situation is causing difficulties for companies and industries that must compete with overseas countries, but this is not a problem which Canada can solve by domestic measures. Despite some recent reversal, the U.S. dollar has remained remarkably strong against all major currencies, and, as is widely recognized, credible action in the United States to reduce their fiscal deficit would improve currency relationships a great deal.

High U.S. interest rates put upward pressure on interest rates throughout the world and, because of our close links with the U.S. economy, particularly on Canadian interest rates. We have at times been able - for short periods - to take some U.S. interest rate pressure on our exchange rate, leaving our domestic interest rates somewhat lower than theirs. But that trade-off was only temporary, and, let me stress, it was only available under favourable conditions. As the Annual Report describes, conditions over the past year did not permit such a trade-off.

The problem we faced for much of that period was not only rising U.S. interest rates but concerns that higher rates would persist because of a large and chronic fiscal deficit in the United States at a time of rapid economic expansion. Last Spring when the Bank of Canada set out to moderate

the upward external pressure on Canadian interest rates, the Canadian dollar declined rather sharply. Moreover, the further the Canadian dollar fell, the more strongly investors demanded higher Canadian interest rates to protect themselves against the possibility of losses from still further exchange rate depreciation. In other words, as confidence in the Canadian dollar was weakened through depreciation, this increased the additional yield, or spread, that market investors required from financial assets denominated in Canadian dollars relative to U.S. dollar assets. Furthermore, since the impact of depreciation on investor attitudes is not quickly shaken off, interest-rate spreads stayed wider for some time after the bout of exchange-rate pressure subsided. In effect, what we had in 1984 was a demonstration that risking a potential loss of confidence in the exchange rate is not a recipe for bringing about lower interest rates.

I would also like to elaborate on the comments in the Annual Report about the effects of exchange rate depreciation. It is all too often forgotten that exchange rate declines affect more than just import prices. Both the prices of domestic goods that compete with imports and goods sold in Canada of a type that can be exported will also go up. How inflationary such widespread price rises will be depends on market conditions. This past year the price effects of depreciation were largely offset because of the fact that the rise in our domestic costs was quite small. However, it takes time for price effects from depreciation to work their way through the economy and we have not yet seen the final result, but I am hopeful that this good performance will continue.

Indeed, for the depreciation to provide effective stimulus to output and employment, the higher prices caused by depreciation must be absorbed without a push for compensating increases in incomes. Otherwise the result will not be an improvement in our international competitive situation but simply more inflation. Advocates of depreciation should squarely recognize the fact that exchange rate declines only provide economic stimulus by squeezing the real incomes of workers. The Annual Report reiterates the Bank of Canada's concern that a large and rapid compression of the purchasing power of Canadians because of exchange rate depreciation risks a self-defeating resurgence of inflationary demands for compensating increases in wages and salaries.

As the Report was being written in February, there was a further sharp strengthening of the U.S. dollar. The Canadian dollar came under downward pressure and once again we were pushed off our course of encouraging lower levels of interest rates in Canada. Before that episode was finished the Canadian dollar had fallen by 6 per cent to a low of nearly 71 cents U.S. and the treasury bill tender rate had risen by over 2 percentage points to a peak of about 11 1/2 per cent. As before, when the Canadian dollar began to fall, investors sought higher interest rates as protection against the possibility of further exchange rate declines. The Bank operated to moderate the increase in rates but did not engage in a counterproductive attempt to prevent any increase in rates through massive purchases of securities in the market. The attempt to prevent any increase in rates would have risked a loss of confidence in the Canadian dollar and pressures for much steeper increases in interest rates.

Fortunately, some of the speculative burst that drove up the U.S. dollar in the first place seems to have unwound during March and April. That process was aided by some declines in U.S. interest rates, based it seems on evidence that the U.S. economy has not been growing quite so rapidly in recent months. The Canadian dollar regained some of the ground that it lost against the U.S. dollar and our interest rates moved back almost to where they were in January.

While some of the interest rate-exchange rate improvement of March and April has been reversed again during the last couple of weeks, the financial situation today nevertheless looks better than it did in February. It would look better still if the recent decline in external interest rates had reflected action on the U.S. fiscal deficit rather than perceptions of a slower U.S. economic expansion. However, the problem of the deficit does remain a matter of very active policy concern in the United States. The issue that is debated there is <u>how</u> to reduce the deficit rather than <u>whether</u> to. I think that it is reasonable to believe that the Americans will succeed in dealing with this problem. The prospects for lower Canadian interest rates will also be improved as it becomes increasingly accepted that it is not Canadian policy to encourage exchange rate depreciation and that we are managing our affairs in a sound, non-inflationary, fashion.

As I concluded in my Report, our economy is in better shape than it has been for some time. Certainly we have problems -- our high unemployment rate and the uneven nature of our economic recovery attest to

that. But if we continue to improve our productivity and hold down our costs as we did in 1984, that will help to keep our economy expanding and contribute to a lower unemployment rate.