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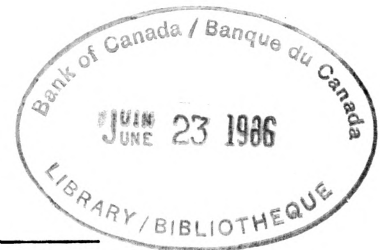

NOTES FOR A

LUNCHEON ADDRESS BY

GERALD K. BOUEY

GOVERNOR OF THE BANK OF CANADA

TO

THE CANADIAN CLUB

VANCOUVER, B.C.

JUNE 20TH, 1986

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Notes for a Luncheon Address by
Gerald K. Bouey
Governor of the Bank of Canada
to the Canadian Club
Vancouver, June 20th, 1986

I am delighted to be in Vancouver during these centennial celebrations and honoured to have been invited to speak to you today. People from around the world are coming to visit Expo 86 and British Columbia this summer. It is exciting to be here for such an international occasion, and it seemed to me to be appropriate therefore to orient my remarks today towards international matters. This international orientation also fits very well with the character of the economy of British Columbia given the importance of export industries in this province and the role that British Columbia plays as the window for Canada on those countries that border the Pacific Ocean.

This orientation also fits the character of the economy of Canada as a whole. And it is commonplace in Canada for speakers with an international theme to note our reliance on trade and to stress the importance of international markets to the well-being of Canadians. But in listening to public discussion I wonder sometimes how widely this situation is appreciated in Canada. Let me just say that it is certainly unrealistic to believe that Canadians can safely ignore developments outside our borders and that we could still live quite comfortably in isolation from the rest of the world.

Nonetheless, to accept the importance to us of international markets, of the international exchange of goods and services around the world, in no way means that the international climate cannot at times also pose problems for us. Indeed, the trade stresses to which Canada has been exposed recently, whether the subsidized competition for international wheat markets, U.S. protectionist measures directed at Canadian lumber and other exports, or the effect on our producers of the decline in the world price of oil, show only too clearly how difficult and frustrating those problems can be.

However, my purpose today is not to address particular trade matters but to review some broader features of the international financial scene. In fact, many of the problems we see today in international trade are undoubtedly in part a result of pressures and imbalances evident in the international financial arena over the past several years. I want to talk more specifically about those pressures and imbalances and their broad impact on Canada, but I also want to highlight some recent encouraging signs of improvement in the underlying international environment.

The sharp and prolonged movements in exchange rates and the extremely wide divergences in international balances of trade in goods and services among major countries that we have seen in the past several years have largely been a product of the differing ways the large industrial countries have run their economic policies. They have differed both with respect to the extent to which they have managed to control inflation and regarding the degree to which they have emphasized fiscal or monetary restraint in the process.

The double-digit inflation of the 1970s, which infected most of the world, was in the end brought down largely with monetary policy. It will be difficult to forget the deplorably high interest rates that were needed to combat those intense inflationary pressures in the face of a lack of fiscal restraint in many countries. The inflation epidemic had to be fought, but because of the serious distortions associated with the prolonged period of extreme inflation and the way inflation was fought, the worldwide recession that inevitably followed was distressingly steep.

Here in Canada this cycle of inflationary boom and bust was particularly severe. Spurred by the sharp rise in world prices for primary and resource-based products, the economic boom of the early 1970s was stronger than elsewhere. An inflation rate worse than that of most of our trading partners became entrenched for a while in Canada. Indeed, by 1980-81 a strongly inflationary psychology had taken hold in Canada. Despite extremely high interest rates, large burdens of debt were taken on. Frequently the borrowing was to finance real estate and corporate acquisitions. In the recession that followed, the combination of the worldwide expansion of supply in the resource industries following on the 1970s price boom, the resulting sharp decline in world commodity prices, the return of more realistic values for real estate and other assets, and the heavy burden of indebtedness carried by many firms and individuals made the economic downturn in Canada very sharp indeed.

The adjustment of the world economy back to more stable prices was bound to be difficult. The legacy of distortions left by inflation was too

great for the process to be easy. Unfortunately the problems of adjustment were greatly exacerbated by differences among countries in the stance of fiscal policy. Most countries' budgetary deficits had worsened dramatically during the recession. Moreover, in the United States, Canada and some other countries, fiscal stimulation contributed further to deficit situations that were already deteriorating. In this situation the rising costs of servicing an ever-growing burden of debt loomed increasingly large. Because of the size and importance of the United States, the high interest rates associated with the financing of its expanding budgetary deficit put upward pressure on interest rates everywhere and contributed to a very strong U.S. dollar. From the end of 1980 to early 1985 the U.S. dollar rose dramatically and contributed to a huge deficit on international trade in goods and services for the United States and corresponding large surpluses for Japan and Germany in particular.

The effects on Canada of the high interest rates and the resulting exchange rate and trade distortions were particularly severe. Compared with currencies in Europe and Japan the Canadian dollar lost relatively little value against the U.S. dollar, but this meant that our currency rose considerably against all other major currencies. Many Canadian export industries benefitted importantly from the strength of the U.S. economic recovery. At the same time, however, those industries and companies that were exposed to competition from suppliers from countries whose currencies had depreciated greatly against the U.S. and Canadian dollars found themselves in a highly unfavourable situation.

These various imbalances did not prevent economic recovery in Canada after the recession, but they did mean that the recovery was uneven. Central Canada had the strongest expansion in economic activity. In the rest of the country, where the reliance on resource-based industries is greater, economic activity and employment remained much less buoyant.

A vital ingredient for an improvement in our resource industries is sustained economic recovery among industrial nations -- our major markets. Curbing inflation has been a fundamental condition for sustained international economic recovery, and a very great deal has been achieved in this direction. Attention in the world is now also focussed on achieving a better balance of financial policies among the major countries to ensure that economic expansion is vigorously maintained. It is in this context that I want to refer to some international policy initiatives that have helped to alleviate the problems of high interest rates and distorted exchange rates and that now provide the potential for a more congenial financial environment in the world than we have had for a long time.

To an important extent one can relate these initiatives to fears, both within the United States and among its major trading partners, of trade protectionism. This regrettable, and dangerous, rise in protectionist sentiment has been in large measure a response to the loss of competitiveness suffered by American producers because their currency had become seriously overvalued against major overseas currencies. In the face of concerns about an undermining of the open world trading system and widespread agreement that the U.S. dollar was too high, a decision was taken by the five major

industrial countries to seek to lower the value of the dollar through coordinated intervention in exchange markets. Since that initiative last September the U.S. dollar has fallen back substantially in terms of those currencies against which it had risen so sharply in the preceding four years or so.

That success in bringing down the U.S. dollar should not however be attributed solely to official intervention in exchange markets. Another influential change has been the effort that Congress has been making to get the U.S. budget deficit under control. The deficit was of course a principal reason for the high U.S. interest rates and appreciating currency in the first place. As the outlook for the deficit has begun to improve, it has led to downward pressure on interest rates and the U.S. dollar.

The support for increased international cooperation has strengthened greatly in recent months. The recent Summit meeting in Tokyo extended what was achieved at the G-5 meeting last September in New York. The resulting formation of an enlarged group of countries including Canada, known as G-7, which has received a mandate to discuss national economic policies and the scope for better coordination of those policies, should, I believe, also contribute over time to a better climate in international financial markets.

The recent downward adjustments in short-term interest rates in major countries and the movement to a less distorted set of exchange rates have been important products of these international policy initiatives. But in many ways the most interesting and significant development has been in

long-term markets. Since last September, for example, U.S. long-term government bonds have come down from rates of 10 1/2 per cent to as low as 7 1/2 per cent recently. While some short-term speculative activity has undoubtedly contributed to the lower long-term rates, I believe there has been a significant underlying improvement that reflects diminished fears of continued high fiscal deficits and of inflation.

The impact of these events on Canada has led to a better alignment in our exchange rates. We are now much more competitive with our trading partners overseas. As well, increased room opened up for interest rates in Canada to come down. Because it is the policy of the Bank of Canada to encourage the movement towards lower interest rates so long as this can be done without threatening to impair progress on inflation, I would like in the rest of these remarks to discuss some of the factors that are relevant to the achievement of that goal.

One very important factor is the performance of our currency in exchange markets. As by now is very well known, the Bank of Canada has consistently been concerned in its policy to resist downward speculative pressures on the international value of our dollar. The most recent bout of extreme pressure occurred in January and February. While part of this undoubtedly reflected the decline in oil prices and weak commodity prices generally, the market reactions were greatly overdone. Our susceptibility to such over-reactions is partly a product of the uncertainty associated with volatile exchange markets around the world, but probably the more important

factor is our past history of exchange rate depreciation. Since those who bet on a declining Canadian dollar in the past have often been proven right, it is very difficult to convince people not to continue betting the same way whenever the dollar comes under pressure.

One response to these concerns about the Canadian dollar has been to say, "let it happen -- let the dollar find its own level". But what this response fails to recognize is that a loss of confidence in our currency involves substantial costs. And it is ironic that many of those people who advocate letting the Canadian dollar fall do so because they want lower interest rates. In fact a loss of confidence, as has been brought home on a number of occasions, brings with it higher interest rates. Investors, whether Canadian or foreign, will seek protection through higher interest rates against the prospect of further losses from exchange rate depreciation.

The other cost of depreciation is the risk of higher inflation associated with the impact of a declining dollar on prices in Canada. As I have pointed out many times before, depreciation is not a miracle solution to economic problems; if it were, the amount of depreciation that we have experienced over the past nine years would have put us on easy street.

Depreciation is sometimes advocated as a disguised means of lowering the real value of wages and salaries in order to improve our ability to compete in international markets. However, if, as is so often the case, wage and salary earners reject this attempt to reduce their incomes and successfully fight to gain compensation for the higher prices caused by

depreciation, the result is a higher inflation rate and no improvement in international competitiveness. Since inflation is bad for economic growth, we are as a nation worse off when we permit depreciation to undermine our price performance.

The depreciation in the Canadian dollar that we have experienced over the past two years has been a source of upward pressure on our prices recently. And after three years of continuous improvement we did not make any further progress last year in bringing down our rate of inflation. Essentially, the twelve-month rate of increase in our Consumer Price Index has remained at about 4 per cent since late 1984. There have moreover been signs recently in some parts of Central Canada of increased pressures on prices and wages. These developments are all the more worrisome when one considers that virtually all the major industrial countries are currently displaying a better price performance than we are.

The crucial contribution that monetary policy can therefore make to sustaining our economic recovery is to seek further improvement in our inflation performance. In practice that means a policy which will maintain confidence in the Canadian dollar. It is in this way that we will achieve the lowest interest rates possible. That is why we have reacted so forcefully to sharp downward pressures on our dollar, as we did last February. The necessary increase in interest rates at the time was not welcome, but I have no doubt whatsoever that our interest rates would be higher now and our concerns about inflation more pressing if we had not taken that prompt action. Thus we have been in a much better position to take advantage of the room

provided by improved international markets, and our interest rates have come down over the past few months.

It is not difficult to point to particular problems on the domestic or international financial scene. I have referred to some of them today. At the same time, what I have wanted to stress is that behind all these problems there has been a fundamental improvement in the economic environment. The problems that we face, while certainly difficult and painful, are for the most part a legacy of the excesses of an inflationary past rather than a signal of new turbulences ahead. After the long and difficult battles we have had with inflation, high interest rates and distorted exchange rates, we and other industrial countries are now almost starting afresh. If we and our international partners have learned from that unpleasant experience just how important it is to run our affairs in a non-inflationary and balanced fashion that also encourages rather than restricts international trade, the opportunity is there to achieve a sustained period of good economic performance of the sort we have not seen for some time.