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Why the Bank of Canada is on the Wrong Track

There are two problems with current Canadian monetary policy that make it too tight .

The first is that interest rates, represented by the prime rate at 21.25 per cent, are much too high.

The second is that the approach to monetary policy the Bank of Canada is pursuing guarantees that, except for temporary dips, interest rates will stay too high for a number of years. Interest rates are too high because they are being maintained at a level that is much higher than necessary to combat inflation.

This is not to deny that, to exercise restraint over private spending in the economy, it is essential that interest rates exceed inflation by a substantial margin so that borrowers are faced with a high real cost of funds when making their decisions to invest in plant and equipment or to purchase homes, cars or appliances.

Determining a high enough real cost of· funds is, of course, a judgment call. But most economists would probably agree that the 4 to 5 per cent range would be high enough. In fact, an examination of the historical record shows that a real, cost of funds in this range is near the maxi- mum reached in the postwar period during periods of tight money and that it was seldom held for any length of time.

In this light and in relation to the August year-over-year increase in the consumer price index of less than 13 per cent and to the second quarter year-over-year increase in the gross national product deflator of less than 9 per cent, recent short term interest rates on treasury bills and commercial paper in the neighborhood of 20 per cent are much too high.

Canadian short term interest rates are also much higher than those in the United States.

Treasury bil1 yields in Canada, for example, are more than 500 basis points higher. These differences in rates do not stem from the need to slow the growth in the money supply to stay within the target range. M-1 (currency plus demand deposits), the definition of the money supply for which the Bank of Canada specifies its target, is currently running below the bottom of the range. Instead, the large spreads can be traced to the bank's concern about the Canadian dollar.

Gerald Bouey, the governor of the Bank of Canada, has justified the margin above U.S. interest rates "'in terms of the large current account deficit in Canada's balance of payments, the Canadianization of the oil and gas industry, and a higher rate of inflation in Canada than in the

United States.

These are fundamental problems and tight money does not get at their roots. Some exchange rate adjustment may be required. If so, this should be allowed to occur, rather than trying to force the economy to adjust to the exchange rate.

The moment of truth for the exchange rate seems to have passed. Since the Canadian dollar bottomed out at 80.4 cents (U.S.) on Aug. 4, it has, in the wake of the Ottawa-Alberta energy settlement, rebounded strongly to more than 83 cents.

An opportunity presented itself. It should have been taken. In the short run, the bank should allow nominal interest rates to drift back down toward U.S. levels. This would bring real interest rates in Canada down to about the 4 per cent that would seem to be required if monetary policy is to remain restrictive enough to exert significant downward pressure on inflation.

A lowering of rates would obviously solve the first problem with the current stance of monetary policy; namely, that interest rates are too high. It could even do this for a certain period of time, probably a matter of months, without exceeding the bank's 4 to 8 per cent target range for monetary growth.

The fact that M-l growth is running below the bottom of the range provides some room for accommodating the increased money demand that could be expected to result from a decline in interest rates. However, ultimately a lowering of interest rates would push the growth of the money supply well above the target ceiling.

This brings us to the second problem with current monetary Policy. The Bank's 4 to 8 per cent money supply growth target, not to mention any further reductions in the target, is inconsistent with a reasonable real rate of interest, unless there are fortuitous downward shifts in the demand for money.

If pursued, this could lead to rising nominal and real interest rates, which could only be halted by a recession of major proportions.

The bank, of course, is a responsible institution that puts the welfare of Canada and the good health of the Canadian economy above a mechanical application of its own money supply growth rules. So it will never get down to this.

Nevertheless, it is necessary to understand, the internal inconsistency of the logic of the current approach to know what will have to be changed.

The gist of the argument is simple. The bank's approach assumes that there is a stable relationship between the demand for money on the one hand and interest rates and nominal income on the other.

To the extent that nominal income increases more rapidly than the money supply, interest rates must rise in relationship to the demand for money.

The economy is faced with a very high rate of inflation next year in the 11 to 12 per cent range. Moreover, except in response to draconian fiscal and monetary restraint, inflation is likely to moderate only gradually.

This stems from the high degree of momentum of the inflationary process resulting from multi-year contracts and inflationary expectations. The recent energy pricing settlement should also tend to prop up inflation.

For purposes of an illustrative, calculation, it is assumed that inflation is 12 per cent and that the economy grows by the 3.5 per cent regarded as real potential growth. This would imply nominal income growth of 16 per cent ..

If nominal income were to, grow at 16 per cent while money supply growth was to be held to 6 per cent, representing the middle of the bank's current target range, there would be a 10 percentage point gap between the growth of nominal income and money supply.

Interest rates would undoubtedly have to go up to equate the demand and supply of money. Estimates of the required increase vary. A conservative, estimate of its magnitude would be 2.5 points.

As long as inflation and real growth continued unabated, interest rates could be expected to steadily climb every year by an amount in this range. Something would have to give. Because of the inertia of the inflationary process, it could only be real growth, thus making a major recession inevitable. Only after it had taken its toll would inflation decelerate sharply.

The tightness of a 4 to 8 per cent target band should not be underestimated. With real potential growth of 3.5 per cent, 6 per cent monetary growth' would only accommodate inflation in the 2 to 3 per cent range. Alternatively, with 12 per cent inflation, it would only accommodate a decline in output of 6 per cent.

Since the first alternative is not likely and the second not acceptable, a continuation of the current approach to monetary policy with its 4 to 8 per cent band is not a viable policy option. Further reductions in the target band would make the situation even worse.

There is also the so-called "transition problem" to be considered. Once inflation is brought down, interest rates can follow suit only if the money supply is allowed to grow more rapidly than nominal income growth for a time.

Otherwise, the extra money demand resulting from falling interest rates cannot be accommodated. A decline in interest rates is impossible if the money supply growth is always being ratcheted down to put continued downward pressure on inflation.

The solution to the problem is relatively straightforward. It involves a switch in emphasis in monetary policy formulation from money, supply growth targets to real interest rates. This would not preclude some focus on exchange rate stabilization from time to time.

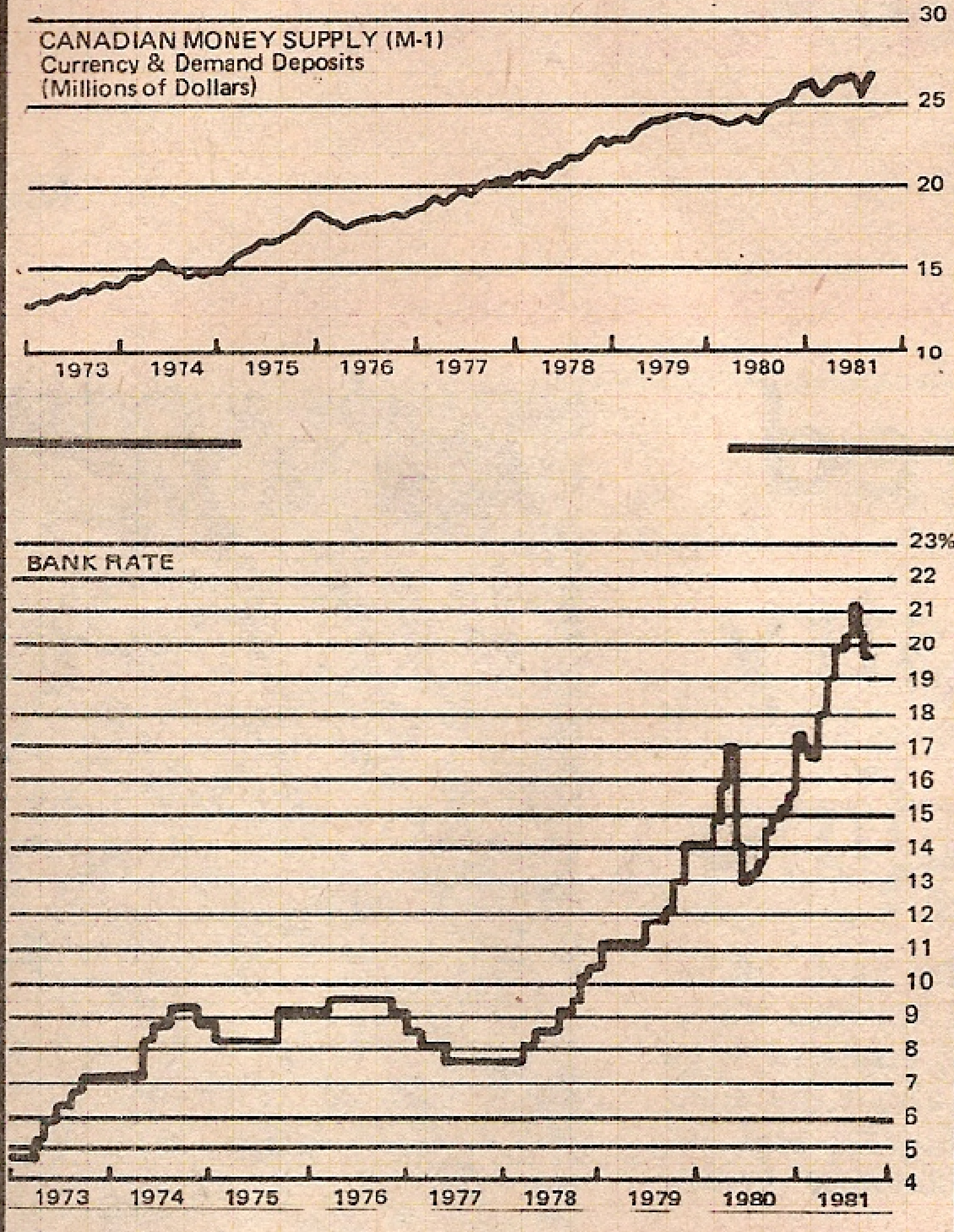
It would also not require the bank to completely forsake monetary targeting in the short run. It would mean, however, that the bank would have to put much more weight on real interest rates in formulating and revising its targets.

The appropriate level of the real interest rate would be open to question, as would its precise definition. In broad terms, however, it should probably be set at about 4 per cent.

This would maintain a firm anti-inflationary setting for monetary policy. It would, in fact, constitute a tighter setting for monetary policy than in any of the years since 1975, when the bank launched its experiment in monetary targeting.

On the other hand, it would allow short term nominal interest rates to come down to the 16 to 17 per cent range, which is more in line with U.S. rates. And it would, permit interest rates to come down in step with inflation in the next few years. Monetary policy would no longer be too tight.

Money growth and rates



Source: The Graphoscope