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LOWER INTEREST RATES NEEDED TO EASE PRESSURES ON ECONOMY

The Bank of Canada has resolutely pursued a restrictive monetary policy to dampen inflationary forces. The severity of the monetary restraint has been necessitated by the government's lack of political will to fight inflation by reducing the fiscal deficit. The imbalance between fiscal and monetary policy has pushed interest rates and the exchange rate to regrettably high levels.

While it took a lot longer than anticipated, tight money has finally bitten hard and economic activity and employment have begun to fall. The unemployment rate has risen from 7.2 per cent last March to 8.8 per cent in October. The soon-to-be released income and expenditure accounts are expected to confirm that output was still declining in the third quarter and that the economy is in a recession.

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Monetary policy has eased as the economy has weakened. The Bank Rate has been reduced, albeit at a snail's pace, from a high of 14.05 per cent on May 24 to 12.25 per cent last week, a decrease of 180 basis points. Interest differentials with the United States have narrowed from near 600 basis points to just over 400 basis points.

The Bank of Canada has been unwilling to relax monetary policy further because of its concern about the persistence of inflationary pressures. Wage settlements averaged around 6.5 per cent in the third quarter. Spurred in part by higher oil prices, the consumer price index jumped to 4.8 per cent year-over-year in October. The Bank is legitimately concerned to make sure that the oil price shock and the GST do not trigger a wage-price spiral.

How far and how fast to lower interest rates is the key question facing the Bank of Canada. Its answer requires a judgment call, involving many complicated factors. There are long and variable lags between changes in interest rates and economic activity. The economy is still responding to last summer's peak in interest rates. Even if interest rates were to drop sharply, it would take some time for the economy to pick up. There is always a risk that if interest rates are pushed down too far and too fast in an effort to produce a quick recovery in output and employment that the eventual surge in economic activity will fuel a renewed outbreak of inflationary pressures. The Bank's caution in bringing interest rates down no doubt reflects this concern.

There are different points of view about the appropriate degree of easing of monetary policy. Some argue that interest rates should be reduced until full employment is reached. Others of a more monetarist bent such as David Laidler of the C.D. Howe Institute contend that interest rates should be lowered sufficiently to raise the rate of growth of the money supply to a level consistent with the potential real growth of the economy and zero (or some other target) inflation. Laidler has been particularly critical of the Bank for permitting the decline earlier this year in M1 (currency and demand deposits) and the slow growth of M2 (M1 plus personal savings deposits and non-personal notice deposits), which he blames for the current recession.

Unfortunately, there are no simple mechanistic rules that can replace human judgement in the conduct of monetary policy. The Bank of Canada knows that seeking to achieve full employment through monetary policy alone would be a recipe for runaway inflation. The Bank has also learned that the monetary aggregates alone are not reliable guides for monetary policy in a climate of financial innovation. This is why the Bank has not established a new target for any aggregate since M1 was dropped as an intermediate target in 1982.

The Bank of Canada has been following an eclectic approach to monetary policy that takes into account a wide variety of factors in the real economy and financial markets as well as monetary aggregates in determining the most appropriate short-term setting of monetary policy to achieve its long-run objective of price stability. I agree with the Bank that this is the most sensible approach given our current less than full knowledge of the workings of the economy and monetary policy.

But my own reading of some of the critical economic indicators suggests to me that the Bank is being too cautious and could do more to cushion the recession by stepping up the pace of the reduction in interest rates. And I believe that this could be done without jeopardizing the achievement of the Bank's long-run goal of making progress in bringing about a return to price stability.

In making this case, the indicators I cite are: the evidence of gathering weakness in the economy; the slow growth or even decline of the monetary aggregates (M1 was down 3.5 per cent year-over-year in October and M2 was only up 8.8 per cent); the continued strength of the Canadian dollar; the persistence of an abnormally large interest rate differential with the United States; the extremely high level of real interest rates (real short-term interest rates are still over 7 per cent); and the growing gap between the unemployment rate and the Non-Accelerating Inflation Rate of Unemployment (NAIRU).

This latter point merits a few words of explanation. The NAIRU is the rate of unemployment above which there should be downward pressure on wages. In a 1988 Bank of Canada technical report it was estimated that the NAIRU is 8 per cent. The recent tightening of Unemployment Insurance mandated by Bill C-21 has been estimated by some to lower the NAIRU by at least a 1/2 percentage point.

The unemployment rate, which is currently running at almost 9 per cent and rising, should clearly be high enough above the NAIRU to restrain wage increases. There should thus, by this measure at least, now be sufficient slack in the economy to keep a damper on home-grown inflationary pressures even by the Bank of Canada's reckoning.

With the United States experiencing a slowdown and possibly entering a recession, there is a real risk that our own recession could deepen and that unemployment could reach double digits. The best insurance against this, in my view, would be for the Bank of Canada to take more decisive action to lower interest rates.