BANK OF CANADA

Extracts from the Minutes of the Board of Directors' Meeting of 15 February 1991

These extracts were approved at the meeting of the Board on 22 March 1991. The next meeting of the Board of Directors of the Bank of Canada is scheduled for 10 May 1991.

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Extracts from the
minutes of the Board of Directors' meeting
held on 15 February 1991

ECONOMIC AND FINANCIAL CONDITIONS AND MONETARY POLICY

Senior staff members joined the meeting and, on the basis of the notes attached to these minutes, commented on economic and financial developments since the previous meeting.

Governor's remarks

The Governor opened his remarks by observing that the underlying developments in the Canadian economy indicated a continued easing of demand pressures. The economic information that had become available since the last meeting of the Board of Directors in early December provided significant further evidence of slowing in the economy. Apart from purely domestic developments, there had also been additional indications of weakness in the U.S. economy, a considerable amount of economic uncertainty created by events in the Persian Gulf, and over the past months a generalized decline in commodity prices. The Governor noted that underlying money and credit growth in Canada had remained moderate.

In this environment of reduced pressure on inflation from the side of demand, room had emerged for a further easing of monetary conditions. The Governor noted that short-term interest rates had declined steadily in the period since the last Board meeting, with the 3-month commercial paper rate for example falling by about 160 basis points. Longer-term interest rates had fallen as well, suggesting that financial markets held expectations of lower interest rates and reduced inflation pressures in the future. Although U.S. interest rates had also declined, there were significant reductions in the gaps between comparable Canadian and U.S. interest rates at both the short and long ends of the maturity spectrum. Canadian commercial banks had reduced their prime lending rates in several stages for a total reduction of 1½ to 2 percentage points during the period.

The Governor emphasized that an important consideration for monetary policy was that any reduction in short-term interest rates should be sustainable and, therefore, consistent with the easing of inflationary pressures. While there appeared to be some improvement in the underlying performance of prices, the easing in domestic cost pressures that is necessary for a sustained improvement in inflation performance had been slow to develop and was still not strongly evident. It was essential in this situation that the anti-inflationary thrust of monetary policy remain absolutely clear as monetary conditions adjusted to the easing in economic activity.

The Bank of Canada's monetary policy operations were therefore oriented towards accommodating sustainable declines in short-term market interest rates. As a result, in the conduct of cash management operations it was generally necessary to resist strong speculative pressures that might have resulted in excessive declines in interest rates. Although the call loan rate for overnight funds varied over a relatively wide range in the period since the last Board meeting, it was consistently maintained at a level above the 3-month treasury bill rate, apart from a brief period in late December to accommodate market pressures during the holiday period. As a result, money market dealers drew heavily on their ordinary Purchase and Resale Agreement (PRA) lines with the Bank of Canada, so that PRA was outstanding throughout much of the period and almost continuously since early January. The Governor noted there were also repeated sales of treasury bills from December to early February to help counter excessive downward pressure on interest rates in the 3-month area, as well as three offerings of Sale and Repurchase Agreements (SRA) to counter unwarranted easing in the overnight money market. On six occasions, however, Special Purchase and Resale Agreements (SPRA) were extended to temper upward pressure on the call loan rate.

The Governor indicated that there had been a relatively large number of advances made to members of the Canadian Payments Association, partly as a result of the generally restrictive cash reserve settings. In total, 121 advances were made in the 47 business days since the last Board meeting, including 44 to major banks.

The directors then reported on economic developments in their respective regions.

STAFF TALKING NOTES
ECONOMIC AND FINANCIAL DEVELOPMENTS

Recent economic developments

Summary

- Economic growth is slowing in the major overseas industrialized economies, but inflationary pressures remain strong.
- External imbalances are generally on the decline, although they remain sensitive to changes in the price of oil.
- Commodity prices have generally been declining over the past four weeks. This is true of energy prices as well.
- In the United States, an improvement in the net export picture partially offset the weakness of domestic demand; as a result, the decline in the volume of production in the fourth quarter of 1990, as reported in the first release of the national accounts, was lower than many observers had expected.
- Employment continued to fall and unemployment to rise in the United States, and this contributed to some lessening of labour cost increases. As measured by the consumer price index, however, inflationary pressures have not subsided significantly.
- In Canada, domestic demand remained weak in the fourth quarter. An improvement in the trade balance was accompanied by lower levels of both exports and imports. Indications are that the decline in real gross domestic product not only continued but steepened in the fourth quarter.
- To date, only a handful of indicators for 1991 are available: a sharp rebound in motor vehicle sales in January, a decrease in housing starts, and lower employment and higher unemployment.
- As measured by the December consumer price index, the fight against inflation continued to make headway. However, this progress is not yet clearly reflected in wage increase trends.

Overseas economies and commodity markets

On the basis of real gross national product (GNP), the five major overseas economies as a whole are going through a period of slower growth. This slowdown, which became evident during the second and third quarters of 1990, appeared to worsen in the fourth quarter. The slowdown was widespread, moreover, with only France escaping its effects. In particular, there was clear evidence in Germany of slower economic growth in the fourth quarter; and GNP in the United Kingdom actually declined in the third quarter.

Despite slower economic growth, inflationary pressures remain strong. In fact, they intensified in the last quarter. Japan leads the field with regard to accelerating inflation as a result of vigorous aggregate demand in that country. Elsewhere, inflation has been either stable but relatively high (in Italy), or declining to a greater or lesser extent, mainly in response to the fall in crude oil prices in late 1990.

Among the major industrialized countries, external imbalances continue to trend downward. Rising oil prices in the third quarter of 1990 were largely responsible for the declining surpluses of Japan and Germany, however, as well as for the temporary deterioration in the current account deficit of the United States in the third quarter of last year, following improvement during the first half of the year.

Excess supply has pushed the price of oil downward relative to its peak of last October. Since 17 January, when hostilities broke out between the allied forces and Iraq, the general perception that the war was going well for the allies has kept the price of oil within the narrow range of $20-22 (U.S.); it now stands (15 February) at just over $20 (U.S.). Excluding energy, the commodity price index has also fallen slightly over the past four weeks, primarily in response to a broad-based fall in metal prices.

Economic developments in the United States

Demand

The marked improvement in net exports in the final quarter of 1990 served to offset the decline in domestic demand and so to stabilize the volume of final sales. The weakness in domestic demand stemmed primarily from softness in the construction industry and anemic household spending.

Over the fourth quarter as a whole, real consumer spending declined by about 3 per cent. While the decrease was particularly evident in motor vehicle sales, it was nevertheless widespread, reflecting a decline in real disposable income which was partly attributable to the drop in employment and the number of hours worked, as well as to rising energy prices. The personal savings rate remained stable at just over 4 per cent.

Consumer spending rebounded in December after two months of decline. This recovery may well be linked to some transient factors: first, the surge in purchases of certain luxury items (automobiles, jewellery, furs, boats, etc.) which became subject to new taxes in January and, second, the return to more normal patterns of energy consumption following November's unusually warm weather. A slump in motor vehicle purchases in January lends credence to this explanation.

For the moment, there is little evidence that domestic demand is recovering. The Persian Gulf crisis and the attendant rise in oil prices caused the consumer confidence index to plummet in October to its lowest level since 1982, and the recovery between November and January has been modest at best. Slow sales of new automobiles in January and the steady decline in housing starts during the fourth quarter — which resulted in a drop in December's figures to under 1 million units at an annual rate basis — also testify to falling household confidence. Businesses, too, have been affected by the general climate of uncertainty, with the result that new orders for capital equipment have been flat for several quarters and the trend towards lower inventories has continued. In fact, an even greater decline in production was forestalled only by the vigour of net exports. Weakness in domestic demand was undoubtedly responsible for the decline in U.S. import volumes, while U.S. exports benefited from strong foreign demand and the depreciation of the U.S. dollar since late 1989.

Production and employment

According to the first national accounts estimates, released on 25 January, real GNP fell by 2.1 per cent (annual rate) in the fourth quarter of 1990. While slower growth has been evident since the second half of 1988, the fourth quarter of 1990 marked the first time that an absolute decline in the volume of production has been seen. The industrial production index also registered a sharp drop in the fourth quarter.

In January, the unemployment rate for the civilian labour force reached 6.2 per cent, after climbing continuously since July 1990. Employment fell by 0.2 per cent, marking the seventh straight month of decline. In addition, the average length of the work week once again recorded a significant drop.

Prices and costs

In December, the rate of increase of the consumer price index stood at 6.1 per cent on a year-over-year basis, a slight deceleration relative to the rate of 6.3 per cent recorded in October and November. Excluding food and energy, the consumer price index has followed a downward trend over the past three months; nevertheless, it remains above 5 per cent, even after the deceleration attributable to the prices of both goods and services.

During the second half of 1990, the increase in the labour cost index slowed, reflecting the existence of excess supply in the goods and services market since early 1990 and an easing of labour market tightness since the mid-year point.

Economic developments in Canada

Demand

Currently available data suggest that consumer spending fell slightly in the fourth quarter of 1990, largely due to a sharp reduction in spending on motor vehicles. The weakness in the auto industry is simply one sign that aggregate demand in Canada during the fourth quarter of 1990 was sluggish; it was combined with an 11.6 per cent drop in the annual rate of housing starts, a lack of vigour in most retail sales categories, nominal investment well below the 10 per cent increase reported in the mid-year survey, and a drop in exports and imports in November that sufficed to offset increases recorded in October.

To date, only two indicators of demand are available for the first quarter of 1991, although these are interesting ones: motor vehicle sales and housing starts in January. Sales of motor vehicles were up by 32 per cent relative to December. This recovery may be short-lived, however, since it is primarily attributable to purchases by car rental agencies; these businesses postponed fleet renewals from the fourth quarter of 1990 to the beginning of this year, anticipating a drop in automobile prices as the manufacturers' sales tax was replaced by the goods and services tax. On the other hand, housing starts fell by some 30 per cent in January to reach their lowest level since September 1982.

Production and employment

GDP at factor cost fell substantially in November. Even if the decline did not continue into December, economic growth will likely post a greater decline in the fourth quarter than that recorded in either the second or third quarters. The economy slowed in virtually all sectors of production (goods and services), although the contraction was felt most strongly in the manufacturing and construction industries.

Employment fell by 0.7 per cent in January 1991, the fourth straight monthly decline. The decline mainly affected full-time employment and was spread across both the services and goods sectors. The sharpest drop was recorded in Ontario, followed by Quebec and British Columbia, with only the Prairie provinces posting employment gains. In spite of the contraction of the labour force in January (-0.4 per cent), unemployment rose to 9.7 per cent (from 9.3 per cent in December), its highest rate since February 1986. The most noticeable increase in unemployment occurred in Ontario, where the rate now stands at 8.4 per cent.

Prices and costs

In December 1990 the consumer price index was 5 per cent higher than at the same time the previous year; excluding food and energy, its most volatile components, its rate of increase was 4 per cent. Another noteworthy development was that the consumer price index for *goods* (excluding food and energy) rose only 2.3 per cent at an annual rate over the final three months of 1990.

Spurred on by higher wages in the private sector, average weekly earnings increased slightly faster in November than in the four previous months. In contrast, increases in major wage settlements continued the gentle deceleration that began in the third quarter, reaching 5.6 per cent in November.

Recent financial developments

Summary

- The onset of war in the Middle East has contributed another element of uncertainty to international financial markets.
- The recent fall in world oil prices has improved the near-term inflation outlook, which in turn has contributed to declines in long-term interest rates in major industrial countries.
- In the United States, short-term interest rates have declined sharply in response to the slowdown in economic activity.
- Given the reduction in U.S. interest rates relative to those overseas, the U.S. dollar has depreciated further.
- In Canada, monetary conditions have continued to ease.

Overseas and U.S. financial markets

The outbreak of war in the Middle East has added another element of economic uncertainty. Nevertheless, domestic developments overseas and in the United States have been important factors affecting interest rate and exchange rate movements worldwide.

Since the last Board of Directors' meeting in early December, long-term interest rates in major industrial countries have declined, reflecting an improvement in market expectations for inflation following the recent fall in world oil prices and further evidence of economic slowdown. These developments have also spurred international equity markets.

Movements in short-term interest rates have been more divergent. In the United States, there has been a marked easing in monetary conditions as the Federal Reserve has responded to mounting evidence of economic slowdown, reduced credit availability and continued moderation in monetary growth. The overnight federal funds rate has fallen in four steps since early December from 7½ per cent to a current level of around 6¼ per cent. Other money market rates have fallen sharply. The 90-day commercial paper rate, for example, has dropped by 140 basis points to 6.6 per cent (on a Canadian equivalent basis). It remains the case, however, that spreads in the money market (for example, between interest rates on 3-month commercial paper and on 3-month Treasury bills) continue to be wider than usual, reflecting concerns in a weakening U.S. economy about financial difficulties in the corporate and banking sectors. Moreover, the prime lending rate, despite having declined by one percentage point in recent weeks to 9 per cent, remains well above what would be suggested on the basis of a normal relationship with the federal funds rate.

In contrast to developments in the United States, short-term money market rates have remained firm in Germany and Japan as monetary authorities in both countries continue to respond to underlying strength in domestic demand and attendant inflationary pressures. At about 9 per cent, 3-month money market rates in Germany are essentially unchanged since the last Board meeting, while in Japan short-term market rates have edged slightly downwards. In the United Kingdom, short-term interest rates fell by one half of a percentage point this week in response to economic weakness. However, with sterling close to the floor rate in the Exchange Rate Mechanism the room for further interest rate declines over the near term may be limited. Given the interest rate movements internationally, differentials have widened substantially against U.S. dollar denominated assets.

Exchange markets have been volatile over the past two months. Over the six weeks leading up to the United Nations' deadline of 15 January for Iraq to withdraw from Kuwait, the U.S. dollar strengthened considerably. However, immediately after war was declared and expectations developed that disruptions to world oil production would be contained, widening interest rate spreads once again became the dominant factor in exchange markets and the U.S. dollar weakened appreciably. Against the German mark, the U.S. dollar fell to a record low of DM 1.4427 per U.S. dollar on 11 February, and sterling touched a decade high of just over U.S. $2.00 per pound on 6 February. On a trade-weighted basis (excluding the Canadian dollar), the U.S. dollar is down one half of a percentage point since the last Board meeting on 7 December 1990, and compared to a year ago it is down nearly 11½ per cent.

Canadian financial markets

In Canada, underlying monetary and credit growth have remained moderate and there has been a further substantial easing in monetary conditions.

As discussed at the Board's last meeting, the rapid growth in M2 in the fourth quarter of 1990 largely reflected the effect of relatively low sales of Canada Savings Bonds. Adjusted for this effect, M2 growth remained in line with its underlying growth of about 8 per cent for the year as a whole. In January, M2 growth picked up to 12 per cent (annual rate), somewhat more than fundamentals would suggest. M1 remained flat in December and January, following very strong growth in the previous couple of months. Looking through the short-run fluctuations, the underlying growth of M1 has picked up to around 8 per cent in response to the decline in interest rates. Total household credit growth extended by banks grew by 8 per cent on average in December and January, unchanged from that recorded during the second half of 1990; growth of business credit has remained weak, averaging about 3 per cent in December and January.

Since the last Board meeting, the 90-day commercial paper rate has declined steadily, falling by 160 basis points to around 10.45 per cent. Compared to the peak last May, short-term money market rates are down about 3½ percentage points. Further declines in short-term rates would seem to be expected by market participants, as indicated by the recent widening of the spread between 3-month and 1-year treasury bill rates. The 1-year treasury bill rate is currently around 9.35 per cent, some 65 basis points below the 3-month rate. Market expectations of lower interest rates are also reflected in the declining yields on mid-term and long-term government bonds, which have fallen ½ to ¾ of a percentage point over the past two months. In response to lower market rates, the prime lending rate has been reduced to between 11¼ and 11¾ per cent — the lowest level since August 1988 — and mortgage rates have fallen to between 11¼ and 11¾ per cent.

As a result of these declines in interest rates, spreads vis-à-vis the United States have narrowed significantly. Three-month interest rate differentials have narrowed to around 380 basis points — the lowest in over a year and down from a high of over 550 basis points last spring. Long-term differentials have dropped to 180 basis points.

Despite the narrowing in short-term interest rate spreads and lower oil prices, the Canadian dollar has remained firm against the U.S. dollar, trading in a relatively narrow range. An important factor supporting the dollar has been the recent large volume of foreign borrowing — particularly by provinces and their enterprises — and conversions of foreign issues. As well, relative interest rates continue to make Canadian dollar denominated assets attractive, a factor that is being reinforced by market expectations of further declines in U.S. interest rates. Against the U.S. dollar, the Canadian currency is currently trading at around 86.66 cents (U.S.), compared with 86.30 cents (U.S.) on 7 December. On a trade-weighted basis, however, the Canadian dollar has risen somewhat less, reflecting the weakness of the North American currencies relative to currencies overseas.