Introduction

Since late 1975 the Government of Canada and, along with it, the Bank of Canada, have altered their approach to management of the national economy. Increasing emphasis has been placed on monetary rather than fiscal policy. The move to monetary policy has, and will have, significant effects of regional concern. These, we believe, have not been sufficiently explored. Although it may be too early to discern the complete ramifications, some preliminary investigations are suggested.

The use of monetary policy, and thus indirectly the interest rate, as an instrument of economic management does not lend itself to regional variation. Hence, monetary policy cannot be expressly used to reduce regional income disparities. In addition, some Canadian industries which are particularly sensitive to changes in the interest rate are concentrated in specific regions of the country. Provincial governments, who bear a major share of responsibility for such regions and are also dependent on such industries for revenues, have few established mechanisms with
which they can expect to influence monetary policy decisions. As a result, especially in times of countercyclical restraint, new regional disparities may arise that cannot be countered without recourse to additional federal expenditures or increased deficit financing by the provinces. In times of federal fiscal restraint and the popularity of a non-interventionist position by economic policy makers, the former may not be forthcoming while the latter may be unpalatable given the high interest rates associated with monetary restraint. This represents a new dimension to economic relations in Canada. In the past, when the focus of economic policy has changed, the federation has evolved in response. This note presents some preliminary evidence that the regional impact of economic policy has been altered as a result of the new emphasis. A range of possible responses to these changes are discussed.

Fiscal and Monetary Federalism

In the period starting in 1945, the federal government accepted the Keynesian doctrine that it should assume responsibility for the stabilization of employment and the level and distribution of national income. Until the fall of 1975, when monetary policy became the primary tool for managing the Canadian economy, there was a general expansion of the economic role of both federal and provincial levels of government through fiscal policy. As their roles increased, so did the links between the two levels of government. The general aim of the provincial governments has been two-fold: 1) to garner an increasing share of expanding revenues, and 2) to prevent increases in regional inequities which could result from federal policies of fiscal restraint.

The Fiscal Equalization Payments, the Provincial Personal Income Tax Revenue Guarantee Payments, the Canadian Pension Plan Investment Loans and the Fiscal Stabilization Payments all have, as one of their main elements, provisions that are designed to protect provincial governments from fiscal downturns, either from a normal cyclical economic decline or from direct fiscal restraint by the federal government. These provisions represent the logical result of regional governments attempting to protect their interests within a federation. It is fundamentally more important to them to preserve any existing levels of services than to garner an increased share of expanding revenues (although this is not, in any way, unimportant).

These measures have not reduced the federal government’s effectiveness in practising fiscal restraint [3; 6], but rather have served to reduce the regional disparities which could result from fiscal restraint. As such, they are in the spirit of the principle of regional equity which underlies the Canadian federation [8:86] and help to ensure that provinces will cooperate in the process of national stabilization.

The problems for the provinces, which arise from the movement to monetary policy as the major policy instrument for management of the Canadian economy, are twofold. The first is that it is virtually impossible to use monetary policy on a regional basis [3]. Further, the distribution and intensity of the regional effects resulting from monetary restraint are likely to be different from those which result from fiscal restraint. Probably the most important reason for this (although certainly not the only reason) is the concentration of interest-sensitive industries in particular regions. Although the likely effects are well known in theory, as yet the magnitudes of the relationships between extremely high (real) interest rates and the general level of economic activity, unemployment, business failures, home owners’ decisions and especially provincial revenues are poorly understood. In addition, as some interest-sensitive industries such as forestry are resource based, they tend to be the dominant industry where present, so that local linkages are very strong. As a result, some local areas may experience virtual economic collapse. Such areas may need additional provincial aid.

Although existing fiscal agreements and programs such as unemployment insurance will help to moderate the new regional inequities that arise from the use of monetary policy, they are not specifically designed to address such problems as industry collapse, increased business failure due to high interest rates, and the adjustments which homeowners must make to the combined problems of falling incomes and high mortgage rates. As no specific fiscal arrangements exist to deal with such problems, the provinces may be less willing to cooperate with policies of restraint. This leads to the second problem.

No mechanisms exist whereby the provincial governments can prevent federal restraint policies, especially the policies of the Bank of Canada. Historically the provinces concentrated on expanding their abilities to prevent the regional inequities which might arise from fiscal restraint rather than gaining more influence over the decisions themselves. The evolving fiscal system made it progressively easier for the provinces to cooperate with the federal government on matters of fiscal stabilization. The Bank of Canada, on the other hand, is entirely the creation and agent of the federal government; there is no effective regional representation on the Bank’s board, for example. As long as the Bank was the

1Appointments have been made on a regional basis [1:231]. However, this has not meant any real regional representation.
junior partner in economic management, no such representation was felt necessary by the provinces.

However, if the provinces do not agree with the economic priorities of the federal government they can only attempt to influence federal government policies through the contacts established for fiscal policy consultation. In the high interest periods of the early 1980s, there appeared to be a consensus among the provinces that federal policy was not in their interests. There were consistent requests for a lower, made-in-Canada interest rate. For example, the Communiqué on the Economic Recovery Program released at the 23rd Annual Premiers’ Conference suggested:

An immediate change in monetary policy whereby the Government of Canada will ensure that Canada receives the full benefit of falling interest rates and that Canadian rates are not kept artificially high in relation to U.S. rates.

The pleas of the provincial premiers fell, to a large extent, on deaf ears.

The concentration of effort on developing agreements designed to ensure their fiscal position within confederation, rather than increasing their input into national economic decision making, has left the provinces vulnerable to the unequal effects of monetary policy; hence they are faced with the prospect of having to employ provincial fiscal policies to mitigate such effects. Such a use of provincial resources, of course, was what the provinces were seeking to prevent through the institutional arrangements which were established within the context of fiscal federalism. Certainly, given available estimates of provincial fiscal policy multipliers [7], provincial stabilization measures could be effective. This would, of course, require increased deficit financing at times of high interest rates. As the form and magnitudes of the economic relationships which result from a monetarily induced recession have not yet been estimated - the required data only now becoming available - the appropriate forms (tax relief to industry, interest subsidization, job creation programs, and so forth) of provincial fiscal response are not currently discernible. It may be that some form of fiscal response is the only policy open to the provinces given the federal government’s concern over the deficit. It would seem likely, however, that one will see increased provincial efforts to expand federal responsibilities in this area. As yet, the provinces have had little empirical evidence to support their efforts. It is to this problem that we now turn.

Empirical Evidence

The geographic concentration of interest-sensitive industries is one of the reasons why a monetary policy induced recession may have different regional impacts:

Monetary restraint has a narrower and more uneven impact on the economy than generalized fiscal restraint. . . . Monetary restraint and high interest rates curtail interest-sensitive expenditures such as car and appliance sales, house construction, and investment in plant, equipment and inventories [3:73].

A comparison of the effects on the above-mentioned sectors of the economy in a recession which is induced by fiscal policy restraint with those caused by restrictive monetary policy should illustrate some differing regional impacts which occur with monetary policy. Restrictive fiscal policy was primarily responsible for the recession of 1974-75 [4], while the recession Canada experienced beginning in 1981 was the result of monetary policies [3].

The hypothesis that a monetary policy induced recession has a more detrimental effect on interest-sensitive sectors than does a recession caused by fiscal restraint was tested by examining the effects of the two most recent recessions on the forestry industry. One would expect the forestry industry to be quite interest-sensitive because of its indirect linkage to the housing sector. High real interest rates decrease demand for new housing, which in turn leads to a lower level of activity in the forestry industry.

Data were used from Statistics Canada on monthly employment in the forestry industry by province for the two recessions. To account for seasonal changes in employment we have calculated the rate of change in employment between the same month in consecutive years; e.g., (March 1982 - March 1981)/March 1981. As the latter recession is more severe than the 1974-75 recession, these rates of change are then weighted for the severity of the recession. The weights are established from differences in the decline in total employment between the two recessions. After these adjustments have been made we would expect the mean rate of change to be higher (more negative) in the latter recession. The hypothesis was tested using the statistical test for the differences between means [2:381].

The results in Table 1 generally support our contention that the use of monetary policy to reduce the level of economic activ-

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1 Prince Edward Island has been excluded from the study because the forestry industry is extremely small and is woodlot rather than lumber-based. Therefore, neither of the two recessions has had any significant impact on that province’s activity.
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<tr>
<td><strong>Mean rate of change</strong></td>
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<tr>
<td>1974-75 (%)</td>
<td>-1.26</td>
<td>-9.45</td>
<td>24.87</td>
<td>41.61</td>
<td>-10.66</td>
<td>1.53</td>
<td>9.93</td>
<td>-5.66</td>
<td>-19.84</td>
<td>0.94</td>
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<td><strong>Adjusted mean rate of</strong></td>
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<tr>
<td>change 1981-82 (%)</td>
<td>-7.14</td>
<td>-11.65</td>
<td>-5.16</td>
<td>3.80</td>
<td>2.69</td>
<td>-7.50</td>
<td>-0.75</td>
<td>2.96</td>
<td>7.11</td>
<td>1.38</td>
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<td><strong>Z</strong></td>
<td>2.53**</td>
<td>0.35</td>
<td>3.32**</td>
<td>1.80</td>
<td>-2.61</td>
<td>3.81**</td>
<td>2.62**</td>
<td>-1.12</td>
<td>2.49</td>
<td>-0.07</td>
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*Statistically significant at the .05 level of significance - critical value is 1.645.*

**Statistically significant at the .01 level of significance - critical value is 2.326.*
ity will lead to new and differential regional impacts. As can be seen, the relative declines in forestry employment in what could be considered the have provinces (British Columbia, Alberta, Saskatchewan, Ontario and Quebec) have been greater (significantly greater in four provinces) in the latter recession. In the Maritime provinces and Manitoba, on the other hand, the relative severity is less. As these regions were slow growth areas, residential construction would have been sluggish in any case, although the increase in the interest rate would still cause some slowdown. Provinces which previously had been growing would have had expanding housing industries. Therefore, the effect, as expected, would be more severe. This would be especially true for provinces like British Columbia, Ontario, and Quebec, where the forestry industry is relatively large. As these provinces depend on forestry for a greater proportion of provincial revenue, they are caught with larger increases in unemployment and declining revenues at the same time. This would make it difficult to maintain the existing level of services. The current policies of restraint in British Columbia are, no doubt, partially a reflection of this problem. The severity would depend, of course, on the fiscal status of the province in question. Some provinces were able to use their fiscal resources to counter high interest rates. The Alberta government has been able to use a portion of its Heritage Fund revenues to buy down interest rates for homeowners and protect its housing industry from the direct effects of high interest rates. Poorer provinces could offer no such programs or, as in the case of British Columbia, only poor substitutes for the Alberta program. Such policies will lead to additional regional inequities.

In short, it seems clear that the decline in the forestry industry is more severe in the recession resulting from tight monetary policy and, given that the industry is regionally concentrated, new inequities have arisen. The forestry industry, however, is not the only industry which one would expect to be more adversely affected by high interest rates. One would expect sales of consumer durables to be similarly affected.

To compare the effects which the two most recent recessions have had on consumer durables we used the same test as was outlined above for forestry. This study examines the effects of the recessions on the sales of new passenger cars, refrigerators, and freezers. Again Statistics Canada data were used. As in the first case, it was adjusted for the severity of the recession. We would expect these results to be similar to those obtained for the forestry industry because sales of consumer durables are also severely affected by tight monetary policy. Since payment for consumer durables is usually made over a period of time, pur-
Chasers must be concerned with the prevailing interest rate at the time of purchase. This should contribute to the recession in the 1980s having a more severe impact on the provinces in which these industries are concentrated. With almost all automobile manufacturers and eight out of nine manufacturers of refrigerators and freezers being located in Ontario, this province would bear a disproportionate share of the burden of tight monetary policy.

The results presented in Table 2, for the three representative consumer durables for which there is available data, again tend to confirm our hypothesis. As the great majority of all consumer durables are manufactured in Ontario and, to a lesser extent, Quebec, the effects of the recession will be felt more heavily in these provinces. Again, have provinces will suffer greatly. This is contrary to the effects of fiscal restraint, which tend to affect general levels of demand rather than specific commodities.

Table 2

<table>
<thead>
<tr>
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<th>Automobiles</th>
<th>Refrigerators</th>
<th>Freezers</th>
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<tbody>
<tr>
<td>Mean rate of change</td>
<td>0.23</td>
<td>-15.32</td>
<td>17.47</td>
</tr>
<tr>
<td>Adjusted mean rate of</td>
<td>-14.73</td>
<td>-17.71</td>
<td>-12.38</td>
</tr>
<tr>
<td>change 1981-82 (%)</td>
<td>Z</td>
<td>2.74**</td>
<td>0.45</td>
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*Statistically significant at the .05 level of significance - critical value is 1.645.
**Statistically significant at the .01 level of significance - critical value is 2.326.

Although the results presented above are intuitively obvious, the impact on regionally based policy makers should not be underestimated. As more complete data become available, the quantitative relationship between monetary policy and the regions should be better understood. At that point one may expect policy proposals which would attempt to reduce the new inequities.

Summary and Conclusions

The federal concept that has evolved in Canada seems to suggest that it is desirable to have stabilization policies which allow, to some extent, for the differences between regions. The fiscal arrangements developed between the two levels of government address this problem. However, economic federalism in Canada has not developed to take account of the regional problems arising from the use of monetary policy.

The use of monetary policy as the primary tool for economic management is relatively recent. Four future paths for intergovernmental economic decision making appear to be possible at present. First, the federal government may continue to use monetary policy and refuse to adhere to provincial concerns. This is likely to lead to additional stress in the Canadian federation, especially if provinces like Ontario and British Columbia feel particularly aggrieved. Alternatively, the provinces could convince the federal government to abandon monetary policy and return to fiscal management. This, however, would create great difficulties for the federal government. As long as the majority of the world's developed economies, and especially the United States, follow policies of monetary restraint, it would be extremely difficult for the Bank of Canada to manage the exchange rate. Given the large portion of GNP which is generated in the trade sector, it seems unlikely that the federal government could abandon the monetary approach.

A third option might be for the provinces to lobby for changes which would allow easier credit for certain industries that are interest-sensitive. For example, legal restrictions on mortgage or automobile loan rates, along with mandatory minimums on the funds made available by commercial banks for such purposes, might be requested. Given the difficulty in administering such policies and the considerable problems in preventing loan funds moving to sources of high interest, such a course seems unlikely.

Finally, the provincial governments might look for additional fiscal agreements that could be used to counter the adverse regional effects of monetary policy. Instead of emphasizing protection of fiscal revenues, the provinces might lobby for automatic tax relief or subsidies for interest-sensitive industries. These might be tied to the real interest rate directly. Of course this would demand considerable research to establish the relationship between the interest rate and the economic state of particular industries. As data become available from the last recession such empirical research may be possible.

In any case, it is likely that the Canadian federation will adjust to the change in emphasis in economic management. Certainly, there was a continuing evolution of economic relationships in response to the acceptance of the Keynesian hypothesis. The regional problems created by monetary policy may, however, prove more difficult to accommodate. The question, no doubt, will provide a fertile area of research for those concerned with regional problems.
References