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REMARKS BY
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TO THE ANNUAL DINNER MEETING OF THE
VANCOUVER BOARD OF TRADE
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Remarks by Gerald K. Bouey,
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Vancouver Board of Trade, January 21, 1974

Last July when I accepted the kind invitation of your President to speak at this annual dinner meeting of the Vancouver Board of Trade, I had hoped that by now we might be moving into a much less inflationary world environment, with good prospects here in Canada for maintaining a satisfactory rate of economic growth and for achieving an improved cost and price performance.

Our prospects for growth remain good, but there is now less reason for optimism about the trend of prices.

There were two main reasons for expecting a marked easing of external price pressures on the Canadian economy. The first was that with the passage of time the temporary scarcity of many foodstuffs and industrial materials could be expected to ease, partly because of better harvests and partly through the response of world supplies to last year's sharp upward movement in commodity prices. The other was the expectation that as we moved into 1974 the pressure of demand would moderate in a number of the main industrial countries, leading to more normal and sustainable rates of economic growth.

Since last autumn, however, a new and major source of disruption has been injected into the world economic picture -- the problem of oil -- and the resulting uncertainties have left the immediate outlook for the world economy rather up in the air. It is difficult enough at any time to try to assess how the economic situation is likely to develop in the period ahead. In many countries today the economic shock of sharply higher prices for oil and oil products -- and also, in some cases, of concern about access to supplies of imported oil even at current world prices -- has presented problems of adjustment without parallel in modern peacetime history.

Although the impact on Canada's supply of petroleum products may not turn out to be severe, we are of course exposed to the direct and indirect effects of dramatic increases in world petroleum prices. These add a new dimension to the cost and price problems that we already have, and confront us with potentially large shifts in the regional and sectoral pattern of income and expenditure flows within the Canadian economy. The world petroleum situation also seems likely to affect Canada in other ways, mainly as a result of its more severe impact on the balance of payments positions, and perhaps also on the levels of economic activity, of some of our trading partners. Nevertheless Canada appears to be in a better position than most countries so far as its prospects for continuing growth during 1974 are concerned.

I would like to return to this matter before I conclude my remarks, but first I would like to say something about the way in which monetary policy has evolved over the past year in response to the developing economic situation and outlook.

Since the early months of 1973 the Bank of Canada has been following a policy much less conducive to high rates of growth of money and credit in Canada than it followed in 1971 and 1972.

I have described the reasons for this change of approach in earlier speeches and public statements. The fundamental reason was that the level of activity of the Canadian economy in relation to its productive capacity had risen to the point where a strongly expansionary monetary policy was no longer appropriate. By the spring of 1973 it was becoming increasingly clear that for the immediate future the level of over-all demand in Canada was more likely to be too high than too low.

The subsequent course of monetary and financial developments in Canada has reflected both the continued strength of the economic situation and this change in the posture of monetary policy.

Although the statistical record for 1973 is not yet complete, the salient features of our economic experience last year are already reasonably clear. Gross National Expenditure in money terms in 1973 was 14 to 15 per cent higher than in 1972. Among the categories of spending that contributed to this very large increase in demand on our productive capacity were consumer spending, outlays on residential construction and export sales. Business expenditures on new plant and equipment also showed a marked acceleration last year and seem likely to provide strong support for continued economic expansion in 1974.

The strength of world demand in 1973 gave rise to substantial increases both in the prices and in the volume of export shipments of many of the commodities we supply to the rest of the world, thereby adding greatly to levels of income and employment in the various regions of Canada. Striking examples of this are readily apparent here in British Columbia in the case of many of your basic industries such as forest products, mining and fishing. Similar examples come to mind from the recent economic experience of other regions of Canada, including regions that specialize in other export products. Thus, while the year 1973 was one of sharp changes in exchange rate relationships among major currencies and of great uncertainty about how the world payments system might evolve, it was nevertheless another year of rapid expansion of world trade in which Canada and most other countries have shared.

The rapid growth of spending in Canada in 1973 was reflected in an unusually large increase in the level of economic activity, although the course of the expansion was rather uneven during the year. A remarkably rapid surge of growth last winter was followed by six months or so of relatively slow growth, owing in part to limitations on productive capacity and to the effects of strikes, but there seems to have been a strong rebound of activity in the closing months of the year. If one takes the year as a whole, the total physical volume of output of the economy was close to 7 per cent higher in 1973 than in 1972. This was a higher rate of growth than in any year since the mid-1960s, and well above the annual average of 5 to 5 1/2 per cent that we can expect to achieve over the longer run.

This growth in output was accompanied by the largest increase in employment attained in Canada since the 1940s, whether measured in terms of the number of new jobs or in terms of the rate of increase. The 5.2 per cent increase in employment in 1973 compares with a previous post-war record growth in employment of 4.2 per cent in 1966. It is particularly gratifying that all regions of the country shared in the record gains in employment. Thus in the Atlantic provinces as in British Columbia the number of employed people was 6 1/2 per cent higher than in 1972, and in Quebec the increase was close to 6 per cent.

With these extraordinarily rapid increases in output and employment in 1973 the economy gave increasingly clear indications of strain as the year progressed. The surge of growth last winter pushed the economy up against the effective limits of its productive capacity in many areas, and we began bumping against these capacity limits at much higher levels of recorded unemployment than one might have expected on the basis of previous experience. The unemployment rate last year as measured by the Labour Force Survey averaged 5.6 per cent, a level that in earlier years would have been associated with rather easy conditions in labour markets but during most of 1973 was associated with labour market tightness. Mounting pressures on the economy's capacity to produce also showed up in growing scarcities of a wide variety of goods, in lengthening delivery delays and in rapidly rising order backlogs. Thus economic expansion could no longer be sustained at rates in excess of the growth in the economy's productive capacity. Further efforts to force the pace would not have added significantly to real economic growth but would merely have stepped up an already high rate of inflation.

I need not labour the point that in 1973 Canada experienced very rapid rates of price increase. The acceleration of price increases in Canada was largely the reflection of the world-wide outbreak of inflation to which I have already referred. This was caused by the interaction of scarcities of important foodstuffs and basic commodities with very strong demand growth throughout the world. We cannot expect this wave of inflation to subside quickly. While some temporary scarcities may be overcome as the pace of demand growth moderates in the industrial world, high prices for materials and rising labour costs will continue to work their way through the price structure in 1974, and to these must now be added much higher petroleum prices.

The rapid expansion of economic activity in 1973 together with the sharp increase in prices gave rise to heavy demands for credit. At the same time the Bank of Canada was seeking to bring about a transition to less rapid rates of monetary and credit expansion in order to help moderate spending pressures in the economy. In these circumstances the efforts of the chartered banks to meet the strong demand for loans soon led to intensified pressure on their liquidity and on short-term interest rates. The upward pressure on interest rates was strongly reinforced by an even sharper rise in short-term interest rates in the United States and Europe.

Beginning last spring I tried to make it clear, both publicly and in discussions with the banks, that the circumstances called for a slowing of the growth of bank loans rather than a drastic curtailment. The banks were also encouraged in their expressed desire to try to achieve this objective in ways that would minimize the impact on small business borrowers, borrowers in the less buoyant regions of Canada, and residential mortgage borrowers. This implied, of course, that efforts to restrain the rapid expansion of bank credit would have to be concentrated mainly on large business borrowers. This in turn was bound to add to the upward pressure on interest rates, since most large borrowers are strong enough to make their credit demands felt in other areas of the market as well as in the banking system.

By some measures it looks as though the firmer posture of monetary policy since last spring has so far achieved little, if any, moderation of credit and monetary expansion in the face of the very strong and persistent demand for credit. In December, for instance, the general loans on the books of the chartered banks were still a full 26 per cent higher than a year earlier, and the public's total holdings of currency and chartered bank deposits were 18 per cent higher. Both of these increases were, in fact, somewhat larger than in 1972.

It should be noted, however, that the behaviour of these particular series can be substantially affected in the short run by temporary shifts in the channels through which credit flows occur. Thus the placement of short-term paper in the money market is for many large borrowers a ready alternative to obtaining a loan from a bank. Whether short-term borrowing of this kind is channelled through the paper market or through the banking system depends in part on fairly small changes in the relative interest cost. Since last summer there has been a sizeable drop in the outstanding amount of short-term paper issued by non-financial borrowers as paper rates rose up to and beyond bank prime loan rates, and some part of the large increase in bank loans during this period is unquestionably related to this development.

It seems likely that the large increase in the outstanding amount of the banks' fixed-term deposits has also been inflated to some extent by the corresponding shift of short-term investment funds from the paper market to the banks. Another factor working in the same direction has been the greatly increased flow into fixed-term personal deposits at banks and trust companies of funds that a year earlier were flowing into the Government's bank balances as a result of heavy purchases of Canada Savings Bonds.

When one takes account of such shifts in the pattern of credit flows one does see some evidence of a moderation of the growth of short-term credit. There has, moreover, been a distinct slowing in the growth of the privately-held money supply on the narrower definition which includes currency and demand deposits but not time deposits. On this definition, average money holdings in the final quarter of 1973 were 12 per cent higher than their level a year earlier, but the annual rate of growth had slowed to 8 per cent over the most recent half-year.

The interaction between strong credit demands and the changed posture of monetary policy in an international environment of sharply rising interest rates led to substantial increases in Canadian interest rates during 1973. Although the Bank of Canada did not press its policy to the point where Canadian short-term rates rose as high as the peak levels reached in the United States and in major financial markets abroad, the increases were nevertheless quite large. Thus typical rates on short-term paper were some 5 percentage points higher at year-end than at the beginning of 1973. Chartered bank prime lending rates for larger borrowers had moved up by 3 1/2 percentage points and there had been comparable increases in key deposit rates. The Bank of Canada's own Bank Rate had been raised in five steps to the present level of 7 1/4 per cent that was established in September.

Late in 1973 short-term interest rate levels in Canada came under renewed upward pressure and further increases in some of these rates occurred. Since there was a reasonable possibility that this pressure would prove to be no more than a temporary phenomenon, the Bank of Canada operated to cushion the upward pressure on rates even though this was accompanied by a temporary bulge in bank loans and deposits.

It should be emphasized that interest rate movements play an indispensable role in helping to keep the growth of the economy orderly and prices and costs under control. Given the pressures on productive capacity that emerged last year and the associated strength of credit demands, it was essential that interest rates should rise. To have attempted to prevent rates from rising as much as they did by permitting even faster monetary growth would have added to the demand pressures on an economy that was already operating at virtually full stretch, and would thus have added to subsequent rates of price increase. In time, moreover, the exercise would have proved self-defeating as these higher rates of inflation led savers to insist on correspondingly higher interest yields in compensation for the accelerating decline in the value of money.

This brings the story up to the onset of the petroleum crisis. The slack in the Canadian economy had been absorbed by a period of vigorous expansion, so that the growth in output in 1974 could not be as large as it had been in 1973. External price pressures seemed likely to ease and some sources of demand were expected to moderate, but a further strong rise in investment spending would help to sustain economic expansion at a pace that would still involve some risk of excessive demand pressure on capacity. Following large increases in prices, profits and farm incomes, there were already signs in the closing months of 1973 that wage and salary increases were beginning to escalate. In these circumstances the kind of demand management policies called for seemed reasonably clear -- to try to maintain a climate of demand favourable to continued economic growth at a substantial rate, but not so strong as to jeopardize the prospects for improvement in our price situation.

The sudden emergence of the oil problem has affected the world economic outlook in a variety of ways.

There are the direct consequences of such physical shortages as may occur. How severe these will turn out to be remains obscure, but they may lead to some reduction in the growth of output and employment in some countries. The effects of any general shortages may be intensified by shortages of particular items such as petro-chemical feed-stocks and bunker oil for ships, which may add temporarily to production difficulties in particular industries and restrict the movement of goods.

The sharp jump in oil prices will add substantially to world-wide cost increases. A broad range of goods and services whose production entails the use of petroleum will become more expensive, in some cases substantially so. The world had been looking forward to some easing in 1974 of the extraordinary increases in prices and costs that had occurred in 1973 even before the recent rise in petroleum prices. Now, unfortunately, such prospects have been pushed further into the future.

Another consequence of the sharp rise in petroleum prices will be to generate massive transfers of income from consumers of oil to producers of oil and to governments. This will leave oil consumers with less money to spend on other things. To the extent that such transfers are not offset, they will tend to reduce world levels of demand.

For most countries the transfer of income from consumers of oil to producers and governments is a transfer from inside the country to outside. Since Canada's exports and imports of oil are roughly equal, our situation is different. Here, the transfers of income constitute an internal problem. As you know this is a matter that is currently receiving the attention of our governments.

For the world as a whole the balance of payments implications of these transfers at the present level of prices are truly staggering -- adding up to an increase of many tens of billions of dollars in the combined petroleum bill of the oil-importing countries. Such an unprecedented shock to the international trade and payments system is bound to force substantial readjustments on the countries most affected, and this in turn will affect other countries.

In the short run at least, the oil-exporting countries will not be able to spend more than a fraction of the massive increase in their incomes on increased imports from the rest of the world. This means that for the time being the oil-importing countries as a group will have little scope for correcting the weakening of their external trade accounts as they would in more normal circumstances -- by reducing domestic demand and using the resources freed from consumption at home to expand their export earnings. Instead, their oil imports will have to result in large deficits on trade account and will have to be covered for the immediate future mainly by external borrowing and by drawing on their foreign exchange reserves. The counterpart will be a massive build-up of financial claims by the oil exporting countries.

This is a very unattractive prospect for the richer countries, who have generally wanted to pay for their imports with exports and have not liked what was involved in borrowing from other countries. It is even bleaker for the poorer countries, whose foreign exchange reserves are modest and whose capacity to carry external debt is already over-strained.

It will be of the greatest importance that the major trading countries see this problem in its international context, and refrain from unwarranted attempts to push on to other countries the increases in their trade deficits arising from the oil situation. Such attempts would compound the threat to economic stability and growth everywhere. It is most desirable in these circumstances that countries consult very closely together to arrive at consistency in their balance of payments aims and policies. I was encouraged to see that both the nature of the over-all problem and the need for close international consultation and co-operation in this area were clearly recognized in the discussions of the Ministers of Finance of the Committee of Twenty that I attended in Rome last week. The problems of adjustment are enormous, and as yet it is far from clear how they will be accommodated.

The effects on the Canadian economy of these external developments, as well as the internal aspects of the oil problem, will require close attention in determining the setting of monetary policy. Our basic objective, however, will remain unchanged: to achieve and maintain a monetary climate that will help the economy realize the growth of output and employment permitted by supply conditions, and that will at the same time not jeopardize our longer-term chances for a better cost and price performance.