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REMARKS BY
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TO THE
MEN'S CANADIAN CLUB OF WINNIPEG
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In the years that I lived in Western Canada it used to be said that regardless of the occasion people soon get around to talking about wheat. I am afraid that it is the same with central bankers; they can always be counted on to talk about their own business. I am going to run true to form and do just that, but first I want to say something about the environment in which economic activity is taking place and monetary policy is being formulated. I especially want to refer to certain worldwide influences that may well turn out to be the most important of all the forces operating on our economic situation for some time to come. The fact that I am in Winnipeg encourages me to follow this approach since I have always been aware of a keen interest here in the world scene.

The world economy, as everyone knows, is in a troubled state. It is threatened at one and the same time by the persistence of severe inflation and by the risk of a prolonged interruption in the growth of economic activity.

The combination of ailments that most countries are suffering from is partly new but much of it is old. This is not the first time in the post-war period that we have seen the tide

of inflation reach new peaks well after the economic boom that set off the upsurge has begun to fade. Nor should we regard as altogether unfamiliar, even if much more serious this time, the stresses and strains generated by the recent and largely unforeseen escalation of world inflation. At such times some prices lead the parade while others lag. The prices at which one economic group manages to sell its output are the costs that others are required to pay, so it is not surprising that in many countries today a growing number of firms and industries are caught in a cost-price squeeze, wage disputes are unusually widespread and bitter, and governments are besieged by groups demanding redress for their economic grievances. All of this is part of the price exacted by the wave of inflation that has been let loose in the world.

The origins of this worldwide inflation can, I believe, be understood without great difficulty. One could trace them back quite far, to developments in the 1960s, including the Vietnam war, but I think that for present purposes it is enough to begin by noting that virtually all of the major countries had experienced an economic slowdown at the beginning of the 1970s, and that they were understandably anxious to restore high levels of economic activity and employment as soon as possible. For this reason they were following highly expansionary monetary and fiscal policies. The degree of monetary expansion that occurred in some countries was increased by their efforts to preserve exchange rate levels that turned out to be unsustainable.

In time the consequence of these policies was a rapid increase in public and private spending in the major industrial economies, which was mutually reinforced through their international trade. Production surged ahead in almost all of them at roughly the same time. By 1973, much earlier than was generally anticipated, the strength of this widespread economic expansion was threatening to outrun world supplies of primary commodities, and the prices of many of them began to climb rapidly. For these and other reasons which I shall mention later, world prices of agricultural commodities were in the forefront of the advance.

In Canada too, the rapid expansion of both foreign and domestic demand was beginning to press against the limits of the economy's productive capacity in an increasing number of areas, again earlier than anticipated. I think it is fair to say that our high unemployment rates had created the impression of more available productive capacity than in fact turned out to exist as we later found when in the midst of relatively severe labour shortages unemployment rates stayed considerably higher than we had hoped could be achieved. In 1973 supply bottlenecks, order backlogs and delivery delays began to make their appearance in industries operating at full stretch. As these conditions spread, price increases grew larger, more frequent and more general both at the intermediate and final stages of production. A broadly similar pattern of developments occurred in other industrial countries of the world.

In the course of time steps were undertaken by the industrial countries to moderate the growth of domestic spending and provide resistance to the wave of inflation that was sweeping through their economies.

Developments on the demand side were not the whole story, of course. On the supply side, one of the earliest and most important sources of this inflation has been the growing food problem. Supplies of food grains and animal feeds have been substantially reduced in recent years. As I hardly need tell this audience, there have been poor harvests in some of the main producing areas, including of course our own prairies. No early relief from the shortfall in the supply of grains is in sight. In the face of a continually growing world demand, this has led to particularly steep increases in the prices of cereals and related foodstuffs. It has also led to the tragic fact that in some parts of the world more and more people are facing starvation.

A year ago a four-fold rise in the world price of oil added a new dimension to the problems already confronting the world. The consequences of the rise in the international oil price are really just beginning to unfold and it remains to be seen how well the world will cope with them. The balance of payments positions of many oil-importing countries have been thrown heavily into deficit. If oil prices remain where they are in relation to other prices, it will not be possible for many oil-importing countries to maintain satisfactory levels of economic activity even in the short run unless they go into debt on a scale that is completely unprecedented.

For some countries the possibility of borrowing to pay for oil is severely limited by the difficulty of finding willing lenders. This is what has given rise to the so-called recycling problem. Beyond what can be handled relatively smoothly by private financial markets, full recycling means channelling funds back to some countries that may not be able to carry the debt by themselves. This task will require international co-operation of a high order, for it is not reasonable to suppose that all of the funds channelled to the economically weaker countries can be repaid.

Even with reasonably effective recycling arrangements for the short run, however, the world will be left with a major unresolved problem, and that is the problem of how to reach a sustainable equilibrium between the main oil exporters and the rest of the world. A widely acceptable solution of this problem will be far from easy to achieve. The interim committee of Governors of the International Monetary Fund chaired by Canada's Minister of Finance will have an important part to play in efforts to deal with these problems.

During the course of 1974 the character of the inflationary process around the world has been changing. The pressure of excessive spending has slackened in most countries and is no longer the main driving force behind the continuing rise in prices. Some commodity prices have already fallen, and to an increasing extent, the continuing rise of final prices is now mainly a reflection of the upward push of costs. These

cost increases, in turn, largely reflect the efforts of various economic groups to protect themselves against the impact of current and past increases in prices and apparently in some cases to try to take out insurance against the possibility of even higher increases in the future.

At the same time the pace of economic expansion has turned sluggish or come to a temporary halt in most of the industrial countries. In some degree a pause of this kind was probably inevitable. Indeed, a pause was essential if the organization of production around the world was not to break down under the distortions of accelerating inflation. There is clearly some risk that the slowdown in economic activity may turn out to be rather more severe and prolonged than any individual country would wish to see or can avoid through its own policy actions. The risk on the other side is that countries may again over-react to the temporary weakness of their economies with an excessive dosage of fiscal and monetary stimulus, thereby ensuring even higher inflation rates two or three years from now.

In broad brush, then, this is where the world economy stands today and the route it took to get there.

In reflecting on economic developments over the past three or four years, I cannot help but sense that all over the world a common pattern of events has been emerging. In a period of economic slowdown, fiscal and monetary policies quite properly are adjusted to try to bring the economy back on the

path of expansion. But it takes time for the economy to respond to these measures and it is very difficult to wait patiently without adding more and more stimulus as time goes on. Excessive stimulus leads in due course to a boom in economic activity which is too rapid to be sustainable. By the time the need to moderate the degree of stimulus becomes apparent, it is generally long overdue. The result is periodic overloading of the economic system, the escalation of inflation and rising inflationary expectations. I do not suggest that this is the whole story of how we have come to overload our economies from time to time, but it is certainly an important part.

Overloading our economies puts us in the position of trying to do things that are basically incompatible. On the one hand, we are trying to operate market economies in which prices and incomes are to a large extent determined through highly decentralized decisions and the general price level is determinied by over-all supply and demand forces. On the other hand, we periodically run our economies so close to full stretch that in many areas of the market we are bound to encounter situations in which the supply cannot possibly expand rapidly enough to keep up with demand. The result is that those same market forces that we rely on set off new rounds of price increases. And then we wonder why no one has yet found the answer to the problem of inflation. If this is how we are going to run the system it is time we realized that no one is going to find the answer. There is simply no way in which market economies offering as much freedom of

individual action as those we are used to can continue to function properly if they are repeatedly overloaded with excess demand.

Experience is now providing us with hard evidence of the difficulties involved in operating an economy under inflationary conditions. You will recall that a number of years ago when the rate of inflation was still relatively moderate there was a continuing debate about how seriously the problem should in fact be regarded. On one side were those who took the view that the evils of inflation were greatly exaggerated, and that it was better to adjust to it and try to live with it than to face up to the costs of bringing it to an end. On the other side, it was felt by many that if we tried to reconcile ourselves to inflation the process would tend to accelerate over time, since the problem of keeping any given rate of increase in the price level from rising would, after a period of adjustment, become just as great as the problem of avoiding inflation in the first place. Theoretical arguments of this kind, however, are seldom overwhelmingly convincing and, as happens so often in the course of human affairs, we are learning the hard way.

Everyone knows about the redistributional effects of inflation which, serious as they are for those who have lost rather than gained, are nevertheless only part of the story. When the value of money begins to shrink rapidly but at varying and unpredictable rates, the potential damage involved goes well beyond the resulting haphazard and arbitrary pattern of gains and losses in real income and wealth.

The fact of the matter is that the effective functioning of modern industrial societies as we know them depends much more than is generally realized on reasonable predictability of the value of the monetary unit in terms of which contracts are drawn and savings and investment plans are formulated. The results of growing uncertainty about the future value of money can be seen in almost every area of economic behaviour. Rational planning for the future becomes more and more difficult and the risks of undertaking forward commitments -- other than those of the shortest possible duration -- become greater than ever. Examples abound throughout the world of severe distortions and imbalances that have been introduced into cost and price relationships and of the strains that these are causing.

What, then, are the options for policy in the present situation?

The first thing to be said is that, quite rightly, no country will choose to try the drastic remedy for inflation of deliberately creating whatever degree of slack is required to bring it to a halt in a relatively short time. As I have already indicated, there is though some risk that the current slowdown in world economic activity may go further and last longer than previous periods of cyclical weakness. This could happen because of the urgent need felt by some countries to reduce their balance of payments deficits and the interaction of the efforts of many countries simultaneously to contain

inflation. Fortunately, however, there is in all of the major countries a general awareness of the kind of policy responses that could lead to a major economic collapse and a strong desire to ensure that member countries of the international trading community refrain from such actions. Indeed, although some countries are restricted in what they can do about their balance of payments deficits, most of them have policy readjustments in train which are designed to limit further declines in economic activity and which will, I hope, lead before long to some renewal of economic growth.

On the other hand, I see no way out of the current predicament of industrial economies that will not involve, for the immediate future at least, both a continuation of inflation and a slower rate of economic growth than that experienced up until quite recently. Things have gone too far for that. The inflationary process has now acquired too much momentum. Since drastic remedies are not acceptable, the only reasonable course is to try to cool off inflation gradually over a period of years by running our economies at levels that involve continued expansion but that stop short of pressing against capacity limitations. It will be difficult to steer such a course but the stakes are high. The co-operation of all the various groups in society in limiting their demands to magnitudes that are consistent with some decline in inflation rates will be needed, and anything that can be done to encourage such co-operation will be useful.

I have deliberately discussed these broad economic policy issues in the context of the industrial countries as a group because they are common problems. Now I want to turn more specifically to the Canadian scene. In his budget last week the Minister of Finance dealt with fiscal policy and the fiscal position of the Government. I will focus my remarks on the recent evolution of monetary policy.

As you will remember, the opening months of 1973 marked the beginning of a gradual shift in the posture of monetary policy in Canada. The change was aimed at moving in an orderly way to more moderate and sustainable rates of monetary growth. Over the course of the next 18 months interest rates in Canada kept moving upward to progressively higher levels. This reflected the interplay of the Bank of Canada's less accommodative policy stance, the strength of the credit demands generated by a booming Canadian economy, and the pressure of sharply rising interest rates abroad.

Although it took some time, I believe we were successful in bringing about a change in the monetary climate that offered considerable resistance to a continuation of excessive demand pressure on the economy. This objective was reached without the disruptive effects of a "credit crunch", although the downward adjustment in bond prices last spring was certainly sharper than one would normally wish to see.

Until the latter part of the summer it was our judgment that the readings we were getting from the main

economic and financial indicators -- though suggestive of a gradual slackening of demand pressures in the economy -- did not yet add up to a persuasive case for a relaxation of the stance of monetary policy. During the course of the summer, however, the weight of the evidence was shifting. There were mounting indications that the growth of aggregate demand in Canada was slowing: although the outlook for plant and equipment expansion remained strong, housing starts were declining sharply and there were increasing grounds for expecting our exports to be affected by the developing weakness of economic activity in the outside world. In the monetary and banking field, private holdings of currency and bank deposits, including savings and time deposits, continued to expand quite rapidly, but year-on-year monetary growth as measured by the narrowly-defined money supply, currency and demand deposit balances, was falling to quite low levels. In recent months there has also been evidence that the demand for bank loans has moderated.

In the circumstances we reached the conclusion that the time had come for an adjustment in the posture of monetary policy. The high water mark for interest rates in this country was reached about three months ago, that is, towards the end of August, and since that time market interest rates have moved to lower levels. In some areas of the interest rate structure, particularly yields on Government of Canada securities, the change has been substantial. A sharp decline in interest rates in the United States contributed to the downward adjustment of

Canadian rates, but other important factors have been some easing of domestic credit demands and the operations of the Bank of Canada, which have allowed the chartered banks to restore some of their depleted liquidity. In recognition of the change in market interest rate levels the Bank of Canada reduced the Bank Rate on November 15th, the date on which the new Canada Savings Bonds were withdrawn from sale. Deposit and lending rate reductions have also been announced by the chartered banks and other private financial institutions.

This recent adjustment in monetary policy should not be misunderstood. It does not mean that we have suddenly abandoned the effort to help bring inflation under reasonable control by keeping the pace of monetary expansion within the bounds of moderation. That objective remains of paramount importance. What this policy adjustment does mean is that we have recognized the appearance of influences in the environment tending to weaken aggregate demand and real economic growth.

In our judgment, the aim of monetary policy should be to maintain rates of monetary growth that are consistent both with continued economic expansion and a slowing of the pace of inflation. Interest rates must be allowed to adjust -- upward as well as downward -- whenever this is required to keep the pace of monetary growth within these limits. While there will always be external influences beyond our own control, a willingness to act with patience and moderation is essential if we are to work our way back to a healthier balance in the economy.