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MAY 28, 1975

REMARKS BY
GERALD K. BOUEY
GOVERNOR, BANK OF CANADA
TO THE ANNUAL MEETING DINNER OF
THE CANADIAN LIFE INSURANCE ASSOCIATION
OTTAWA, MAY 28, 1975

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For quite a number of years now I have had the pleasure of attending the Annual Meeting Dinners of The Canadian Life Insurance Association. I have always found this occasion to meet with you to be valuable as well as most enjoyable. So much so that this year when your President invited me not only to come but also to address you after dinner I felt he was making me an offer I could not refuse.

I note that the general topic for discussion at this conference has to do with the problems facing life insurance companies in an inflationary economy. This is not surprising since in recent years there has been a general drift into progressively deeper and more chronic inflation throughout the world, with the rate of decline in the value of money varying widely and unpredictably from year to year. Inflation has been creating serious difficulties both for those who have a need for long-term savings instruments and for those who need to borrow at long term in order to finance capital projects. It has undoubtedly imposed a severe handicap on life insurance companies in their efforts to meet the needs of the public for reliable long-term savings protection against future contingencies.

As inflation has become more rapid and more chronic, the yields available to insurance companies for the investment of their current cash flow have come to incorporate an implicit premium reflecting in some degree the rate of inflation experienced in the recent past and thus perhaps expected to continue for some time into the future. In recent years, however, the size of this inflation premium has failed to keep fully abreast of the rising rates of inflation actually experienced. This has produced the phenomenon of negative real interest rates -- that is, rates of interest which are not high enough to compensate the saver for the erosion of the purchasing power of his capital as the price level rises. It is difficult to believe that this can possibly be a stable or enduring feature of our capital markets.

A few years ago one often heard the view that inflation needn't be regarded as a very serious problem. All that was required was a little ingenuity in devising ways of protecting its potential victims from loss or compensating those who had been hurt. After the experience of recent years the problem can no longer be so easily dismissed. For inflation to benefit anyone, it must continue to take advantage of at least some people. In practice, that means it must continue to escalate faster than at least some people can learn to anticipate and find ways of adjusting to. The further we go down this road the harder it will be ever to stop. In my judgment, we really have no alternative but to learn to master inflation.

Less than three months have passed since I had the opportunity to make public in my Annual Report some reflections on the current economic scene, and I don't think my views have changed appreciably in the meantime. The main thing I want to do tonight is to elaborate a little on some of the salient points.

There is really no great mystery about the nature and origin of our current economic difficulties. For many months now most of the world's industrial countries have been passing through a severe recession. It is no accident that this recession has come hard on the heels of a worldwide inflationary boom of major proportions. The continuing spiral of price and cost increases that was set off by this worldwide boom is a prime example of the instability generated when the economic system is allowed to overheat. Soaring interest rates are another reflection of the strains and stresses that come with a booming economy. Yet another example of this instability is the general scramble to build up stocks of particular kinds of goods before they become scarcer and more expensive. This creates all sorts of imbalances and distortions in the pattern of economic activity whose eventual reversal is bound to be disruptive and painful. This year's under-employed world economy is, in a very real sense, the direct descendant of the world economy that was so severely over-stretched a year or two ago.

If the combination of inflation and recession we are currently experiencing is in large measure the predictable consequence of the worldwide economic boom that preceded it, what caused the boom in the first place?

The short answer is that it was caused mainly by the over-expansionary fiscal and monetary policies pursued by almost all of the world's industrial countries in the early 1970s. These policies had been invoked in an effort to restore high levels of output and employment following the economic slowdown at the beginning of the decade. One unusual feature of this period is that it was marked by acute international monetary instability, and for many countries fear of the domestic consequences of relatively strong exchange rates reinforced the tendency to permit unusually rapid rates of monetary expansion. Earlier international exchange rate relationships were in the process of breaking down, and in the highly uncertain environment many countries were reluctant to see their exchange rates move as far as was appropriate at that time, although in the end vast changes became necessary. I doubt whether it is generally appreciated how important a factor this was in laying the foundations for the worst outbreak of inflation of the postwar period.

By the time steps were being taken in most countries to moderate the expansionary thrust of these domestic policies, they had already resulted in sharply rising public and private expenditure and a boom in national levels of economic activity

that was mutually reinforced through international trade. Had there been a more widespread appreciation that a boom of such proportions was imminent, these policies might have been adjusted earlier. But many countries were misled by the persistence of apparently high unemployment rates into thinking that the amount of spare productive capacity in their economies was much greater than turned out to be the case. The price pressures generated by this boom came on top of the already elevated rates of inflation which were the legacy of the previous upswing, and they were greatly reinforced by special factors affecting the prices of farm products and of energy supplies.

The early 1970s were by no means the first time in the postwar period that policies intended to promote speedy recovery from an economic slowdown ended up by generating an unstable boom, a further worsening of inflation and, before long, yet another recession. Since we are now back in much the same position as we were on these past occasions, except at higher rates of inflation, we should think rather carefully about how we ought to react on this occasion.

The temptation to press expansionary policies too hard and to keep them in operation too long arises primarily from the concern felt by everyone about any substantial rise in unemployment, and from a desire to overcome it as quickly as possible. Compared with the immediacy of this problem, the distant and uncertain risk of compounding our inflation problem two or three years into the

future is all too readily perceived as a gamble it is reasonable to take. In any event, if the cost of a little less unemployment is only a little more inflation, isn't the choice obvious?

The trouble is that it's not enough for policies to be well-intentioned -- they must also be capable of achieving over time the results that they seek. People do learn from experience, and they come to realize that the prospect of "a little more inflation" is only the beginning of the story, not the end of it. Inflation accelerates once it comes to be expected. It gets built into wage contracts and pricing decisions. As time passes, what we find we are in fact trading off in order to get a little less unemployment -- and that only on a very temporary basis -- is not a "little" more inflation but rapid and growing inflation as far ahead as one can see.

It's not surprising, then, that over the years the policy record of most countries has been one of switching back and forth from fighting unemployment to fighting inflation and back to fighting unemployment. By now it's pretty obvious that this approach has not succeeded, and has instead saddled us with deep-seated problems that stand in the way of achieving consistently good economic performance. If we in the industrial countries are to avoid yet another repetition of our past mistakes, we are going to have to stop switching and show more steadiness in keeping both of our objectives -- satisfactory levels of employment and reasonable price stability -- equally

in mind. It's time it was generally realized that these are complementary aspects of a stable and well-functioning economy, not mutually exclusive alternatives one of which can be purchased by sacrificing the other. Whatever steps we decide to take to counteract a recession should be taken with our eyes firmly fixed on where we want to be in terms of our cost and price performance two or three years later on when economic activity has fully recovered.

The substance of what I have been saying can be illustrated with reference to the conduct of monetary policy, which although by no means the only important factor involved is the field in which my own special responsibilities lie. So far as monetary policy is concerned, experience has shown the dangers of over-reacting first to higher unemployment when it has become the problem of most immediate concern, and then to rising inflation when that problem in turn has come to occupy center stage. In part this is a matter of the long time lags between changes in the rate of monetary expansion and the ultimate effects on employment and prices. In the past, when the growth of the money supply has been allowed to rise sharply in hopes of promoting more rapid economic recovery from a recession, central banks have not generally felt that they were taking serious risks of rekindling inflation. This was because, in economies where the level of output had fallen well below the limits of capacity, it would clearly take at least a year or two of vigorous expansion before

the zone of high employment would be re-entered and any widespread overheating of the economy would again become a serious risk. This consideration seemed to argue for letting the growth of the money supply proceed at a rather rapid rate for the time being and then slowing it down to a more conservative pace once the economy was again approaching its capacity limits.

In practice, once levels of demand, output and -- eventually -- employment began rising quite sharply, the very speed of the advance created considerably more price pressure than had been expected. The self-generating forces of recovery tended to be underestimated and not enough attention was paid to the mutual reinforcement of stimulative action taken by a number of countries at the same time. And because the return of the unemployment rate to more normal levels tends to lag behind in the process of economic recovery, central banks have felt reluctant to move to more cautious rates of monetary expansion until quite late in the day.

By the time they felt able to do so, therefore, it was generally too late to prevent the expansion of money and credit from contributing to some degree of overheating of the economy. Moreover, by then economic expansion had acquired so much momentum and had involved so many exposed positions that any marked curtailment of the rate of monetary growth was likely to increase substantially the risks of an early economic downturn. The net result has been that with each successive

cycle, central bankers have found themselves reluctant parties to the printing of money at progressively faster rates.

Today there are signs of a growing recognition of the need for steadier monetary growth at moderate rates if this cycle is to be broken -- a recognition perhaps most evident in some of the world's main industrial countries, notably the United States and Germany. Efforts are being made in these countries to win public support for the observance of some prudent speed limits in the expansion of the supply of money -- for a determined effort not to depart very far from a moderate rate of monetary growth except in the most compelling circumstances. Although it remains to be seen what degree of success these countries will achieve in their efforts to maintain a greater degree of monetary discipline than in the past, the fact that these efforts are being made at all is in itself an interesting development. It is perhaps worth mentioning that in this country too, the need for greater steadiness in rates of monetary growth from one year to the next has become a consideration of growing importance in the minds of a number of people, including those of us at the Bank of Canada who are concerned with the formulation and conduct of monetary policy.

So far as the present economic situation here in Canada is concerned, it's true that to date we haven't had as deep or lengthy a recession as many other countries. On the other hand, our underlying cost situation is a good deal more worrying than

in the case of some of our main trading partners, including the United States. We would seem to have a reasonable chance of an early upturn in economic activity , but it would also seem that we must expect a relatively large deficit in our current balance of international payments and relatively high levels of unemployment for some time.

The distinctly easier monetary environment that we have had since last summer is one of a number of influences working in the direction of an economic upturn. During the first quarter of this year short-term interest rates in Canada reached levels very much below their highs of last August. Long-term rates, which are substantially affected by views about our inflation prospects over a rather longer time horizon, showed smaller but nevertheless appreciable declines.

These changes in interest rate levels were associated with an unusually sharp jump during the first quarter in the rate of growth of currency and demand deposits, the main forms of money used for making payments in Canada. This is a definition of the money supply which is subject at times to rather large erratic swings over periods as short as a month or two, although still useful for making comparisons over periods of a few quarters. During the latter part of 1974, for example, the growth rate of this series had turned unexpectedly negative for a month or two. Then followed the sharp increase in the first quarter but in the weeks since then the growth of the money supply has slackened again.

Taken over a period as long as a year or so the increase in this money supply series does not appear unreasonable in all the circumstances.

In recent weeks there has been a certain amount of backing and filling of interest rates in the money market, bond market and mortgage market so that some of these rates currently stand a bit above their recent lows. In this connection I should remind you that the Bank of Canada cannot undertake to hold interest rates at particular levels if it is to pay adequate attention to keeping the growth of the money supply within reasonable bounds.

The rate at which costs are currently rising in Canada poses a difficult problem for monetary policy. It will not help this country to achieve on any lasting basis the goal of restoring satisfactory levels of activity and employment if the central bank simply accommodates in full, through correspondingly rapid monetary expansion, whatever rate of inflation is tending to be built into the cost structure of the economy. The proper role of monetary policy in current circumstances is to ensure that the growth of money and credit is fully adequate for economic expansion to be resumed at lower rates of inflation than we have been experiencing recently.

In my remarks tonight I have tried to emphasize that reasonable price stability is an essential condition for a

well-functioning economy. While we can not expect to get rid of inflation overnight, I believe that over time we can achieve progressively lower rates of inflation, and monetary policy can play its part in this respect.

Despite our immediate difficulties, we can, if we are so determined, build a solid basis for achieving satisfactory levels of employment with reasonable price stability on a continuing basis. No obstacle stands in our way that will not yield to self-discipline and patience.

A statement before the
House of Commons Standing Committee
on Finance, Trade and Economic Affairs
by Gerald K. Bouey
Governor of the Bank of Canada
Thursday, November 6th, 1975

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Mr. Chairman, I am here today to try to answer any questions your Committee may have about the Bank of Canada's role in the over-all anti-inflation programme. If you would like me to do so I am prepared to make a brief introductory statement.

There is no doubt in my mind that Canada is in serious economic trouble. Our costs and prices have continued to spiral upwards very rapidly in spite of more than a year of recession in this country and a more prolonged and severe recession in the outside world. Two years ago what was happening to prices in Canada was part of a worldwide phenomenon. More recently, however, the trend of costs and prices in a number of the main countries with which we trade has clearly begun to moderate, so that to an increasing extent continuing rapid inflation in Canada is now a special problem of our own.

The policy dilemma posed by this situation is that we can no longer count on being able to reduce unemployment in Canada simply by taking sufficiently strong measures to raise the level of internal demand. There is a very real risk that further stimulation of demand in present circumstances would serve mainly to fuel still higher inflation. As a result, unemployment would remain high; conceivably it too could go still higher.

In my view, it has now become absolutely essential to bring inflation under control in this country if we are to avoid major economic and social damage. This is our only realistic hope of achieving a sound recovery and sustained economic growth. That is why I support the idea of undertaking a concerted programme of measures directed towards this end.

Because the inflationary process in Canada has become so deeply entrenched and has gained such momentum, there is no way of bringing it under control quickly except at very heavy cost in terms of foregone output and lost job opportunities. That is why any drastic move to severely restrictive monetary and fiscal policies has been rejected.

An alternative approach would be to rely on monetary and fiscal moderation alone to slow down the rate of inflation. The problem with such an approach is that it might well take a very long time to succeed, given the fact that we start with such high rates of increase in prices and money incomes, and that the cost in terms of lost employment and output might still be substantial. It might have been a more practicable solution if rates of inflation were not already so high. Nevertheless, in my view a policy of monetary and fiscal moderation can work more effectively and with minimum dislocation if it is supplemented by an effective programme of price and income restraints. With the active support of all Canadians, these restraints can help to ensure that inflation will in fact moderate

sufficiently to permit a steady improvement both in job opportunities and in the output of goods and services that we jointly produce and consume.

No one should be in any doubt about what is involved here: with the collective help of all Canadians in bringing inflation under control, we will find ourselves collectively better off, not worse off as many seem to think.

As I have said on previous occasions, there is no great mystery about the nature and origins of our current economic difficulties. Almost all of the world's industrial countries, including Canada, pursued very expansionary monetary and fiscal policies in the early 1970s. The main reason that these policies were adopted was in an effort to restore high levels of output and employment following the economic slowdown at the beginning of the decade.

It was widely believed at the time that until full economic recovery was assured the right course of action for central banks to follow was to resist the tendency for interest rates to rise and credit to tighten even if this involved rapid expansion of the money supply. This was particularly so in countries whose exchange rates were already under strong upward pressure at a time of acute international monetary instability. For many countries the fear that any substantial rise in their exchange rate would greatly complicate their domestic economic problems strongly reinforced the tendency to permit unusually rapid rates

of monetary expansion. This was also a consideration of some importance in the monetary policy followed in Canada.

A policy approach of this kind depends of course on an ability to forecast economic developments quite accurately and, having regard to the inevitable time lags, to tighten fiscal and monetary policies substantially well before the limits of the economy's productive capacity are reached. This is not how things turned out. The separate national policies of countries interacted, creating a worldwide inflationary boom of major proportions in 1973 that set off a continuing spiral of very large price and cost increases. Some countries, including Canada, found that their usual measures of unemployment turned out to be highly misleading as a guide to how much room actually existed for further economic expansion. The steep rise in world price levels resulting from the boom was powerfully reinforced by a marked shortfall in the supply of foodstuffs due to poor harvests and by the action of the OPEC countries in quadrupling the price of oil.

The strains and stresses produced by such an overheated economic system take many forms -- a general scramble to build up stocks of particular kinds of goods before they become scarcer and more expensive, a fierce struggle for money income increases large enough to protect the recipients against the effects of price increases that have already occurred or are anticipated, soaring prices, labour costs, interest rates

and so on. Established patterns of economic behaviour are distorted by all sorts of imbalances whose eventual reversal is bound to be disruptive and painful. It is no accident that world recession followed hard on the heels of the world inflationary boom, or that a sound basis for renewed and lasting economic growth now seems so difficult to achieve.

I do not propose to dwell longer on the origins of the current problem of inflation. To a considerable extent the causes of the demand-pull inflation are not as immediately relevant to the control of our present inflation as those forces which are keeping it going and even causing it to accelerate. For example, I have stated on another occasion that the current wave of inflation was not initiated by a marked acceleration of wage and salary increases, but because of their relative importance in total costs, very high wage and salary settlements have been a major force behind the continuation of the rise in prices and costs. The objective must be to bring about a deceleration of both price and cost increases.

Besides dealing with this cost-push problem, we must try to manage total demand in the economy better than we have in past cycles. So far as monetary policy is concerned a major change of emphasis seems to me to be occurring in many countries. The experience of recent years has shown how much trouble can be stored up for the future by following a monetary policy that is overly concerned about the short-term impact of interest-rate movements on economic activity or the exchange rate, and not

sufficiently concerned with the cumulative effect over time of the rate of monetary expansion on the trend of prices. Experience has, I believe, demonstrated the need for greater steadiness in rates of monetary growth.

Over a two-year period ending in the second quarter of 1973, a period in which unusually high rates of monetary expansion occurred around the world for reasons that I have already mentioned, the public's holdings of currency and demand deposits -- the main forms of money used for making payments in Canada -- increased at an average rate of no less than 15 per cent a year. By comparison, an average rate of about 5 per cent a year would probably have been high enough to accommodate the growth in production of goods and services in Canada at the long-term trend rate if prices had been stable.

The fact is, of course, that over recent years an underlying rate of inflation has been built into our economy which is now much too high to be eliminated at all quickly by suddenly reducing the rate of monetary expansion to anything like such a low figure. The consequences for economic activity would be much too disruptive in the short run, so that whatever progress is to be made in moderating the rate of monetary expansion in Canada must be achieved gradually over time.

Some moderation has occurred. Over the two years ending in the second quarter of 1975, the average rate of growth of currency and demand deposits in Canada was down to about 10 per cent a year. During the summer

months the rate of growth of the money supply so defined bounced back up to unusually high figures, but the Bank has since taken action -- culminating in the Bank Rate increase early in September -- in an attempt to deal with that situation.

I should point out that the technical means available to the Bank of Canada for slowing down the growth of the money supply so defined is to restrict the quantity of cash reserves it makes available to the banking system in its day-to-day operations. The effect is to slow down the rate at which the banking system expands and this puts upward pressure on short-term interest rates. Higher short-term interest rates affect the willingness of the public to hold money in non-interest bearing forms. I want to stress the key role played in this matter by higher short-term interest rates, which from time to time will include the Bank of Canada's own lending rate, the Bank Rate.

How strong an impact such action by the Bank of Canada will have in slowing the growth in the months ahead of currency and demand deposits will depend in part on the strength of the other major determinant of the demand for money balances, that is, the level of total spending in the economy. The Bank of Canada is, however, able to exercise a broad controlling influence over the underlying trend of monetary expansion -- not from week to week or even, necessarily, from month to month, but certainly over periods long enough for the behaviour of the economy to be significantly affected by the trend of the money supply.

In exercising this influence, the Bank of Canada tries to avoid over-reacting to the wide variations in the rate of monetary growth that can -- and frequently do -- occur over relatively short periods of time. In most cases these variations are the result of transient and essentially self-reversing disturbances of only a few weeks' duration. If the Bank of Canada reacted sharply to every temporary spurt or pause in the growth of currency and demand deposits, its actions would necessarily involve much larger, more frequent and more disruptive changes in interest rates than would serve any useful economic purpose.

The broad objective that the Bank of Canada continues to pursue is, as I have stated elsewhere, to maintain enough monetary growth to support rising levels of economic activity together with a moderation of the rate of inflation.