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REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO THE
HALIFAX BOARD OF TRADE
ANNUAL DINNER MEETING
HALIFAX, N.S., MAY 12, 1977

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I want to begin by expressing my pleasure at being here for the 225th Annual Dinner Meeting of the Halifax Board of Trade. To have been operating since 1750, to be the oldest "Association for the Benefit of Trade" in North America and the British Commonwealth, is an impressive and proud record indeed. Now I know what economists mean by the "long run". I extend my warmest congratulations to you and I want you to know that I feel greatly honoured to have been asked to address you on this occasion.

There is another reason why I am glad to be in Halifax for a couple of days. In the Bank of Canada we do our best to keep abreast of economic developments in this part of the country, and we are greatly assisted in this endeavour by our director from Nova Scotia, Mr. Bill Mingo, but I am nevertheless pleased to have this opportunity to have a close, if quick, look for myself and to talk to some of you on your home ground.

Regional economic problems in Canada are difficult enough at the best of times, but they become even more difficult when the national economy is in trouble, as it is today. The Maritime region is feeling all too acutely the impact of escalating energy costs, painful levels of unemployment, and pervasive and persistent inflation. Fortunately, there are some promising developments as well. But the fortunes of this area are bound up to a large extent with those of the country as a whole, and I would like to address my remarks mainly to our common national problems. I might say that I particularly welcome a chance to explain to you how it was that the Bank felt it appropriate to reduce its Bank Rate again last weekend -- the fourth reduction since November -- even though, as anyone who noticed my recent annual report will be aware, I continue to regard inflation as a most serious problem.

The particular points I want to focus on tonight are three in number. First, I want to explain what, in my view, is the essential nature of the problem that we face today in getting the Canadian economy to function satisfactorily. Then I want to talk about what has to happen if the problem is to be resolved. Finally, I want to say a word about how monetary policy can be expected to contribute to the solution of the problem.

To begin with, then, what has gone wrong with our economy? How is it that after two years of recovery from the low point of a cyclical

It is the interrelation of unemployment and inflation that is, in my opinion, the most important single fact in the current Canadian economic scene. We have as much unemployment as we have now primarily because we have had so much inflation of costs and prices. The rate of cost and price inflation has been coming down but it is still too high and it is standing in the way of a lasting solution to our unemployment and balance of payments difficulties. It no longer makes sense to think in terms of giving priority to fighting inflation <u>or</u> to fighting unemployment. Success in dealing with inflation is essential to success in dealing with unemployment. I put emphasis on resisting inflation because I want to see a sustained increase in productive employment in this country. I put emphasis on resisting inflation because I think that the gravest longer-term threat to employment and to the economic well-being of Canadians is the risk that we fail to deal effectively with inflation.

If, then, it is essential to find a way of dealing with inflation, it seems to me useful at the outset to distinguish between those factors which set off an outbreak of rapid inflation and those which keep it going long after the original causes have disappeared. The onset of double-digit inflation a few years ago was in large part attributable to well-intentioned but overly-expansionary economic policies on a world-wide basis that generated excessive demand pressure on productive resources -- a situation compounded by special factors such as poor grain harvests and slowdown in activity we are still facing a combination of rather sluggish economic growth, weak investment, high unemployment, a large balance of payments deficit on current account financed by heavy foreign borrowing and yet at the same time a continuing, only partly subdued, upward push of our labour costs and prices?

Not so many years ago this would have been regarded as such an unlikely combination of problems as to be virtually unthinkable. An economy might have problems of slow growth, high unemployment and excess capacity, but if so it was unlikely to be suffering from any significant degree of wage and price inflation or to be drawing heavily on other countries to supplement its own production of goods and services. Alternatively, an economy might have an inflation problem and a large balance of payments deficit, but if so it was unlikely to be experiencing slow growth or high unemployment.

Put very simply, the belief was that a country could have either an unemployment problem because not enough money was being spent in the economy, or an inflation problem because too much money was being spent -- but not both problems at the same time. There are still people around today who are reluctant to give up this familiar view of how the economy works, and who would have us shut our eyes to one or the other aspect of what has now become, to all intents and purposes, a single interrelated problem.

A major reason why people continue to act on the assumption that high rates of inflation are here to stay is that they have become very skeptical that disinflationary policies will be pursued long enough to be successful. They doubt that there is enough will to deal effectively with inflation. The resulting expectation of continuing inflation, through its influence on wage and price behaviour, is itself a cause of continuing inflation which, in turn, perpetuates the expectation -- a vicious circle. Progress in reducing inflation is correspondingly slow and unemployment remains high because we price ourselves out of the market. If, in the circumstances, governments and central banks relax their efforts to control inflation, this only serves to confirm the public's view that skepticism is justified.

The problem of persisting inflation is not unique to Canada, but we have the additional problem that for some time now our domestic costs and prices have been rising faster than those of the United States, our chief trading partner and competitor. At the margin we are still in danger of further loss of competitive position, even after the recent downward adjustment of our exchange rate. I say at the margin because our merchandise exports are, after all, running at an annual rate of over $40 billion. But even this high rate has not been enough to keep our deficit on goods and services transactions with other countries from being in the $4-5 billion range. There are many other economic and social reasons for wishing to have a non-inflationary economy, but the need to earn our the sharp rise in oil prices. However, although the pressure on productive resources subsided some time ago with the slowdown in world economic activity, inflation continues, although at a reduced rate in most countries.

What keeps it going? No doubt there are a number of reasons, but I believe the most important of these is the widespread expectation that high rates of inflation are here to stay. This expectation now seems to be built into our economic behaviour so firmly that wages and prices keep being pushed up even when labour and product markets have been relatively weak for rather a long time. It used to be said that in a modern economy there is generally strong resistance to any reduction in the absolute level of wages and prices. Now it might be more accurate to say that it is the rate of increase of wages and prices that seems to be subject to this downward rigidity. There was already some evidence to support this proposition at the time of the 1970-71 recession, which made scarcely a dent in the relatively high average level of wage settlements in Canada right through from 1966 to 1972. To give a more current example, in recent months the rate of price increase in the United States seems to have stopped declining for the time being even though levels of unemployment and unused capacity in that country are still relatively high. Clearly, it will be no easy task for the new U.S. Administration to achieve the goal it has set itself of getting the inflation rate down to 4 per cent by the end of 1979.

domestic price level would be pushed up by higher import prices, and the more this would be translated into claims for correspondingly large wage increases. Whatever temporary improvement in our competitive position we had gained through exchange rate depreciation based on inflationary policies would soon be lost again as domestic inflation gathered momentum. It doesn't make sense to try to deal with the economic consequences of persisting inflation by inviting even more serious inflation.

This is not merely a theory. There are too many examples around the world of exactly this sequence of events. Unhappy and impatient as we are bound to be about the present state of our economy, we should be under no illusions about the danger that would lie in store for us in going down this particular path.

Well, if the persistence of inflationary expectations and behaviour is the basic reason why our economy isn't functioning very well these days, how can the problem be overcome? What can we do to improve our competitive position and restore the health of our economy? In principle, there are really only two ways out for our economy -- or for any other economy for that matter. One is through increased productivity. I include here the whole range of public economic policies and private initiatives that affect incentives and efficiency. The other is by keeping our costs under better control -- that is, the wages and salaries and other money incomes that the price of what we can produce living in competition with other countries without a continuing depreciation of the Canadian dollar is one we would be foolish to ignore. If we keep pricing ourselves out of markets both at home and abroad, we shouldn't be surprised that we aren't selling or producing as much as we could, that we aren't generating adequate growth or enough job opportunities, and that we keep borrowing abroad rather than paying our way in the world.

How do we get out of this situation? There are still some people who would say that the answer is simple -- relax about inflation. Accept the proposition that a relatively high, continuing rate of inflation is the best we can hope for in existing circumstances. Expand government expenditure and the money supply rapidly again in order to restore strong economic growth and high employment in spite of the declining purchasing power of our money, and rely on our floating exchange rate to float downwards far enough and fast enough to enable us to compete internationally.

The trouble I have with policy advice of this sort is that it would compound our difficulties rather than resolve them. The more we followed advice of this sort the worse our problems would get. The rapid rate of monetary and fiscal expansion originally intended to stimulate production in Canada would instead generate strong expectations of higher inflation to come and would fuel a renewed acceleration of the wage-price spiral. The further and faster our exchange rate went down, the more our and that it will not be permitted to revive again. What we also need is a more widespread recognition that when the price of labour or output is pushed up unduly, markets and jobs are endangered. This basic change in expectations and behaviour must somehow come about if inflation is to be dealt with effectively and if a sound basis for economic expansion is to be laid. The understanding and co-operation of all groups in the economy is required if we are to break out of the vicious circle that I mentioned earlier without even greater stresses and strains than we are now experiencing.

This brings me to the question of what can and is being done in the area of monetary policy to help restore satisfactory economic growth without inflation in Canada. The Bank of Canada is firmly committed to a policy of gradually lowering the rate of growth of the money supply over time. Under a policy of this kind, a reasonable rate of economic expansion can be accommodated so long as it is accompanied by some continuing decline in the rate of inflation. A gradual moderation of the rate of monetary expansion is necessary to help maintain a market environment in which large cost and price increases cannot be passed on easily or automatically. It is also necessary if people are to become convinced that their expectations of continuing rapid inflation are unfounded. Indeed, the Bank of Canada has made it very clear that no one should expect a resumption of rapid monetary expansion to accommodate any must cover. We can be competitive if we do what we can to be efficient, and at the same time avoid trying to extract money incomes from our production that are higher than the market will bear. Money incomes that are set too high mean over-priced goods and services and reduced employment opportunities. The high unemployment which inflationary practices generate is a self-inflicted wound.

Over the last year and a half we have made encouraging progress in Canada in gearing down the rate of increase of our labour costs and prices. We need to continue our efforts in this direction. I believe that the prices and incomes control programme has made a valuable contribution in this regard, and so have monetary and fiscal policies by avoiding the over-stimulation of demand. When the control period is over we will have to rely mainly on these traditional monetary and fiscal instruments. In other words, we shall have to fall back on the one means of price and wage restraint we have always had -- at least in the private sector -- namely, the maintenance of a market environment that will not readily support excessive increases in prices or rates of pay.

However, we need something more than that. We already have a decidedly weak market environment, and yet cost and price increases are still too large and too frequent. What we need and have not yet got is a sufficient degree of public confidence that inflation really is on the wane

By last August, with the rate of inflation also coming down, the Bank felt able to lower its sights somewhat further, and a new target range for monetary growth of 8 to 12 per cent a year was announced. Since that time the Bank has had problems, not in keeping the growth of the money supply from exceeding the upper limit of this range, but in keeping it from falling below the 8 per cent a year lower limit. While the Bank is determined to avoid rates of monetary expansion too high to be consistent with a gradual decline in Canada's inflation rate, it wants at the same time to avoid unduly low rates of monetary growth. Our current economic situation and prospects clearly make it very desirable that interest rates be no higher than are necessary to avoid inflationary rates of increase in the money supply. That is why the Bank has again taken action to use the room now available for some further reduction in short-term interest rates in Canada.

I have tried in my remarks today to state as frankly as I can the nature of the problem this country faces as I see it and the direction in which I think we must move if we are to find a workable and enduring solution for our present difficulties. It is true that we still have a long way to go, but it is also true that we have come a long way back from the dangerous situation we were in only two years ago. There is much to be concerned about in our immediate situation -- the further increase in the unemployment rate, the renewed bulge in food prices, the uncertainty about the country's political future, and so on.

future outbreak of large wage or price increases. While monetary policy can't provide the solution for all of our problems, no one should be in any doubt about one thing -- that inflation can never be controlled if the money supply is allowed to grow too rapidly.

It is true, of course, that the process of moving to much lower rates of monetary expansion and inflation than we have seen for some time involves many difficult and painful adjustments in economic behaviour, and that an attempt to make this happen too abruptly could be intolerably disruptive. That is why the approach the Bank is following is meant to be gradual and moderate rather than heavy-handed or extreme. It is against this background that last weekend's reduction in the Bank Rate must be seen if it is to be understood correctly.

More than a year and a half ago the Bank of Canada explicitly stated for the first time the monetary growth targets at which it was then aiming in its efforts to moderate the pace of monetary expansion. The objective at that time was to bring the growth rate of the money supply back down well below 15 per cent a year but not below 10 per cent a year. Over the ensuing months the Bank encountered considerable difficulty in keeping the rate of monetary expansion from exceeding the upper limit of the range at which it was aiming, and it was not until the spring of last year that clear evidence of slackening monetary growth appeared.

But there have also been some developments of an encouraging nature. As I mentioned earlier, the average size of wage and salary increases in Canada is continuing to moderate. The world economy is much less inflationary than it was a year or two ago, and after a lengthy pause last year, economic expansion has clearly resumed in most of the industrial countries, with growth prospects particularly good in the United States. The outlook for our exports has also been helped by the recent downward adjustment of the exchange rate of the Canadian dollar, an adjustment which was not brought about by the kind of inflationary policies that I referred to earlier. However, I would put at the top of the list the growing recognition in this country of the real nature of our national economic problem -- namely, that we Canadians cannot go on trying to pay ourselves more than we earn. Because this perception is increasingly reflected both in private and in public attitudes, I have high hopes that we are on the road back toward achieving the kind of economic performance that the Canadian economy is capable of realizing.