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REMARKS BY
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Remarks by
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to
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For some time now I have sought on occasions like this one to explain what I believe to be the main obstacles to good economic performance in Canada and the role that monetary policy can play in helping to overcome them. What I have been trying to emphasize is the difficulty of achieving more satisfactory levels of output and employment so long as rates of pay and prices in Canada keep being pushed upwards as rapidly as they have been in recent years. We need to ensure, of course, that the aggregate level of public and private spending by Canadians grows at a reasonable rate. But we also need to keep the prices of our goods and services -- and the cost of the labour needed to produce them -- from rising faster than our markets both at home and abroad will bear. That's why I believe that we can deal successfully with our unemployment problem only if at the same time we manage to deal successfully with our inflation problem -- only, that is, if we become more competitive.

It's on these grounds that I have been arguing the case for monetary and other policies, together with changes in private attitudes and behaviour, that will gear down the rate of inflation and contribute to a lasting improvement in our unemployment situation. It goes without saying that the necessary changes in the way we have been conducting our affairs in Canada cannot be made easily or quickly. The expectations and habits acquired over a long period of gradually escalating inflation are now too deeply ingrained in our society, and an attempt to break them overnight would be intolerably disruptive. That's why the shift of emphasis in public policy in Canada in recent years has been designed to gear down the pace of inflation by gradual stages over a period of years. Thus the monetary policy that we are following involves a gradual but continuing moderation of the rate of monetary growth -- not a sudden turning off of the tap, but rather a continuing firm resistance to underwriting future increases in rates of pay and prices as large as those of the recent past. In my view this is a reasonable way of attacking the problem. But if it is to pay off in the end, it will take both patience and determination.

I have attached crucial importance to the role that inflationary expectations play in the process that keeps our costs and prices rising rapidly even when the market environment is too weak to support such increases. Expectations of inflation arise from past performance. To change these expectations we must leave no doubt that there is the will to deal with inflation. That is why there can be no turning back half way down the road.

Briefly, that's the basic message of my recent speeches and annual reports. Today I want to say a few words about what has been achieved so far in getting the Canadian economy back on track, and how this may influence its performance over the period ahead.

So far as the current economic situation is concerned, there is no shortage of difficulties to point to. Unemployment remains undesirably high. In recent months food prices have produced a significant bulge in the rate of increase in consumer prices. Although there has recently been some recovery in retail sales, consumer confidence does not seem to be strong. Business confidence is also at a rather low ebb, judging from the level of new investment in plant and equipment in fields other than energy. On the external side, we have been making progress in our merchandise trade but our balance of payments deficit on current account remains very large and we are financing it by going into debt abroad at a rate that is correspondingly high.

That's one side of the current picture, but there is another side. There are factors at work in our economy which, given time, should considerably improve our situation. Indeed, I would argue that the Canadian economy has now in fact made many of the adjustments that were necessary in order to allow it to perform better and to compete more effectively with the rest of the world. Thus, while the bad news is that our economy has been going through a difficult period, the good news is that we may already have completed a large part of what was bound to be a difficult journey. Much of the essential groundwork has already been laid both for a pick-up in the pace of economic activity and for a better cost and price performance -- provided, that is, that we stick to the course we are on.

The most fundamental way in which we have been getting our economy into better shape is through the progress that has been made in reducing inflation. On that front we have seen a remarkable moderation of the average size of negotiated wage settlements -- from annual increases that were running in the 15 to 20 per cent range back in 1975 to increases that are currently averaging no more than 7 to 8 per cent a year, and that soon, now that the new guideline is in effect, should be down to 6 per cent or less. Thus the rate of increase in our labour costs -- a fundamental determinant of our ability to compete internationally -- is now back into much the same range as that of labour cost increases abroad.

At first glance the recent trend of the Consumer Price Index would seem to be at odds with the view that the underlying pace of inflation in Canada is continuing to moderate. But here is an instance where appearances are deceiving. An unusual temporary down-swing in food prices in 1976, combined with the effects of a strong Canadian dollar in holding down the prices of imported consumer goods, gave an exaggerated impression of the degree to which our underlying price performance was improving at that time. A renewed bulge in food prices in 1977, combined with the effects of a substantial decline in our exchange rate, have correspondingly obscured the continuing improvement in our non-food price performance over the course of the present year. Taking the two years together, the over-all rise in the Consumer Price Index to date has not been greatly out of line with what had been hoped for back in 1975 when the Anti-Inflation Program was first introduced. Hopefully, the prices of foodstuffs both from domestic and foreign sources will not continue to rise at such high rates much longer. Meanwhile, the recent weakness of world prices for many industrial commodities, together with the decline in Canadian interest rates from last year's levels, both represent -- for the time being at least -- some relief from pressure in these particular areas of production costs.

Other important adjustments that have been made in the economy include a firmer control of expenditures by governments across the country and a less rapid rate of monetary expansion. This relatively moderate rate of monetary growth has been accompanied by a decline in short-term interest rates, which are now significantly lower than a year ago. The same is true of mortgage rates. Long-term rates have also declined. Interest rates are not high now in relation to the underlying rate of inflation. Funds are readily available to creditworthy borrowers in financial markets and from financial institutions. Whether looked at in relation to our monetary targets or in relation to credit conditions, the current setting of monetary policy is not, in my view, impeding the achievement of more satisfactory levels of output and employment in Canada.

Another important adjustment that has occurred is the large decline in the foreign exchange value of the Canadian dollar over the past twelve months. In large measure a decline of this kind was inevitable sooner or later because of the recognition in exchange markets that costs and prices inside Canada had gotten far out of line with those of our chief trading partners, particularly the United States. It is our past catching up with us. The constructive aspect of this exchange rate adjustment is the offset it provides to the damage done in recent years to our international competitive position. The help it gives us will not last very long, however, if Canadians insist on obtaining compensating increases in rates of pay to offset the direct effect of exchange depreciation on Canadian prices. To take advantage of the degree to which it has restored our competitive position, we must strictly contain the feed-back effects of this exchange rate depreciation on our domestic costs of production. If we fail to do so we shall be only running in circles and getting nowhere -- at least nowhere that we want to go.

The combination of an improving domestic cost and price performance and a substantial depreciation of the Canadian dollar has gone a long way towards building a solid basis for a resumption of more satisfactory rates of growth of output and employment in Canada. I am in fact hopeful that we will see the beginning of this better performance in the course of the coming year.

For this hope to be realized various things must go right. One of them is that the economic expansion that is currently proceeding in the outside world must continue. In the view of some observers, the fact that this expansion lacks the exuberance of previous periods of world economic recovery gives reason to fear that it may soon peter out, abetted by a rising tide of protectionism, unless governments adopt considerably more aggressive stimulatory policies than they are now doing. I concede that there are risks here. There are many countries in the world experiencing economic conditions that are unsatisfactory for essentially the same reasons that they are unsatisfactory here in Canada. Investment in new plant and equipment is relatively weak throughout the industrial world. But the prospects for a continued reasonably strong expansion of the U.S. economy, which is so important for us, look good. Other major economies are likely to grow too, though perhaps at a modest rate. The reluctance of major countries to court the risk of a renewal of inflation may in fact turn out to augur well for a moderately-paced but long-lived expansion of the world economy.

Another thing that must go right is a strengthening of business and consumer confidence in Canada. Confidence is usually at its lowest ebb just before economic activity finally begins to pick up, but it strengthens quickly with an upturn in activity. It is not unreasonable to expect signs of such a revival to make their appearance before long given the prospects for somewhat stronger growth in total spending and the improvement that has occurred in our competitive position. A demonstration that Canadians are capable of getting their domestic inflation problem back under firm control will certainly help in restoring confidence. Economic factors are, however, not the only considerations and much will also depend on the course of events in the on-going debate over the political future of Quebec and the rest of Canada.

Perhaps the major requirement on the domestic scene concerns the wage and price setting behaviour of Canadians in the period ahead. For the remainder of the control programme, the basic guideline for pay increases has been held down to 6 per cent, and profit margin controls will remain in effect for most firms throughout 1978. These arrangements should be of considerable help in limiting the price and cost impact of the decline in our exchange rate. But what will happen as controls come to an end? What will be left to keep cost increases from greatly outstripping productivity gains, and prices from rising at least proportionately? In the private sector of the economy the answer is: what there always was -- the discipline of competitive market conditions and the bottom line. As we approach the decontrol period it is important that there be a widespread appreciation that this form of restraint on price and cost increases will be there, and that even though markets may be strengthening next year, they will not be strong enough to bear average increases in rates of pay of more than 6 per cent a year. In this environment, inflationary pay increases -- whether a post-control bubble or not -- will cost Canadians jobs.

The responsibility for adjusting our wage and price behaviour to a market environment which, while reasonably strong, will not be inflationary, is one that all of us share. I realize how distasteful it is for any group in the country, whether private or public, to accept the fact that increases in its own rates of pay or prices or taxes or other impositions can be a significant factor in pushing up our costs of production to levels that make it more difficult for some Canadians to find work. But the hard fact is that these myriad decisions, taken together, can have this effect, and that's why I hope that in the period that lies ahead such decisions will be made in a realistic and responsible way. And of course I do not in any way exempt the public sector from such responsibility. There, for example, if pay demands are made that would outstrip the gains achieved in private employment, much will depend on the determination of governments and their agencies not to yield to them. The cost of giving in to such demands must inevitably be borne by the public either as taxpayers or as captive consumers of public services, and the example of excessive pay increases in the public sector would undoubtedly lead to at least some excessive increases in the private sector.

Naturally I am anxious that as we approach the end of controls no one should look to monetary policy to accommodate inflationary increases in costs and prices through excessive monetary expansion. There are two main ways a central bank can contribute to inflation. One is to overdo monetary expansion by sacrificing longer-run considerations in the desire to help bring about a quick improvement in economic activity. The other is to overdo monetary expansion by accommodating passively whatever rates of inflation are generated by excessive pay and price increases. Neither does any good in the long run. We have been around that track before. This, in part, was what the Bank's recent announcement of a reduction in its monetary growth targets was about. It was necessarily rather technical in character but I think its message was reasonably clear. It is, first, an assurance that the Bank will permit enough monetary expansion to accommodate as much real growth in the economy as could reasonably be expected over the next year or so, provided this is accompanied by some decline in the current rate of inflation. Secondly, as I have already indicated, it was intended to underline the fact that the Bank is not prepared to permit any greater monetary expansion than this objective requires.

It is clear that we Canadians are going to discover the answers to some critical questions in the next year or so. We are going to find out, for example, whether we can make our relatively free market system of price and income determination work again. There are the other risks and uncertainties that I have mentioned, and more. Small wonder that there is a range of views about the likely performance of the Canadian economy in 1978. My own view, based largely on the degree to which the economy has already adjusted to the necessities of the situation, is that there are reasonable grounds for feeling a degree of optimism about this country's economic prospects. It is not unreasonable to suppose that we Canadians, if we act sensibly, can reduce our rate of inflation next year to roughly the same, or even a little lower rate, than that of the United States. It is also not unreasonable to suppose that we can at the same time achieve a quite respectable increase in employment and in the physical volume of production in Canada. As I have indicated, the monetary growth targets that the Bank of Canada is currently pursuing, though lower than last year's targets, are intentionally designed to accommodate an outcome of this general character without significant strain on credit market conditions.

Whether or not things work out as well as this in the Canadian economy in 1978 will depend in large measure on the response of Canadians in their wage and price behaviour to the current setting of public policies.

There is no doubt that we can, if we are so inclined, revert to saddling our economy with costs of production so high as to perpetuate existing unemployment levels, further erode the value of our money, and throw away the chances of achieving the degree of prosperity that a country as potentially rich as Canada ought to be able to afford its citizens.

I believe that Canadians have too much common sense and too much sense of community responsibility to respond to the challenge of the times in that way. I believe that we have all learned some painful lessons from our recent economic history, and that we are indeed making progress in overcoming our economic problems. One hears a good deal of pessimistic comment these days but I suggest that, as is often the case in economic matters, much of it is well out of date. Such pessimism would have been more appropriate a few years ago when we were really headed for trouble -- for example, during the period when money incomes in Canada were increasing by as much as 15 to 20 per cent a year while increases just across the border were far smaller. How did we imagine that was going to work out?

For the reasons I have given today, I believe we have come a long way back from a very dangerous situation and that we are still moving in the right direction. That's why today I count myself among the optimists about Canada's future economic prospects.