NOT FOR PUBLICATION BEFORE: 12:30 P.M. MOUNTAIN DAYLIGHT SAVING TIME
2:30 P.M. EASTERN DAYLIGHT SAVING TIME

SEPTEMBER 16, 1977

REMARKS BY
GERALD K. BOUEY
GOVERNOR OF THE BANK OF CANADA
TO
THE CALGARY CHAMBER OF COMMERCE
CALGARY, ALBERTA
SEPTEMBER 16, 1977

Remarks by
Gerald K. Bouey
Governor of the Bank of Canada
to
The Calgary Chamber of Commerce
Calgary, Alberta
September 16, 1977

It is a pleasure to be in Calgary again and to have this opportunity of speaking to The Calgary Chamber of Commerce about our economic situation and the policy the Bank of Canada is following.

I am also glad to have the chance to learn something at first hand about the special concerns of people in this province. In the Bank of Canada we try to keep as closely in touch with economic developments in the various regions of the country as we can. In this effort we are assisted by our directors who come from right across the country. The Bank's Board is fortunate indeed to have among its members as able and well-informed a representative from Alberta as it has in the person of Mr. Robert Campbell. The Bank also has a branch, called an Agency, here in Calgary and last year we opened an office in Edmonton. The main role of our representative there is to help us keep more closely in touch with economic and financial developments in Alberta and the other prairie provinces.

One of the things a trip from Ottawa to Calgary does for anyone interested in economic matters is to remind him of how diverse the Canadian economy really is. At a time when economic conditions in much of the rest of the country offer little to cheer about, this province strikes a visitor as an island of comparative prosperity. Of course I also know that there are questions and problems. These include the terms governing your out-of-province sales of oil and gas, the impact on Alberta of the northern gas pipeline project, the market situation for beef and grain, the development within the province of secondary industry, and the future of the important petro-chemical industry. I know that many thoughtful Albertans are deeply concerned about what the vigorous activity in the energy field is doing to the cost structure and competitive position of other forms of economic activity in this province, and how this is likely to affect Alberta's future prospects. Keeping costs under control is certainly one major problem that Alberta shares with the rest of the country, and you are therefore bound to have an interest in the general problem facing Canadians of how to bring about the progressive reduction in our rate of inflation that is required if we are to achieve sustained economic prosperity.

One hears a lot of unhappiness expressed these days about the state of the Canadian economy -- and for obvious reasons. We have high levels of unemployment, we have unused productive capacity and we have a rate of inflation which, though down from peak levels, is still much too high. Today I would like to offer some comments on the nature of the underlying problem we face and the challenge that confronts us in trying to make our economy work better in the years ahead.

The situation in which we find ourselves today is the product of our economic history over recent years. Let me refer briefly to that history.

In common with almost every other industrial country, Canada emerged from the worldwide inflationary boom of 1973 with wages and prices escalating at unprecedented double-digit rates. In some respects Canada had been exceptionally lucky. Unlike many other industrial countries during the boom, Canada had been an important beneficiary of the dramatic inflation of world demand and prices for farm commodities and industrial materials, because these are products we produce and export on a large scale. Since Canada was in a net surplus position in its external trade in petroleum and natural gas, the four-fold increase in the international price of oil did not have nearly as great a disruptive impact here as in many other countries.

At the time, Canada's good fortune in these respects helped make it possible for Canadians to experience unusually rapid rates of increase in both private and public consumption and investment. It also delayed the arrival in Canada of the subsequent business recession, and it greatly reduced the severity of that recession by comparison with what happened in the United States and many overseas countries.

These very same factors, however, also added to the problem of dealing with inflation, and by the summer of 1975 some unwelcome consequences of our relative prosperity were becoming alarmingly apparent. The hectic process of leap-frogging wage and price increases was still gathering momentum in Canada, while in the United States -- our major trading partner -- inflation was already on the wane as that country began to recover from its plunge into deep recession. We were facing the social and economic strains of rampant inflation at home and our ability to compete internationally was being rapidly undermined.

The experience of many countries in recent years shows both how easy it is to let inflation get out of hand and how difficult and painful it is to get it back under control. A major reason for this is that in the contemporary world a severe attack of inflation leaves as its legacy a widespread and stubbornly-held expectation that rapid inflation will continue indefinitely. Because of this expectation prices and costs continue to be pushed higher and higher even when the economy is well into a prolonged period of soft markets for goods and services and labour. So long as people persist in basing their economic behaviour on expectations of continuing rapid inflation in the face of policies designed to bring inflation under control, the performance of the economy is bound to be highly unsatisfactory.

Strong expectations of continuing inflation are a comparatively recent phenomenon. They developed rather slowly over a long period. Many of you will remember that, after the tragic experience of the 'thirties, the psychology of depression remained with us for a long time. Despite the severe shortages of the immediate post-war period and the massive increases in money and liquidity produced by war finance, and indeed despite the sharp upward adjustment in the price level that followed immediately after the war, expectations of continuing inflation did not develop to any important extent. Nor did they after the sharp outburst of inflation at the time of the Korean war. The widespread fear of an eventual return to depression seemed to exercise a strong restraining influence on attitudes towards prices and costs for many years into the post-war period, even at times of intense demand pressure on our resources. Inflation on any significant scale seemed to be regarded as a phenomenon associated only with war and its immediate aftermath, and there was indeed a strong historical basis for that view.

But attitudes began to change as during the 1950's and the 1960's strong economic growth continued with only short interruptions and as moderate inflation gave way to more rapid inflation. It was becoming increasingly apparent that the well-intentioned desire to terminate periods of recession and high unemployment as soon as possible was leading each time to fiscal and monetary policies that involved the risk of accelerating inflation. When the expansionary fiscal and monetary policies adopted throughout the industrial world to combat the recession of the early 'seventies -- together with a number of other special factors -- produced double-digit inflation, expectations of continually rising prices were greatly intensified, and they now constitute a major impediment to good economic performance. We have reached the stage where expectations of inflation dominate the scene much as expectations of depression did at the end of the war. Now considerable caution must be exercised in introducing expansionary measures to stimulate output and employment for fear that such action will give fresh impetus to inflationary expectations and behaviour. Public policies must provide a firm basis for confidence in the future value of money. It is now "game over" with respect to any attempt to solve our problems by policies that take major risks on the side of inflation.

Expectations of a related kind that grew out of the post-war experience of rapidly rising living standards are also causing some difficulty. The view seems to have developed that real income per person employed, i.e., money income after adjustment for inflation, should automatically grow every year whether or not improvements in productivity make this possible. To attempt to satisfy these unrealistic expectations is a sure recipe for inflation. One does not have to look far to see that all countries go through periods when real output per person does decline; economic advance is not an uninterrupted process and it is not entirely within the control of any country. We cannot afford to act as though the world owes us a living and a steadily improving one at that. How well we get along in today's strong competitive world depends on our willingness and ability to work with increasing efficiency, and on our willingness to accept the fact that we cannot expect to enjoy high levels of employment if we insist on charging more for our goods and services than the market is prepared to pay.

As I see it, the persistence of inflationary attitudes and behaviour is a serious obstacle that we face in getting our economy back in a position in which it can function satisfactorily. It is a major factor responsible for the curious combination of high inflation and high unemployment that we are currently experiencing. It is also the main reason why inflation and unemployment are no longer separate problems between which priorities can shift, but are rather a single, interrelated problem.

The conclusion, which I believe to be inescapable, is that if we want to achieve and sustain high levels of output and high employment we really have no alternative but to grapple with inflation and with the inflationary practices that keep it going.

That of course is what we have been trying to do in Canada for some time through a combination of fiscal and monetary restraint supplemented by the Anti-Inflation Board programme. The AIB has attacked the problem of inflationary expectations directly and I believe this has been helpful. What can be said about the performance of the economy given these policies and the other influences at work?

To begin with, what degree of progress are we making in getting our inflation under control? The short answer I would give is that we are indeed making significant progress, not as rapidly as we might have hoped, but nevertheless solid progress.

I realize that things may not look quite this way judged solely by the recent behaviour of the over-all Index of Consumer Prices. By last December the twelve-month increase in this Index had fallen dramatically from around 11 per cent in the summer of 1975 to less than 6 per cent. Subsequently, however, the twelve-month increase in the Index has moved back up to over 8 per cent. Taken at face value this looks like evidence of back-sliding, but appearances can be deceiving. The degree of improvement in Canada's underlying cost and price performance last year was not in fact nearly so rapid as might be inferred from the behaviour of the Consumer Price Index. The latter was heavily influenced by an unusual and obviously temporary decline in the absolute level of food prices, together with an appreciation of the Canadian dollar that just as obviously was unlikely to last very long. By the same token, the gradual but continuing improvement in our underlying cost and price situation so far this year has been obscured by the influence of a renewed jump in food prices -- which already seems to have tapered off -- and by the immediate price impact of the substantial exchange rate depreciation we have experienced.

The impression of a gradual but continuing improvement in Canada's underlying cost and price situation is supported by an examination of wage settlement data. Average annual increases in base wage rates over the life of contracts, which were running at 17 per cent a year in 1975, came down to 10 per cent in 1976 and down further to just under 8 per cent in the second quarter of this year. Both in terms of most of the more readily comparable price measures and in terms of wage-settlement data, it now seems fair to say that Canada's underlying inflation rate, though still too high, is currently running no more than about one percentage point a year above the rate of inflation in the United States.

I realize that to many Canadians the progress we are making against inflation seems disappointingly slow. Certainly there are no grounds for complacency: we still have to get through the process of de-control when it comes without throwing away the opportunity that the recent exchange rate adjustment has given us to repair the damage to our international competitive position and restore a more viable structure of international trade and capital flows. The rates of increase of our money incomes and prices have to decelerate for a considerable period yet -- with or without controls. We are by no means out of the woods yet. But if we can manage to persevere, our prospects on the inflation front are by no means devoid of hope.

So much for our recent cost and price performance. What, then, about the recent hesitant growth of the Canadian economy, the increase in the number of unemployed, the unfavourable climate for business investment and the persistence of such a large current account deficit in our international balance of payments and the related continuing rapid growth of our indebtedness to foreigners? In these respects the recent performance of our economy is generally regarded as being highly unsatisfactory -- and so it is. But I do not agree with some extreme statements about how unsatisfactory it is. One occasionally even hears it suggested that we may be headed for something comparable to the collapse of the 1930's. Well, we certainly face real problems in trying to cure our unemployment situation, but they are far from those of the 1930's.

For one thing, we are currently living in an international environment that is generally favourable to economic growth in Canada. The level of world economic activity may not be as high as one might wish, but it is nevertheless relatively high. It may not be growing as rapidly as one might wish -- especially in overseas countries -- but it is certainly growing. This means that so long as we are competitive we have a good chance of achieving an export-led expansion.

Within Canada the flow of money expenditure, though not as buoyant as it might be if inflation had not generated so much uncertainty, seems likely to rise fairly strongly in the year ahead. Of course if much of the rising flow of spending continues to be absorbed by rising prices here at home, or satisfied by foreign competition, its positive impact on the physical volume of Canadian output, and in turn on employment and new investment, will be that much weaker. In a very real sense, then, the prospects for employment and output in Canada depend very much on the response of wages and prices to the present economic climate. If that response is good our economic situation can improve steadily. In such circumstances our economic policies, however they may be adjusted from time to time, must be consistent with the maintenance of an environment in which a non-inflationary response is encouraged.

Now against this background I would like to turn more specifically to monetary policy. The basic objective of the monetary policy we are following is to encourage a moderating trend in our inflation rate so that we can achieve the healthy economic growth we all want.

One doesn't need to be an economist to grasp the idea that whatever the nature of the forces immediately responsible for driving up the general level of wages and prices, there is no way in which the process can continue indefinitely unless the amount of money in the economy is allowed to keep rising fast enough to accommodate it. This suggests a prescription for bringing inflation to an end; stop the money supply from increasing at rates faster than the minimum rate needed to accommodate satisfactory economic growth at stable prices.

This is, in fact, the ultimate goal of the strategy currently being pursued by the Bank of Canada. There would, however, be serious repercussions if the rate of monetary expansion were cut back very rapidly.

The most difficult obstacle is one to which I have already referred at some length in this speech, namely, the extent to which inflationary expectations and behaviour have become firmly established. In the present circumstances a sharp reduction in the rate of monetary expansion would, in the short run, have a severely restrictive impact on the volume of output and employment in Canada. While the hard truth of the matter is that any effective action to lower the rate of inflation seems bound to involve at least some temporary reduction in the growth of output and jobs, no one wants to invite hardship that can be avoided. That is why the Bank of Canada is following a long-term policy of moving towards a non-inflationary rate of monetary expansion by stages, lowering its monetary growth targets in a series of gradual steps spread out over a period of years rather than all at once. We believe that in this way the responses of the economy can and will be more orderly, the hardship will be minimized and the benefits will be more lasting.

Two years ago the Bank of Canada initiated the practice of making public from time to time the monetary growth targets towards which it was currently working. At that time the announced objective was to keep the trend rate of increase of the money supply, defined as currency and chartered bank demand deposits, well below 15 per cent a year, but not lower than 10 per cent. By the early spring of 1976 the actual growth of the money supply over the previous ten months had been held to about 11 1/2 per cent, and this was taken as the new base period when, in August of 1976, the upper and lower limits of the target range were revised downward to 12 and 8 per cent a year, respectively. During much of the subsequent period the problem for the Bank of Canada has not been that of trying to resist a tendency for the rate of monetary expansion to become too high; rather, the sluggishness of the economy has required four successive reductions in the Bank Rate in order to counter a persistent tendency for the growth of the money supply to fall short of the lower limit of the target range.

In recent months the impact of these interest rate reductions has brought the trend rate of increase of the money supply back up to around a 9 per cent annual rate. Given our present economic situation, I am reasonably satisfied with the recent trend of the money supply, and I have not regarded it as a matter of any great urgency to undertake a further revision of the upper and lower limits of our target range for monetary growth, although we will be doing so in due course.

An up-dating of the Bank's monetary growth targets does not of itself signal or involve any change in existing credit conditions. Action along these lines does, however, recognize the fact that the scale on which inflation is being financed through monetary expansion should continue to decline with the passage of time if inflation itself is to continue to slacken. The setting of new targets must also, of course, take into account the current state of the economy and the need for enough monetary expansion to support a reasonable rate of economic growth as inflation recedes.

The main point I want to register, however, is that the Bank of Canada is as determined as ever to maintain firm control over the rate of monetary expansion as we move into the critical period ahead. But I must add that while it is essential to have good monetary and other economic policies it has become increasingly clear that the way people respond to these policies and to the general economic environment is equally important. The responsibility for solving Canada's economic difficulties cannot be left entirely to public policies. To get back to attitudes and behaviour compatible with high and sustainable levels of output and employment is thus a major challenge to all Canadians.