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RECOVERING FROM INFLATION

NOTES FOR REMARKS BY
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TO
THE CANADIAN CLUB
TORONTO, ONTARIO
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The Canadian economy like so many others around the world is passing through a very difficult time. The economic weakness that we are now experiencing is much worse than at any other time in the post-war period. In my remarks today I want to try to put our present situation into perspective. If the major source of our current difficulties is clearly recognized we will stand a better chance of a good economic performance in the future.

The major source of our current difficulties is inflation. A lot of inflation. It is what Theodore H. White has called "The Great Inflation". I think that term is warranted.

Let me encourage you to see current economic developments in historical perspective by reminding you of the broad sweep of events over the last half century. First came the Great Depression of the 1930s, and then the Second Great War, 1939 to 1945. Then came what can be called the Great Post-War Prosperity, from 1946 to about 1970. It was perhaps the best quarter century in world history in terms of advances in living standards. Unemployment in Canada was generally low. For much of the period inflation was held in check. This was made easier by the fact that strong expectations of inflation were slow to develop owing in large part, I believe, to recollections of the Great Depression and fear of a return to that condition. But that fear gradually faded as it became increasingly apparent where the biases of post-war economic policies lay. Each successive cycle in economic activity was marked by a higher average rate of cost and price increases. Attitudes gradually shifted, and the development of a generalized inflationary psychology was well under way by the end of the period.

This brings me to the Great Inflation. I do not intend to spend time today going over its origins and history in any detail. I have done that on other occasions. Fundamentally it was caused by over-ambitious economic policies in general, and financial policies in particular. Nearly all countries drove their economic systems too hard, harder than they were capable of performing without generating inflationary pressure.

It is worth noting that the world supply shocks of the 1970s, of which the change in the energy situation was the most dramatic, were not prime causes of the major upsurge in inflation of the early 1970s; it was well under way before the first increase in oil prices. Energy costs made the situation much more difficult to handle in all countries, but many of those most exposed to the oil shocks nevertheless managed to achieve the greatest success in restraining inflation.

During the 1970s the countries that accommodated inflation did not enjoy better economic performance than those that resisted it. Far from it. Lack of firmness in financial policies only reinforced inflation and expectations of inflation. The tough decisions that could have been taken earlier had then to be taken in a more exposed position. By the late 1970s countries throughout the industrial world had nearly all come to see inflation as the main threat to satisfactory economic performance, and were practicing financial restraint.

Policies of financial restraint, in particular monetary restraint, have been bringing inflation back under control. The mix of fiscal and monetary policies around the world could have been improved upon. In many countries the load of restraining inflation was put more on monetary policy than on fiscal policy, and this led to extraordinarily high interest rates and to a very uneven impact of restraint on different groups in the societies. A more balanced approach would have been better. Earlier implementation of firmer financial restraint would also have been better. The mild restraint that was applied in the earlier years was unable to cope with the momentum of inflation and inflationary expectations, and it was only after the degree of restraint had become very strong indeed that progress against inflation began to be made.

We are now experiencing the clash between the powerful momentum of inflation and financial restraint strong enough to curb it. The fact that all major countries have been pursuing anti-inflationary goals has meant that domestic restraint has been reinforced by a global effect.

The strains to which we in Canada are now subject have been much intensified by resistance to the anti-inflationary process. Whether due to the persistence of expectations of high inflation or to rigidities in our economic systems, the trend of salaries and wages has responded much less flexibly to the developing situation than was desirable. There are now, however, some signs that more and more people are responding in their own interests to the weak market situation.

The result of all this is that a reduction of the rate of inflation in Canada has been accompanied by a severe decline in economic activity. The strains are distressingly obvious: high unemployment, a lot of idle plant capacity, low business profits and many business failures. More than anything else this outcome is the result of having allowed inflation to get so far out of hand. How much better it would have been to have avoided inflation in the first place!

When one thinks of the dimensions of the Great Inflation it is natural to think in terms of the magnitude of the increase in prices or of the decline in the value of money. Thus over the past decade the purchasing power of a dollar in Canada dropped by over 60 per cent, or by more than over the preceding twenty-five years. But as a description of what happened in our economy that is only the tip of the iceberg. There was also the extent to which confidence in the future value of money was dissipated and the effect of this on economic planning. There was the turmoil, the uncertainties and the frustrations that ensued from volatile interest rates and from the sharp changes in exchange rates that reflected swings in views as to where countries were headed. There was the pervasive erosion of people's confidence in the performance of the economic system and in its basic fairness.

One of the ways that growing expectations of inflation shaped attitudes in Canada and elsewhere was the increasing acceptance of the notion that the sure way to success was to take on increasing amounts of debt. This was, in effect, betting that the immediate burden of indebtedness would be written down by inflation in fairly short order, leaving the borrower ahead of the game. Thus prudent behaviour became devalued. And this of course was the way it worked for quite some time, on a national and an international scale. In the process borrowers, consciously or otherwise, acquired a vested interest in the continuation of high inflation. And if the rate of inflation took another surge, so much the better.

The recent Report of the Ministerial Advisory Committee on Inflation and the Taxation of Personal Investment Income -- The Lortie Committee -- accords with the observations that I have just made. The Committee agreed that the interaction of inflation and the taxation system, coupled with conventional accounting concepts, had a significantly adverse effect on both the level and the allocation of savings and investment. The members of the Committee all agreed that the best long-term solution was to greatly reduce or eliminate inflation. They recommended unanimously that governments in Canada, as well as all other sectors, exert every effort to reduce or eliminate inflation.

As a result of the distortions that have taken place, the process of withdrawal from a world of inflation was bound to create difficult transitional problems in financial markets. Overly large debt positions acquired in an inflationary climate constitute one such problem. The need to deal with this overhang of debt will act as a drag on expansion for some time to come. One mitigating element is the fact that in recent years so much debt, even medium- to long-term, has been taken up on a floating rate basis -- that is to say at interest rates that are linked to those on short-term obligations. The level of shorter term rates declines as inflation is lowered. This is now providing a welcome measure of relief to the burden of debt service.

The indebtedness problem has a major international dimension. A number of countries that built up huge debts during the inflationary period now find their ability to service those debts greatly hampered by weak world markets for their exports. Borrowing clearly cannot go on as before, but there is a need to ensure that sound financing does not dry up completely as lenders tilt their attitudes and policies in a more cautious direction. An international community of interest is involved, with a major and increasing role to be played by international financial institutions in seeing the adjustment through with a minimum of disruption to world trade and payments. This will involve a great deal of international co-operation, which must and will be forthcoming.

I come back now to our current situation. There are not many bright spots in it but one fundamental change for the better is the progress that has been made in reducing the rate of inflation. As a result scope has become available for a reduction of interest rates, and a major downward adjustment has occurred. For example, since mid-year the prime lending rate of the chartered banks has fallen from 18 1/4 per cent to 13 per cent. These developments were of course greatly helped by the steep decline in interest rates in the United States.

Now that I have come to the subject of monetary policy I should note that for some time the Bank of Canada has been unable to make much use of monetary aggregate targets in the conduct of policy. If you will bear with me I will try to make a brief explanation of this rather technical matter.

Beginning in 1975 the Bank adopted an explicit monetary aggregate target. It had come to the view that targetting on the narrowly-defined monetary aggregate, M1, would help it to make the right judgments about interest rates in inflationary times. I believe this practice did improve monetary policy. The use of a monetary target also helped to clarify what was meant by monetary restraint.

Unfortunately, the monetary aggregate to which the Bank of Canada has been paying most attention, currency and demand deposits or M1, has for some time -- more than a year -- been a less reliable guide than it was earlier. On a number of previous occasions the Bank has made reference to the instability that has emerged in the relationship between M1 and levels of spending and interest rates. It is now clear that there have been major and continuing shifts out of M1 as a result of changes in banking practices. These practices include the continuing expansion of cash management facilities to businesses which permit overnight investment of surplus current account balances, and the increasing availability and use of new personal accounts that combine both chequing and saving features. As a result the recorded M1 series is not a useful guide to policy at the present time. In these circumstances I want to make it known that the Bank no longer has a target range for it. I regret this development because a monetary aggregate that is in fact systematically related to the trend of total spending is helpful in judging the appropriate degree of monetary expansion, and particularly in avoiding cumulative error. Thus the Bank is continuing to search for ways for making more use of a monetary aggregate than it can at the present time.

What I have stated here about monetary aggregates will not be news to those who have been following closely Bank actions and reading our statements in recent months. They will also be aware that the absence of a usable monetary target has not been a critical matter in the recent period. Relevant evidence from economic and financial developments has certainly not been lacking. In the current economic environment the Bank has very much wanted to see interest rates as low as would be consistent with continuing resistance to inflation. It rejected the idea of deliberately attempting to force interest rates down quickly by several percentage points, regardless of the impact on the exchange rate, because this would contribute to loss of confidence in the Canadian dollar, and this, together with the inflation that would ensue, would make it impossible to sustain the lower level of interest rates. I believe that our approach has been realistic and forward-looking, and I am pleased that it has facilitated a major downward adjustment in interest rates in recent months. I believe that our approach offers the best prospect of further progress in achieving lower interest rates, although even if things go well it is not reasonable to expect an uninterrupted downward trend -- markets do not operate that way.

Our interest rates are now not far above those of the United States, where the inflation rate is much lower than here. Further progress in getting interest rates down in Canada depends more than anything else on getting our inflation rate down further.

As a result of the progress that has been made in turning back inflation in Canada we can talk more confidently about a trend of price increase expressed in single digits rather than double digits. However, that is well short of reasonable price stability. What is more, our main trading partners are a good deal closer to that goal than we are. So the progress we have made to a better price and cost performance needs to be continued. The more rapid that progress, the better will be our prospects for a resumption of real growth.

I do not believe that many of you would disagree with that view but some commentators imply that the time has come to forget about the problem of inflation and concern ourselves only with expansionary policies. This advice rests on the most popular and most serious misunderstanding about economic policy that there is -- namely, that governments and central banks can achieve and maintain high employment if they are prepared to stop worrying about inflation. No economic advice is more seductive, none is easier to follow for a time, none has been tried more often and none has failed more completely. The fact is that a high degree of monetary stability is an essential condition for -- not an obstacle to -- sustained high employment. That is why it is wise to end the Great Inflation.

In concluding, I want to pull together some of the thoughts I have expressed today. The major source of our recent serious economic difficulties is the inflation that we have been through. Success in bringing inflation down is essential if we are to get out of these difficulties. We can take heart from the slowing in inflation that has taken place already in Canada, and from the further progress in prospect. In these circumstances, the trend of interest rates has been down. As we further rid ourselves of the burden of inflation, lower interest rates can play a key role in the economic recovery we all want so badly.