Miss Murray

DEFENDING AGAINST INFLATION

Remarks of
Louis Rasminsky, Governor of the Bank of Canada,
before a meeting of the Canadian Club of Winnipeg,
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I should like to begin by thanking you for the invitation to address the Canadian Club of Winnipeg and expressing my pleasure at being here today. The invitation was, from my point of view, very opportune. I have certain things on my mind that I want to say, and as they have to do with our central economic problems it is appropriate that I should say them in the centre of the country.

The format that I have given my remarks is to comment on the recent behaviour of the economy and of financial markets and to explain the recent monetary policy of the Bank of Canada. The message I have to deliver is that the economic foundations of the country are strong but that we run the risk of weakening them unless we bring the present inflationary psychology to an end. This can be done if there is resolute action on the part of the Government and if there is understanding and cooperation on the part of all sections of the public.

To provide some perspective for my later remarks, I would like to take a brief backward glance at the great economic gains this country has achieved in recent years. We are now well into our seventh year of virtually uninterrupted economic expansion. In the course of this expansion our real output has increased by over 40 per cent and we have greatly strengthened the economic foundations of the country. We have added greatly to our manufacturing capacity and demonstrated our ability to sell more manufactured goods in world markets. We have produced some large grain crops and have had, until recently, unusually favourable markets in which to sell them. We have continued to seek out and develop a wide variety of forest and mineral and power resources. We have added significantly to our infra-structure in the form of roads and other means of transportation. We have provided greatly increased facilities for general and technical education. And at the same time as we have done all these things we have raised our standard of living rapidly: personal consumption per head has risen by nearly a quarter since the beginning of this decade.

I have dared to start my address with this trite reminder of our recent progress because I am afraid that in our natural preoccupation with the problems which confront us -- and we are indeed confronted by some difficult problems which I shall be talking about later -- we may lose sight not only of the gains that we have made, but of the fact that our basic problem is how to cope with prosperity and add to high levels of output already attained: our present difficulties do not arise out of any basic economic weakness or shortage of resources.

I recently returned from Rio de Janeiro where I attended a meeting of the International Monetary Fund and the World Bank at which 106 countries were represented. I am not going to give you a report on that meeting today but I would like to say this. We have it much more within our own capacity to deal with our problems than do the great majority of the countries that were represented at Rio. Over half of them have an average income per head of less than $250 a year; ours is about 10 times that figure. It is a chastening thing for a Canadian to reflect that even though our standard of living and the level of government services in Canada rank among the highest in the world, it is possible that we should find ourselves in difficulties because of efforts to increase our incomes and our use of government services at an even faster rate than can be justified by the great expansion of our real output.

Recent Economic Developments

I turn now to a brief review of recent economic developments. During the past 18 months or so there has, as you know, been a considerable reduction in the rate of economic expansion in Canada. In the 5 year period from the Spring of 1961 to the Spring of 1966 our real output increased at an average annual rate of about $6\frac{1}{2}$ per cent: we were close to the top of the international league tables of economic growth. You will recall that at the beginning of the expansion there was a good deal of unused industrial capacity in Canada and the unemployment rate was $7\frac{1}{2}$ per cent. Once most of this slack had been taken up, the very high rate of growth of the early years of expansion clearly became unsustainable. Our further potential for growth of necessity became limited to the amounts that could be produced by the continuing expansion of the labour force and the increase in output per worker. Our growth rate had to come down, and the main question was whether this would take place without the expansion coming to a full stop as has happened so often in similar circumstances in the past. In fact, as matters turned out, economic expansion has continued, though at distinctly more moderate rates. Since the Spring of 1966 our growth in real terms has been at an annual rate of 2 - $2\frac{1}{2}$ per cent. This is well below our potential for growth, but it is to the good that we have moved away from a position of unsustainable expansion without this being followed by an actual recession. Employment has continued to grow, and notwithstanding the continued rapid increase in our labour force, unemployment rates have risen only moderately -- from $3\frac{1}{2}$ per cent during the period of greatest pressure on our physical resources in 1965/66 to just over 4 per cent in recent months.

Moreover, if one looks ahead, it requires no gift of prophecy to see that we have the elements of further substantial growth. Our labour force is continuing to increase rapidly, and it is better educated and more highly skilled than ever before. This, taken in conjunction with the large private capital investment in our basic industries and in manufacturing, should enable us to achieve substantial rates of increase of output. Moreover, at least in the short-run, the external environment should favour continued expansion in Canada: in particular, the United States economy will, according to official forecasts, be moving ahead at a pace which requires restraining rather than stimulating.

The question for us therefore is not whether the opportunities are present for further substantial and steady growth in our standard of living, but whether we are going to take advantage of our opportunities. Some aspects of our recent economic performance are worrying, and I now want to say something about these.

During the past two years costs and prices in Canada have risen too rapidly. In the earlier years of the economic expansion the cost and price performance of the economy was relatively good. It took some time to absorb the slack that was present when the expansion started, and this permitted the economy to expand very rapidly without the pressure of demand pushing up costs and prices to any notable extent. Indeed, over the first four years of the economic expansion, from early 1961 to early 1965, the price performance of the Canadian economy was better than that of any other industrial country except the United States -- and we were not far behind -- despite the fact that we had experienced a devaluation of the exchange value of our currency with consequent upward pressure on our import and export prices.

But after the slack in the economy was taken up there was a marked deterioration in our cost and price performance. Over the past two years the consumer price index has risen by an average of 4 per cent a year compared with an average of 2 per cent a year during the previous four years. It is an unpleasant fact that during the past year all of our major trading partners have achieved a better price record than we have.

When the expansion began to slow down in 1966 it was reasonable to hope that the reduction in the pressure of aggregate demand on the economy would be reflected in an improved cost and price performance. Unfortunately the upward trend of costs and prices seems to have continued unabated. The average annual percentage increases provided by major wage settlements, which in the first half of 1966 moved up to the very high figure of 8 - 9 per cent -- a figure far in excess of any increase in productivity -- have continued at approximately the same level in spite of the moderate weakening in the labour market indicated by the higher unemployment figures. Salaries have also continued to rise very rapidly. The consumer price index, excluding food, has risen by 5 per cent in the past 12 months, compared with 3 per cent in the preceding year. It is true, of course, that it takes time for past cost increases to work their way through the economic system and one must allow for some lag in adjustments of this kind. But it is disturbing that there is no clear evidence that the cost increases are tapering off.

The continued rise in prices in the United States has naturally affected our price performance here, but the rate of increase in their costs and prices continues to be well below ours.

The cost and price performance of the Canadian economy in the face of a considerable lessening in the pressure of aggregate demand is particularly worrisome because the control of aggregate demand is the chief means available to the public authorities in the short-run to try to influence costs and prices. I shall return to this problem later on.

Review of Monetary and Credit Developments

I would like to turn now for a few minutes to the financial side of the economy. Here too we have seen some developments quite different from what might have been anticipated at the beginning of 1967. The most striking has been the substantial increase in interest rates which has occurred since last spring, an increase which has brought long-term interest rates to record high levels despite the fact that the pressure on our physical resources is less than it was a year or so ago.

In the early years of the economic expansion,. so long as there was a considerable amount of slack in the economy, the policy of the central bank was to allow the increasing demands for credit to be met without a tightening of credit conditions. But as the rising output of the economy began to catch up with its growing productive capacity in 1965 - in other words, as the slack was taken up - this policy was modified, and credit conditions were allowed to tighten. As you know, credit conditions in 1966 became very tight and interest rates reached high levels. Late in 1966, when it became clear that the over-all pressure of demand in the economy had diminished, credit conditions were permitted to ease significantly. The money supply increased considerably, market interest rates declined rapidly for three or four months, and Bank Rate was reduced from $5\frac{1}{4}$ per cent to 5 per cent this January and to $4\frac{1}{2}$ per cent early in April.

The April Bank Rate reduction reflected the reduction in market interest rates that had already occurred by that date and in fact market interest rates reached their lowest levels at about that time. Even though the money supply has continued to increase rapidly since then, the average yield on long-term Government of Canada securities rose quite sharply and recently the average reached a level in excess of 6.4 per cent. This compares with a low of just under $5\frac{1}{2}$ per cent last spring and a level just below 6 per cent at the height of the credit squeeze in 1966. Other long-term interest rates have also risen to record high levels. As you know, the cost of borrowing in the market is around 7 - $7\frac{1}{2}$ per cent for provincial governments and $7\frac{1}{2}$ - 8 per cent for corporations while the prime conventional mortgage rate is around $8\frac{1}{2}$ per cent. Short-term interest rates have also risen substantially since last spring and on September 27 the Bank Rate was increased from $4\frac{1}{2}$ per cent to 5 per cent in recognition of the increases in short-term rates that had occurred since April.

How are these interest rate developments to be regarded? I should note, first of all, that broadly similar developments have occurred in the United States so we are not concerned here with a purely Canadian phenomenon. In neither country can the rise in interest rates be attributed to a low rate of monetary expansion. On the contrary, the rate of increase in the money supply, on any of the conventional measures, has been high in both countries this year. Certainly if the rate of monetary expansion had been lower, interest rates would have risen even higher.

I would like to say something now about the money supply. The money supply can be defined in various ways. Under the broadest definition used in Canada, which is the total of currency in the hands of the public and all chartered banks deposits, changes in the money supply mean virtually the same thing as changes in the size of the banking system. Over the first nine months of this year the apparent rate of increase in the money supply on this definition has been at a seasonally-adjusted annual rate of about 17 per cent. While there is no doubt that the recent rate of increase in the money supply has been high in Canada, I think the public should know that commonly-used measures such as the one I have just mentioned give a considerably exaggerated impression of the increase in liquidity which has actually been occurring. I do not want to get into an involved technical discussion here but there have been a number of special factors at work, the most important being the influence of recent changes in banking practices and in the competitive position of the chartered banks following the revisions in the Bank Act.

One such factor has been the chartered banks' growing practice of requiring their customers to hold substantial balances with them in the form of non interest-bearing demand deposits as compensation for services performed. This has tended to inflate the figures both for bank loans and for bank deposits, thus increasing the apparent money supply without there being a corresponding increase in the amount of money actually available to the banks' depositors. More important is the fact that since the revision of the Bank Act we have been going through a period of major structural change in our financial system. For many years the chartered banks had been growing at a slower rate than other financial intermediaries but this situation seems to have altered markedly now that the banks have been released from certain competitive disadvantages. The banks have been competing extremely aggressively for the funds of the public, and in recent months may even in some cases have been paying uneconomic rates for large blocks of funds. In any event, there is no doubt that the chartered banks have recently increased their rate of growth relative to the rest of the financial system, at the expense of the direct flow of funds from savers to borrowers through securities markets as well as of flows of funds through financial intermediaries other than banks. Clearly, part of the increase in the money supply which has occurred this year represents merely a shift in the form in which the public has been induced to hold its savings.

It is not possible to put precise figures on the influence of these special factors, but it would not be surprising if they accounted for most of the difference between the 17 per cent annual rate of growth which I mentioned earlier and the corresponding figure for the United States, which is 12 per cent. If one uses a "purer" definition of the money supply, such as currency in circulation and demand deposits in the hands of the public - which is the definition normally used in the United States - and makes an approximate allowance for the growth of compensating balances, the rate of increase in the money supply in Canada this year works out at not much more than half the figure one gets by using the definition which includes not only demand deposits at banks but also their savings and time deposits.

When all is said and done, however, there is no doubt that recent rates of monetary expansion in Canada as well as in the United States have been unusually high and reflect the emergence of a strong preference on the part of investors for short-term, liquid financial assets in spite of very sharp increases in the interest return available on bonds and mortgages.

Why this preference for liquidity? A number of factors seem to have been at work. A dominant one in both Canada and the United States appears to have been the expectation that it would not be possible to accommodate the very substantial increase in the borrowing requirements of governments without tight credit conditions. This attitude has of course been influenced by the widely-held expectation that the economic slowdown would be of short duration.

I believe that another important factor has been the extent to which monetary policy was relied on to restrain the excess pressure of aggregate demand on resources in 1965/66. Investors and borrowers, with this experience fresh in their minds, sought to safeguard themselves against the recurrence of the tight credit conditions which they expected when the economy started to move strongly upward again. Financial institutions, whose resources had been stretched during the period of tight credit conditions, also wished to restore their liquidity. In effect, the actions taken in anticipation of higher long-term interest rates in the future helped to make them a reality.

Concern about the impact of the borrowing requirements of governments was based mainly on the large swing in the position of federal governments in Canada and the United States. In Canada, it was forecast at the time of the budget this June that the Government would be a net user of cash, that is, that its disbursements of all sorts would exceed its receipts of all sorts, to the extent of nearly $1, 600 million in the current fiscal year. Even though part of these cash requirements could be financed by drawing on its unusually high cash balances, the great bulk had to be obtained by borrowing. The increase in the Government's net cash requirements over the past two years has been very large. In the preceding year they amounted to $720 million and the year before that they amounted to $160 million. An important element in the increase in the Government's cash requirements during the past two years has been the rapid rise in budgetary expenditures, which went up much more than budgetary revenues. In addition, however, to the increase in its budgetary deficit the Government has had heavy cash requirements for transactions outside the budget. Over the two-year period I have been talking about, non-budgetary cash requirements have risen by $700 million. The most important item contributing to this has been the large increase in the amount of funds loaned by the Government for housing. I must add that the market borrowings of provinces and municipalities have also been heavy despite the fact that they have had important new sources of funds from the Canada and Quebec pension plans. There is no doubt that the much greater demands of governments have played an important part in the recent adverse development of financial market conditions.

Beyond the factors that I have already mentioned as contributing to the high level of interest rates, it seems likely that investors' psychology has been affected by the poor cost and price performance of the economy in recent years. Our long-term interest rates may now reflect efforts to obtain protection against the possibility that recent rates of price increase might continue.

In a situation in which there is widespread doubt as to the viability of interest rate levels and anticipation of rising prices there is a serious risk that attention will be diverted away from underlying economic realities towards means of protecting oneself against the dangers that are feared. There is a foreshortening of outlook on the part of investors, including professionals operating in the bond market, which may lead to exaggerated responses and speculative attitudes.

The circumstances which I have been describing in the past few minutes have confronted the central bank with some difficult problems. To recapitulate: the economy has been growing at a quite moderate pace but costs and prices have nonetheless been increasing at a disconcerting rate; the outlook appears to be for accelerated economic expansion in the United States, with which our economy is so closely linked; the financial requirements of governments have risen very sharply; investors and borrowers have sought to become more liquid; and the banks have greatly intensified their competition within the financial system. The over-all response of the central bank to these circumstances has been to accommodate to some extent the extraordinary demands on financial markets by permitting the banking system to expand at a quite rapid rate.

Why has the Bank of Canada permitted this much monetary expansion? The short answer, as I have already indicated, is that if we had kept the rate of monetary expansion significantly lower, the rise in interest rates would have been even greater than it was. The Bank of Canada cannot operate with the rate of monetary expansion as the sole criterion for its policy. As I stated before the Porter Commission in 1962 and on many occasions since, I believe that the central bank must be guided mainly by the criterion of credit conditions - the cost and availability of credit - throughout the financial system, and that insofar as this lies within its power it should try to see that these are appropriate to the circumstances of the economy. In framing its policies the central bank cannot close its eyes to financial disturbances, to shifts in liquidity preferences, to changes in the share of the total liquid assets of the community which take the form of claims on banks as distinct from other types of liquid assets, nor can it close its eyes to international complications. These factors, as well as the desire to influence aggregate demand in an appropriate direction, mean that from time to time considerable variations are bound to occur in the rate of monetary expansion. The Bank of Canada has shielded the market only to a limited extent from the interest rate effects of the unusually large demand for funds. The central bank has not embarked on a policy of encouraging an expansion of the money supply in order to bring about or maintain unusually low interest rates. Quite the contrary. The level to which interest rates have risen gives some indication of the central bank's resistance to the development of excess liquidity in the economy.

It cannot be forgotten however that at any given time there are some practical limits to the extent to which long-term interest rates can be permitted to rise without creating real problems for the economy. If our rates were to rise a good deal more than those outside Canada, and particularly those in the United States, we might well have to face the problem of an excessive capital inflow. There are other difficulties, in particular the uneven impact of very tight credit conditions on different groups and activities, including the relatively severe impact on housing and on small business and on parts of the country where there is a fair amount of slack.

It must be realized moreover that the task of trying to keep interest rates within reasonable bounds is not one that should be left to monetary policy alone. Fiscal policy must do its part as well by limiting the demands of government on financial markets. For this reason, I heartily concur in the view recently expressed by the Minister of Finance that there should be a large reduction in the budgetary deficit. It would be an important contribution to the solution of our present problems if the Government's net borrowing requirements were substantially cut from the high levels at which they are now running.

The Central Problem of Economic Policy

In the past few minutes, I have been talking about two aspects of our recent economic performance which give cause for concern. One is the continued tendency for costs in Canada to rise, notwithstanding some alleviation of aggregate demand pressures and a moderate increase in unemployment rates. The other is the recent substantial increase in interest rates which has occurred in spite of a flattening out of private investment and a large increase in the money supply. I believe that the only effective way to deal with both these problems is to break any inflationary expectations that may exist by making it clear beyond doubt that inflation will not be accepted in Canada as a way of life. I believe that this is the most urgent task of economic policy at the present time.

It is curious that one should feel obliged to argue the case against inflation, but the view is seriously put forward by some that a certain degree of continuous price rise is not inherently undesirable and is perhaps a necessary "trade-off" for keeping the economy operating at all times at levels of unemployment which do not exceed an acceptable figure. I completely disagree with this view and I believe that harm has been done by the respectability it has been given in Canada and elsewhere. Continuous cost and price rises are not only undesirable in themselves, but they can undermine our ability to keep the economy operating reasonably close to its potential in terms of real output. The most obvious danger is that if we fail to keep our costs under control we will price ourselves out of export markets and lose out to import competition at home, so that the growth of the economy will be seriously impaired. Inflation has other grave disadvantages as well. One cannot but be impressed by the futility of a system in which everyone must try to protect himself against rising prices, and by the inequity involved in the severe penalties inflicted on those who are unable to do so because they have little or no bargaining power. It is not the strong but the weak who suffer from inflation.

There can be no question that the proper control of aggregate demand, or total spending if you like, is absolutely essential if inflation is to be avoided. The level of aggregate demand can be influenced by fiscal and monetary policies. The proper management of fiscal and monetary policy necessarily involves forming some judgment about the level of demand pressure which the economy can sustain, i.e. how much spending in the economy will evoke additional output without producing unacceptable cost and price increases. In the past couple of years unemployment at no time fell as low as the 3 per cent figure adopted by the Economic Council as a medium-term goal, and yet costs and prices have risen very rapidly. This experience clearly raises the question: just how high would the level of unused resources have to rise if we were to rely on demand management to assure reasonable price stability and did not supplement demand management with other policies?

I take it for granted that no one wants to see the economy operate with more unemployment and unused capacity than absolutely necessary. It is therefore desirable that we try to get as much help as possible in other directions. Apart from efforts to cut costs by increasing efficiency and eliminating unnecessary expenditures, whether in the public or the private sector, I believe that public opinion can become a potent force in moderating cost pressures on the economy by keeping increases in incomes closer to what the economy can really back up in the form of goods. In real terms, the increase in our income per head depends on the increase in our output per head. If we increase the money incomes we pay ourselves more rapidly than we increase our production, then costs and prices are bound to go up. It is a hard fact, and not a political or a social judgment, that over a period of time what we can consume depends on what we produce. If this fact is not reflected in appropriate restraint and prudence on the part of government -- all governments -- management and labour, then we shall have to adjust to hard economic reality in other more painful ways.

Human nature being what it is, it is not surprising that there is some lack of patience in waiting for the benefits that can be obtained from the increased output of the economy, and when businesses or employees find themselves in strong bargaining positions they often attempt to anticipate these benefits. In such situations public attitudes can be extremely important. If the public comes to regard it as normal that every effort should be made to exploit these situations to the full, then we are bound to experience increases in income per person which on the average are far in excess of what the economy can provide in real terms. Public understanding of the limits of the economy in providing real increases in incomes, and public support in restraining money demands within these limits are essential. Strong leadership in promoting this understanding and in encouraging realistic attitudes on the part of the public is, I believe, necessary today. Governments have the opportunity of providing this leadership and of giving an example by carefully controlling their own expenditures.

I have come to the end of what I have to say today. Parts of my message have not been too cheerful and the message does not even have the merit of being new. I have said little of substance here that is not to be found in the Annual Reports of the Bank of Canada of the past two years and in the Per Jacobsson Lecture I gave in Rome a year ago. I repeat that I think that the central problem that we are now faced with in Canada is to break into the circle of rising costs and prices, and, as part of this process, to reduce the demands of governments on financial markets. It is not easy, and it will require courage and determination on the part of the public authorities and the active cooperation of the public, employers and employees alike. But the stakes are very great. We have in this country an enormous potential for growth and rising standards of living. This centennial year has in many ways demonstrated that Canadians are capable of greater achievements than we had realized. We have made remarkable advances in recent years and if we behave sensibly we have good reason to look with renewed confidence to our future. Out of the future growth of production we have it within our capacity to make great gains on many fronts. The main risk we run is in trying to distribute these gains before we have earned them. That way lies danger.