REMARKS OF LOUIS RASMINSKY
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Remarks of Louis Rasminsky, Governor of the Bank of Canada, before a meeting of the Canadian Club of Toronto, April 20th, 1970

When I accepted the invitation of your President several months ago to speak to the members of the Canadian Club of Toronto today, I was very pleased to be able to do so. At the same time, however, I was conscious of the fact that I would be making this speech less than a month after the publication of my Annual Report to the Minister of Finance and I was a little worried about the problem of finding something new and different to say. After all, one cannot really set out to use the instruments of monetary policy for the purpose of generating interesting speech material. No doubt I have considerable protection in the fact that many of you have not read and will not read my report. Be that as it may, I cannot guarantee that there will be no repetition today, because our economic problems are basically the same as they were when the report was written in late February. However, we are a little further down the road in the struggle against inflation, some changes in the scenery have come into view, and parts of the same landscape appear in a slightly different light.

I imagine that even those of you who have not read the Annual Report of the Bank will be aware that during the past year interest rates in Canada reached very high levels and that credit conditions became very tight. The monetary policy of the Bank of Canada has for some time been directed at combatting the inflationary pressures which are threatening our continued

prosperity. It has been strongly restrictive. We managed the cash reserves of the chartered banks in such a way as to make it necessary for them to dispose of nearly $1\frac{1}{2}$ billion of liquid assets between November 1968 and February 1970. This naturally reduced their capacity to make loans. In addition, we used for the first time our power to raise the banks' secondary reserve requirements and in so doing immobilized a further amount of their liquid assets. The measures taken by the Bank coincided with a major swing in the fiscal position which greatly reduced the borrowing requirements of the Government of Canada. Interest rates in Canada, which were of course influenced by similar movements in the rest of the world, had risen to record high levels by the turn of the year. The Treasury bill rate was just under our Bank Rate of 8 per cent and other short-term rates even higher. Prime commercial paper yielded about $9\frac{1}{2}$ per cent. The average yield on long-term Government of Canada bonds exceeded $8\frac{1}{4}$ per cent and provincial and corporate issues substantially more. The prime conventional mortgage rate rose to $10\frac{1}{2}$-$10\frac{3}{4}$ per cent.

During the past month or two there have been some declines in certain market rates of interest and some of these are now well below the high peaks reached around the turn of the year. The 91-day Treasury bill rate is more than 1 per cent below its peak, the commercial paper rate is more than $1\frac{1}{2}$ per cent lower than its year-end level, and the average yield on long-term Government of Canada bonds is down about $\frac{1}{2}$ per cent. There has been a modest

improvement in the terms on which some provinces, municipalities and corporations have been able to sell new issues. However, the downward adjustment of interest rates has not become general throughout the financial system. Mortgage interest rates, for example, have shown little sign of softening.

The recent declines in market yields in Canada have been influenced in important degree by interest rate developments in the United States and in the Euro-dollar market, though there is some evidence that the demand for credit may have been somewhat less intense in Canada than it was last year. In the United States short-term rates have declined because of changing market expectations associated with the continued slowdown of the U.S. economy and with signs of a shift by the Federal Reserve System toward a slightly less restrictive monetary policy. The slight easing in the degree of pressure on the banks in the United States has been reflected in a decline in rates in the large international money market known as the Euro-dollar market where American banks had earlier been borrowing very large amounts and have recently been effecting repayments. The rate on 90-day Euro-dollar deposits which had reached the extraordinary level of 12 per cent last summer and was well above 10 per cent at the end of last year has come back down to a little over 8 per cent.

The reduction in short-term interest rates outside Canada made it possible for the Bank of Canada to withdraw at the end of March the special request that it had made to banks and other financial institutions that had been

designed to shield the Canadian short-term interest rate structure against the extraordinary levels in external markets through limiting the outflow of funds in the form of "swapped" deposits. In recent weeks the total amount of such deposits has been below the level of the ceiling that had applied.

There is one other recent change on the monetary side to which I would like to refer briefly. I have already mentioned that under the monetary policy followed by the Bank of Canada, the chartered banks found it necessary to dispose of very large amounts of liquid assets up to February of this year. In fact their liquidity ratio, which naturally has a strong bearing on the willingness of the banks to undertake new loan commitments, fell to much lower levels than in any other post-war period of monetary restraint. Since February there has been some flattening out in the main categories of bank loans outstanding and some increase in chartered bank liquidity, though the ratio of more liquid assets to total assets is still not far above its low point.

From what I have said, which I am sure is well known to those of you who follow the current information available on financial markets, it is apparent that in the past couple of months there has been some change in credit conditions in Canada. These developments afford me an opportunity to underline something which, though obvious, is often overlooked, namely that in respect of monetary conditions there are many

possibilities between the most extreme degrees of ease and tightness. The basic aim of policy continues to be to try to create and maintain in Canada a financial environment which will encourage a gradual move towards greater price stability. The precise degree of monetary restraint that is needed for this purpose cannot be expected to be constant. The extent and direction of the adjustments that are made from time to time will depend on the economic situation and outlook, on the evidence of progress in checking the cost-price spiral, and on external developments. Naturally I can make no forecast for you today. One advantage of monetary policy is that it has flexibility and can be moved in either direction -- tighter or easier -- as circumstances require.

To turn for a moment from the financial side to other aspects of the economy, it is clear that the slowdown in the rate of increase of economic activity in Canada and the United States which developed in the course of 1969 has continued. I need hardly say that this slowdown is not in itself an objective of policy. But, given the way our economies operate, it is a necessary prelude to the objective of moderating price and cost increases. The U.S. economy appears to have completed its second consecutive quarter without

any real growth; indeed there seems to have been a slight decline in economic activity in the first quarter of this year. In Canada the underlying trend does not appear to have weakened as much as in the United States. So far in 1970 real growth appears to have continued, though probably at a slower rate than in the second half of last year. There has been marked weakness in the housing and automobile sectors of the economy but this appears to have been more than offset by other sectors of demand, including an unusually strong export performance in the first quarter, a factor which has incidentally contributed to the recent firmness of the Canadian dollar. While it is difficult to be precise, it does appear that one source of the strength in the first quarter in both our exports and in over-all output was the recovery of industries whose production had been seriously affected by strikes until late in the fourth quarter of last year.

In both economies the amount of slack has been tending to increase though here again the change has been more pronounced in the United States than in Canada. In the United States, where unemployment had remained at the relatively low level of $3\frac{1}{2}$ per cent of the labour force until the fourth quarter of last year, the seasonally-adjusted rate moved up to 4.4 per cent by March, the highest level since 1965. In Canada, the slowing of growth of output has been accompanied mainly by a slower growth in the labour force rather than in a marked increase in unemployment. After allowing for the normal adverse

seasonal swing, the average unemployment rate in the first quarter of this year was no higher than its average level in 1968 and 1969; the monthly seasonally-adjusted rate did, however, move up during the quarter and the rate of 5.1 per cent in March was the same as last October.

So far, the response of costs and prices to the slowing in both economies has not been great. While the acceleration of prices has been halted there is not yet convincing evidence of any significant moderation in the rate of increase, though there may be a modicum of comfort to be derived from the more modest increase in our consumer price index for March. So far as wages are concerned the average pattern of recent settlements under collective bargaining suggests that we are continuing to build into major sectors of the economy average annual increases in excess of 8 per cent; broader measures of wages and salaries actually received are still showing year-to-year increases of 7 to 7½ per cent on average. These rates of pay increase are obviously far in excess of the average productivity growth in our economy and are not compatible with a movement towards price stability.

We continue then to be in that difficult stage where we are experiencing both increasing amounts of unused capacity on the one hand and a continuation of a high rate of inflation on the other. It is a period in which much patience is required. To find the necessary patience, it helps to understand the way in which modern, market-oriented economies operate

and the difficulties of the alternatives that are open to us.

Why then is it taking so long for the policies of restraint to have their effect on costs and prices?

First of all, let me say that unless we are to have major upsets in our economy there can be no such thing as instant disinflation. It is true, I think, that if the public authorities, including the central bank, had only this objective in mind to the exclusion of all others, the inflation could be ended quite quickly -- at least to the extent that it originates at home. This could be done by pushing monetary and other policies to an extreme of toughness which would produce very substantial unemployment and perhaps even economic disorganization. It is because we have a multiplicity of related objectives that we operate in a more moderate gradual way that requires time to have its effect on prices and on costs. The orderly transition from strongly entrenched inflation to reasonable price stability is necessarily a long one.

There are many reasons for this. To begin with, there are the time lags associated with economic policy. First there is the problem of determining what the general stance of policy should be -- the so-called recognition lag. Once the direction which policy should take is clear and action is taken, a further period of time must elapse before it can become fully effective. Let me illustrate this by reference to recent experience. When monetary policy was again strongly directed toward dealing with the problem of

inflation in the autumn of 1968 interest rates rose fairly quickly and borrowing conditions in the domestic bond market became increasingly difficult. However, it took a considerably longer time for enough liquidity to be removed from the banking system for credit conditions -- in which I include not only the cost of credit but also its availability -- to become generally restrictive. The banking system started that period with what could be regarded as a moderately comfortable liquid position, but given the intense pressure of loan demand the banks were willing to see their liquidity reduced to much lower levels than might have been expected on the basis of earlier experience. Before 1969, a liquidity ratio of 30 per cent in the banking system was generally regarded as not too comfortable; by February of this year this ratio had fallen to about 25 per cent. The full impact of credit restraint was also delayed by the use of channels such as increased borrowing abroad, an expansion of trade credit, and the commercial paper market which grew very rapidly. By the second half of last year, however, credit had become not only expensive but also very difficult to obtain, and businesses and consumers began to adjust their spending plans.

These particular time-consuming processes are now however, largely past, and in physical terms the overload of demand has been removed from the economy. The prerequisites for better cost and price performance have been achieved. But we are now involved in another lag, and that is the time that it takes for the spiralling of costs and prices to decelerate. The economy

can continue to grow during this period; but the policies followed must take fully into account the spiralling of costs, the deep-seated inflationary expectations that have been prevalent and the need to maintain market conditions that are conducive to the restoration of price and cost stability.

Apart from the normal lags to which I have referred, there are some special factors which have reinforced the slowness of response of our economy to the anti-inflationary measures.

One is that other countries with which we have close trading relations, and particularly the United States, have also been suffering from inflation; and a good deal of price and cost pressure has been transmitted to us from outside. To be sure, we have generated much inflationary pressure by ourselves, but the external influences have certainly added greatly to the problem of bringing inflation under control.

Another major reason for the relatively slow response of prices and costs to anti-inflationary policies is, I believe, the strength of the inflationary expectations that have developed in recent years. This is a factor operating strongly in the United States and other countries as well as in Canada. I suspect that we are only now beginning to grasp fully the significance of this phenomenon. Ironically, it is in considerable part a result of the success we have achieved in operating our economies at high levels. During the past nine years we have had almost uninterrupted economic expansion, with rising rates of inflation

during the second half of the period. It is not surprising that expectations of continued expansion and continued inflation should have developed. In fact, we can now look back over a much longer period -- a quarter of a century since the end of the Second World War -- of high and almost continuous prosperity.

We have in consequence developed over the last quarter of a century great confidence in virtually continuous expansion. The underlying growth factors -- population, technology, a substantial expansion of Government programmes -- have been very strong. With growing confidence in the future, a rising level of expectations emerged. At the same time our people had the virtually continuous experience of at least a moderate degree of inflation and sometimes considerably more. These factors reinforced each other and clearly made it difficult to contain people's demands on the economy, including those they make through governments, and to limit their expectations about money incomes in a way that would bring them more into line with the real income increases that the economy is in fact capable of producing. Yet it is only if the increase in money incomes keeps broadly in step with the increase in productivity that we can have reasonable price stability.

Moreover, it has to be acknowledged that over this long period policy-makers were very conscious of the desirability of maintaining high rates of economic expansion and high levels of employment and were on balance quicker to react to the danger of economic recession than to the danger of inflation. I suspect that the bias in favour of reacting more quickly to the danger of

recession was partly due to the fact that the costs involved in recessions or in slowdowns of the economy were much more visible than the costs of inflation. The losses of output which occur when the trend of economic activity falls below the trend line of potential output can be measured fairly readily. On the other hand, the costs of inflation are much more difficult to measure and for a time are less visible.

When inflation gathers such momentum that the only way to keep it from accelerating is to apply severely restrictive policies, the tendency is to treat the resulting loss of real output as a cost of the failure to maintain full employment when it is and should be recognized as a cost of inflation. Moreover, we have not been prepared in this country (rightly I believe) to contemplate seriously the possibility that inflation would not be kept from accelerating to an extreme degree -- on the ground that although it has happened in some other countries "it can't happen here". This forces us back then to the position that we cannot expect to measure arithmetically the potential costs of inflation and weigh them against the costs of anti-inflationary policies. We have to rely on common sense. This tells us that, in addition to all the other problems to which it gives rise, no real gains can be obtained from inflation. Once there is a general expectation of continuous rises in prices at high rates and people adjust their behaviour to that expectation, the task of keeping inflation from accelerating requires policies that are just as restrictive in terms of losses of output as those that used to be necessary from time to time to keep inflation from developing.

Those who recommend that we should accept inflation as a means of maintaining a high level of activity and should adjust various types of income to it are recommending a policy that cannot produce the results they seek.

From what I have said about the influence of expectations and external factors, about the difficulties of economic forecasting and the imprecise tools we have to work with, about the problem of time lags in economic policy, it is obvious that the over-all goals we Canadians have set ourselves for the performance of our economy are very ambitious. It is the case that time lags will also operate when public policy desires to encourage more rapid expansion. For example, resumed monetary expansion would probably be used initially in large part to rebuild depleted bank liquidity and it would take time for businessmen and consumers to react to favourable changes in credit conditions by increasing their spending. A most important part of the task of choosing appropriate policies therefore is in assessing the direction in which the greatest risks lie. Under present conditions, having regard in particular to the state of inflationary expectations and to the strength of the underlying demand factors, both in the private and the public sector, I believe there is no doubt that the most serious risks lie in allowing inflationary pressures to regain their strength.

May I try to sum up some of the main ideas I have tried to communicate to you today? We have made considerable progress in getting our economy onto

the right track, but it is not yet apparent that there has been a decisive diminution in the rate of price and cost increases. We are currently at a stage where it would be easy to become discouraged if we did not recognize the reasons for the slow response to the policies that have been followed. Monetary policy must retain its flexibility and for the time being, monetary and fiscal policies must steer the narrow line between being excessively restrictive and bringing about an unnecessary loss of production and employment on the one hand and being insufficiently restrictive and so encouraging a renewal of inflationary spending on the other. Success in our basic economic policy also requires that business and labour respond promptly to the changes in market conditions which have occurred. And, finally, successful policy depends in important measure on public understanding that there are no panaceas or magic solutions and that a steady reduction in cost and price increases offers the best chance of a prosperous economic future.

I would like to conclude with one final remark. The basic problems of economic policy involve difficult judgments, and it is natural that there should be differences of opinion on diagnosis and prescription. But it would be a great error to believe that one can classify those who participate in the discussion of economic policy into two groups -- those who are concerned about people and therefore worry about unemployment and those who are not concerned about people and worry only about monetary stability. I consider such an antithesis utterly false and gravely misleading. We all want to achieve as great increases

in output, employment and living standards as can be managed. The real difference of approach lies in differences in the extent to which various people are prepared to take longer-run considerations into account. For my part, I feel that we should do what we can to alleviate the short-run costs on particular sectors of the community and sections of the country of anti-inflationary policies, but that our best hope of maintaining, over the longer run, a satisfactory growth of employment and attaining our great economic potential is to persist in the effort to preserve the purchasing power of money.