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 Montreal, February 2nd, 1970

This is about the time of year when many of us who find the Canadian winters a bit long begin to yearn for at least one sweet harbinger of spring, even though we know full well that reliable signs must still be some weeks away. In our impatience, we are in fact prepared to shift, if only for today, Groundhog Day, an uncommonly large share of the burden of long-range weather forecasting to certain creatures who are probably not even aware of their responsibility. I don't know how meteorologists feel about the forecasting record established by these particular specialists. Unlike economists, groundhogs have only one chance a year to engage in forecasting, but they do have the advantage of knowing that whatever their performance may be, spring always does manage to come within a few months.

If we turn to consider the economic climate, there are some similarities. Inflation has been going on for some time now; anti-inflationary policies have been in place for a considerable period; and there is growing impatience for some definite sign that the end is in sight. It has been a long cold winter in more ways than one. Unfortunately, the analogy breaks down at this point - there is no parallel to the inevitability of spring within a given number of months. I wish that I could express the comforting conviction that the end to inflation is close at hand, that all we have to do now is sit back and wait for the forces of nature to do their beneficent work. I am afraid that I am unable to do this today. I do, indeed, believe that progress has been made and that we are on the right track in the struggle against inflation. But I think that if we really want to bring inflation to an end we shall have to continue to work at it. Moreover, I am convinced that we have no practical alternative to doing so, no matter how long it takes.

I am proposing in these remarks to begin by saying something about the way in which the main anti-inflationary policies have been developing - and it will not surprise you that I deal primarily with monetary policy since it is there that my own responsibility lies. I shall then try to account for the fact that these policies seem to be taking such a long time to do their work. Finally, I will talk a little about inflation itself and the reasons why I believe that we must persist in the fight against it.

For some time now, monetary policy has been strongly directed toward the reduction of inflationary pressures, and credit conditions have been steadily tightening. The cost of money, which is of course greatly influenced by external as well as domestic developments, has risen almost continuously since September 1968, to record levels.

The economic purpose of tight credit conditions is to influence businessmen and consumers to reduce the rate of increase in their total spending and so lessen the pressure of demand in the economy. These decisions, to spend or not to spend, are, of course, influenced not only by the cost of credit but also by its availability. Over the past year or two, it has taken longer for a general restriction of availability to develop than it has for the cost of credit to increase. It is true that there was a substantial decline in the amount of long-term bonds issued in the domestic bond market in 1968 and a further reduction last year. But part of the decline was offset by increased borrowing in foreign markets. So far as the mortgage market is concerned, the willingness of borrowers to pay high interest rates resulted in the flow of funds into mortgages being relatively well maintained until the second half of 1969, when this too tapered off.

As regards bank loans, it took some time for the restrictive monetary policy to have a substantial impact on their availability. This occurred partly because in the autumn of 1968, when the present restrictive phase of monetary policy was initiated, the banks were very liquid, and partly because they have shown themselves willing, under the pressure of loan demand, to see their liquidity run down to considerably lower levels than had occurred in the post-war period. By the early months of 1969, the combination of the restrictive policy of the central bank, on the one hand, and the continued expansion in bank loans, on the other, had reduced the banks' ratio of more liquid assets to total assets to a not-excessively-comfortable figure of 30 per cent, and by April 1969 this had fallen below 29 per cent, to a new low. In that month, moreover, the Bank of Canada announced that it was using its power to raise the minimum secondary reserve ratio of the banks, which had the effect of impounding about $250 million of the banks' liquid assets, thus making them unavailable to finance further loan expansion. As interest rates rose, there were several increases in the Bank Rate, which has been at 8 per cent since last July.

The central bank has continued to keep the cash and liquid positions of the banks under pressure in order to maintain an appropriate degree of tightness in the credit system. The ratio of the banks' more liquid assets to their total assets has moved down to around 26 per cent; the banks clearly have few resources to spare for additional lending.

A definite slowing in the rate of increase in bank loans occurred in May and June. The annual rate of increase in the aggregate of business and consumer loans in the second half of 1969 was less than 4 per cent. It is the case that, allowing for seasonal factors, some increase has occurred in the past few months when financial markets have been particularly tight and some outstanding commercial paper issued by corporate borrowers may have had to be financed directly or indirectly by the banks. Since the middle of the year the banks have kept their consumer loans from expanding, and as banks account for nearly half of the total amount of consumer credit extended, the rate of increase in total consumer credit outstanding in the economy has now slowed down considerably.

The effects of monetary policy on the banking system show up clearly in the broad aggregates. Despite some upward movement in November and December, the total assets of the banks have grown at an annual rate of only 2 per cent since mid-1969 - 5 per cent for the whole of the year. The total amount of currency outside banks and bank deposits held by the general public, the privately held money supply as broadly defined, was lower in December than in the previous March and rose by less than 4 per cent in 1969.

In addition to relying on its normal techniques of operation, the Bank of Canada has asked for and received the co-operation of the chartered banks on a number of matters. In response to requests by the Bank of Canada, the large chartered banks have not been competing aggressively for large blocks of short-term funds through the sale of Canadian dollar instruments. As an additional measure to help to avoid too great a general escalation of short-term rates, and to protect Canadian interest rate levels against part of the very sharp rise in rates in the Euro-dollar market, the chartered banks in July agreed to place a ceiling on their swapped deposits, i. e., Canadian dollar funds which have been converted into a foreign currency and placed on term deposit with a bank, and which the bank has undertaken through a forward contract to convert back to Canadian dollars at maturity. In pursuit of the same objective I last week asked a number of other financial institutions not to frustrate the effect of the ceiling on swapped deposits by arranging similar transactions in other ways. In another field, in order to soften the impact of tight credit conditions on less prosperous areas of the country, the Bank of Canada has asked the chartered banks to have special regard for borrowers in those areas. We have also asked the banks to have special regard for small businesses throughout the country since, unlike large corporations, they do not normally have alternative sources of credit. The Bank has also expressed the view that the chartered banks should maintain a reasonable continuity of lending on housing mortgages. Finally, in view of the higher bank loan rates now prevailing in the United States, which gives U.S. corporations an incentive to borrow here directly or through Canadian subsidiaries, it was suggested to the chartered banks that they should give priority in the use of their total loan resources to the credit-worthy demands of their Canadian customers.

Although the general impact of monetary policy has spread through financial markets and affected all financial institutions, the strong demand for mortgage funds and consumer credit has led to an increased rate of growth of non-bank financial institutions such as trust and loan companies and finance companies who have been able to pay higher rates on the funds entrusted to them. This, together with the expansion of the commercial paper market, to which I shall refer in more detail in a moment, has produced some offset to the decline in the rate of expansion of bank credit.

One of the reasons why monetary restraint has taken a considerable time to have its full impact is precisely this wide variety of sources of credit available to some borrowers. The rapid growth of the commercial paper market in the last half of 1969, frequently with short maturity terms that are not related to the real requirements of the borrower but rather to the desire of the investor to stay liquid, is a good example. There are, however, limits to the extent to which such channels for obtaining credit can expand, and the degree of strain that was evident in the commercial paper market towards the turn of the year may be an indication that the rate of expansion was somewhat overdone. Another example of the way in which the impact of credit restraint may be delayed is through the slowing-up on the part of some businesses of settlement of their accounts payable. This process tends to push the burden of credit stringency back onto large suppliers who may have better access to bank or other credit than their customers. Once again, there is a limit to the extent to which this channel can be used. My own impression is that, taking not only the banking system but all other channels of credit into account as well, credit conditions have become progressively tighter, reflecting the steadily growing impact of monetary policy on the availability of credit.

Fiscal policy has also been playing an important role in the effort to restrain the growth of total spending in the economy. The rate of increase in Government of Canada expenditures has slowed, and the over-all cash position of the Government has improved markedly over the last year. This is well known. What is probably not as well recognized is that the improvement in the fiscal position of the Government of Canada has also been of great assistance in enabling the central bank to keep the liquidity of the banking system under control. In the last twelve months there has been no increase in the amount of Government of Canada market issues outstanding. This fact has been of help to the Bank of Canada in its policy of squeezing liquid assets (largely Government securities) out of the banking system and getting them absorbed by non-bank investors. In 1968, by way of contrast, the Canadian dollar market issues of the Government of Canada outstanding increased by over $1 billion and, despite successful efforts to achieve some increase in non-bank holdings, it was not possible in the circumstances of the time to avoid a large increase in bank holdings of Government securities, and consequently in bank liquidity.

So much by way of description and explanation of the anti-inflationary policies that have been followed. The main burden has necessarily fallen on the broad instruments that influence the total level of demand, or of spending, in the economy, that is, on fiscal and monetary policy. Other policies which deal with the supply side of the equation - which aim at increasing the efficiency and mobility of our resources - are of basic continuing importance. Such policies, including important activity in retraining and developing labour skills, have been and are being actively pursued by the Government. But unfortunately they yield their valuable fruits only over a considerable period of time and make little contribution to the urgent problem of controlling inflation now.

What, then, can we say about the effectiveness of the policies which have been followed? I believe that there is considerable evidence that these policies have had an important influence on the total level of spending, though this slow-down of spending appears, up to the present, to have had more impact on the level of output than on the rate of price increase. However, we can claim, as a minimum, that the acceleration in the upward push of prices has been stopped. Had vigorous policies of demand restraint not been used, the increase in our prices and costs would certainly have been even greater than has been the case.

Some considerable slowing down in the rate of economic expansion occurred in both Canada and the United States in 1969. In the United States, where the over-all stance of monetary and fiscal policy has also been restrictive, the signs are very clear. The growth in total output, which was running at an annual rate of $6\frac{1}{2}$ per cent in the first half of 1968 and had slowed to $2\frac{1}{2}$ per cent by the first half of 1969, averaged about 1 per cent in the second half of last year. The Canadian economy continued to grow at a very rapid rate in real terms up to the end of the first quarter of 1969. Since that time I think there can be no question that the pace of expansion has slowed markedly, but the conventional measures of activity are extremely difficult to read owing to the number of major strikes which developed in the second quarter of the year and continued to affect important sectors of activity until well into the fourth quarter. For this reason, I am inclined to believe that the underlying rate of growth in the Canadian economy since the first quarter of last year may have been a bit stronger than is suggested by such indicators as GNP or industrial production.

In contrast to the U.S. situation, where the labour market remained very tight all through 1969, the over-all unemployment rate in Canada is currently close to 5 per cent. In some parts of the country it is considerably higher. Unfortunately, the persistence of a somewhat easier labour market in Canada in 1969 has not as yet been accompanied by any discernible improvement in the performance of prices and costs. On the contrary, the consumer price index over the past twelve months increased by 4.6 per cent compared to an increase of 4.1 per cent over the preceding twelve-month period. On the cost side, the evidence is no more encouraging. Average weekly wages and salaries in Canada continue to show a year-to-year gain in the range of 7 to 7½ per cent, which was greatly in excess of the trend of productivity increases, let alone of the negligible productivity growth that actually occurred over the past year.

To sum up, we have been witnessing a situation in which the growth of the economy has been markedly slower for almost a year, while prices and costs have continued to rise at an extremely unsatisfactory rate. Does this mean that our policies are not working? I do not think so. Since the middle of last year there has been evidence that business is finding it increasingly difficult to pass on all the increase in its costs in the form of higher prices. This is reflected in the squeeze in profit margins which has been developing in recent months. I think this development suggests that the policies of restraint are beginning to bite. As it becomes increasingly difficult to absorb large increases in costs in this way, business corporations will have to intensify their efforts to slow down cost increases.

Let me now turn to the question, why have the policies of restraint taken so long to have their effect on prices and costs?

Given the way in which our economic system works, some lags between the slowdown of spending and its effect on prices are , to be sure, inevitable. But even after allowing for this there are, I think, two special factors which have contributed to the disappointingly slow progress in checking inflation. One of these is the seriousness of inflationary pressures abroad. It is an unhappy fact that prices last year in nearly all the industrial countries increased at rates much above the long-term average. This phenomenon undoubtedly has added to our own problems, both by its direct effects on Canadian prices and by its indirect effects on Canadian attitudes toward price behaviour and income determination. However, having said this, I would like to remind you that the authorities in other countries are also striving to deal with their inflationary problems. While our own progress will be seriously hindered until others deal effectively with their situation, we must not be lulled into believing that for this reason it is up to others to solve our inflationary problem for us. It would be all too easy for us to fall behind in the effort to deal with inflation. Rather, we should try to stay a step ahead of others for this would be much to our advantage in terms of exports and employment.

The second special factor that explains the delay in the effectiveness of public economic policy has been the development of strong expectations of continued inflation. The effectiveness of monetary and fiscal policies, which operate in large part by influencing the incentives to spend, must depend to a very considerable extent on the behaviour of a very large number of individuals and corporations; and this behaviour has been greatly influenced during the past two or three years by the prevailing expectations about the trend of prices and incomes. In the monetary field, the most striking evidence of inflationary expectations has been the attitude toward high interest rates. Long-term Government of Canada bond yields are now over 8 per cent and prime conventional residential mortgage rates about $10\frac{1}{2}$ per cent. The demand for credit on the part of private corporations, individuals and governments has been very strong, but I do not think that it is possible to explain the present high level of interest rates, or their failure to exercise more restraint up to the present, except in terms of inflationary expectations on the part of investors and borrowers alike.

The problem I have just been discussing is, of course, not unique to ourselves - much the same kind of inflationary psychology exists in the United States for similar reasons. Public policy must continue to be directed to bringing these inflationary expectations to an end. Expectations can change very rapidly and those who are gambling against this happening are doing so at their own risk.

I believe that most people are quite opposed to inflation and are anxious to see it stopped but there are a number who are now asking whether the cure is not worse than the disease and whether we would not do better to live with inflation. Certainly, people receiving substantial increases in money incomes at least for a time do not give much thought to how much of the increase is bound to be illusory because it will get eaten up by higher prices. There is also naturally some fear that the attempt to deal with inflation may carry restraint to the point where the economy is pushed into a recession. This is a consideration which has to be in the minds of the public authorities at all times. So too must the hardships involved in the incidence of necessary anti-inflationary measures not only on individuals, but on regions of the country where unemployment levels are unusually high and where policies of restraint therefore seem inappropriate, and on some particular sectors of the economy where the restrictive measures bear most heavily.

But in the final analysis, taking all these difficulties into account, I do not feel that the acceptance of inflation is a feasible alternative to the policies we are now following. In saying this I have in mind the inequities of inflation, its serious impact on the poor, the retired, the elements in the community with the least bargaining power. I have in mind the harm that inflation does to the prospects for sustained economic growth, by undermining reliable standards of value and encouraging speculation, waste and inefficiency. I have in mind the distorting effects on capital markets, including the particularly severe impact on the availability of funds for social capital. I have in mind its undermining effects on our international competitive position. And I have in mind that all these inequities, hardships and distortions are suffered for no good purpose, for no gain in real output which can be counted on to persist over an appreciable period of time. The so-called stimulating effects of inflation depend on being able to pick people's pockets successfully. But people cannot be fooled indefinitely, and when they realize what is happening, more and more seek to protect themselves by using their bargaining power in the effort to keep ahead of the game. This, of course, cannot fail to accelerate the process and at a certain level - whether it is 4 or 5 or 6 per cent a year - the degree of inflation becomes intolerable and restrictive measures, with all their difficulties, have to be used simply for the purpose of keeping the inflation from accelerating further.

To sum up, I think that the only conclusion that it is possible to reach is that even though we find the process disappointingly long, there is no alternative that would not be worse. We must stay the course, we must persist in the fight against inflation. In view of the length of the effort that has been and may continue to be required, I believe that this means that in addition to over-all measures of restraint, we shall have to lay increasing emphasis on trying to develop selective policies - policies which are designed on the one hand to blunt the sharp edge of restraint on particularly exposed sections of the community and particular areas, and which are designed on the other hand to pinpoint the sources of inflationary pressure and try to deal specifically with them.

The period of time during which it is necessary to retain restrictive over-all policies, and suffer the loss of employment and output involved, could be considerably reduced if agreement could be reached by all sectors of the community to shorten the lags in the effectiveness of the broad policies affecting demand by exercising moderation in price and cost decisions. There is no moral judgment involved in making this statement, no attempt to attribute blame or responsibility for the present position. The fact of the matter is that we are all caught up in a process of action and reaction from which all suffer and which it is in everyone's interest to bring to an end as soon as possible. The Prices and Incomes Commission has recently taken an important initiative which deserves the full support of the whole community.

The potential of our economy for the 1970's is very great. But let us not deceive ourselves. We can spoil our chances of reaching it if our over-all situation is one in which continuous efforts are being made to adjust to inflation and in which restrictive policies have to be applied merely to keep inflation from accelerating. I have enough confidence in our good sense to believe that we shall reject this as a way of life. I believe in fact that we are now well embarked on this process of rejection.