Speech by L. Rasminsky

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MACKINTOSH SYMPOSIUM

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In arranging the division of labour among the four of us who are leading off this symposium in honour of the late Dr. Mackintosh, the organizers suggested that I should say something about monetary problems in a national and international setting, dealing first with the way these problems looked at the end of the war and then with how they look today - - all without grossly exceeding a 15 minute time limit. I am very glad to have been asked to take part in these proceedings, though this is not because I have any brilliant new light to shed on the problems I have been asked to talk about. These are now presenting themselves to the world in a way that seems almost to defy rational solution; in fact, about the only redeeming feature I can see in the present situation is that I am no longer the Governor of the Bank of Canada. But I am glad to take part because my participation provides me with an opportunity to express my affectionate admiration for Dr. Mackintosh and to bear witness to the contribution he made in the fields I am to talk about as well as in others in which he left a greater legacy of written work.

Bill Mackintosh was a Director of the Bank of Canada from 1964 to 1968 and during most of this time he was a member of the Bank's Executive Committee. His great reputation was, of course, known to the other members of the Board, and his intellectual primacy was soon established by his quiet but penetrating observations and by his discerning questions at Board meetings. Whenever I introduced any discussion of the general economic situation or of monetary policy, I would automatically look to Dr. Mackintosh for the first reaction, and the other members of the Board would instinctively defer to him. What he had to say was invariably cogent

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and imbued with realism, deep wisdom and humanity. It was said in the modest, pithy and witty way that was so characteristic of the man. The problems of monetary policy are frequently perplexing, and it was a great help and comfort to me to be able to talk them over with Bill during the years that he was a Director of the Bank.

I was also closely associated with Dr. Mackintosh in the discussions that took place during the war regarding post-war problems, including the problems of the international monetary system. The same relatively small group of officials in Ottawa who were concerned with the problems of war-time financial and economic policy were also working on plans for the post-war period. Our main preoccupations were, of course, to avoid the sharp deflation and depression which in the past had generally followed major wars, and to establish, by international agreement, a world exchange and trading system that would encourage the growth of international trade and that would avoid the risks of competitive exchange depreciation, rigid exchange restrictions, bilateral exchange agreements and the rest of the paraphernalia of beggar-my-neighbour techniques and policies that had developed in the course of the Great Depression of the 1930's.

As I think of what was in fact accomplished along these lines after the end of the war, I cannot help recalling the nine years I spent in Geneva on the Secretariat of the League of Nations, from August 1930 to August 1939. It was from this vantage point that I saw the contraction of world trade by about two-thirds in value between 1929 and 1933, the decline of about 30 per cent in world industrial production, the reduction of 25-35 per cent in the American money supply, the increase in the American unemployment rate to 25 per cent, with similar figures in other countries.

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It was from this vantage point that I saw the Keynsian revolution which gradually helped to stop the rot by legitimizing the use of fiscal policy in a conscious effort to raise the total level of demand and employment in the economy. And it was from here that I saw how difficult it is to reverse a spiral of trade restrictions and competitive currency depreciation once it has started. The self-destructive nature of these policies was seen clearly enough and set forth lucidly in many League publications. Countless resolutions were passed at the League calling on countries to reduce trade barriers and restrictive exchange practices but their immediate effect was mainly educational - an effect that I would, of course, not wish to deprecate at any time, and especially when speaking from a university platform. Indeed, I do not think that it would be going too far to say that the lessons learned and taught at Geneva in the thirties played an important part in shaping the plans for post-war international collaboration formulated during the war - plans that bore fruit in the establishment of the Fund and the World Bank and the Food and Agriculture Organization, in the General Agreement on Trade and Tariffs and in other specialized international economic agencies.

What an extraordinary contrast there has been, both with regard to domestic economic policies and with regard to the effectiveness of international cooperation between the 1930's and the period since the end of the war! There have of course been many ups and downs since 1945, many alarums and excursions. But taking it by and large the period has been one of unparalleled world economic expansion; and nowhere has this been more striking than in Canada - though one has to add immediately that very serious problems have been surfacing in the past few years and have now emerged for

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all to see. Contrary to the expectations of deflation - in part, perhaps because we were so fearful of it and prepared so well to deal with it - the most difficult and intractable problem of the post-war period has turned out to be inflation. After 10 years of gradually rising price increases in most rich industrialized countries starting in the early '60's we have seen during the past couple of years a rapid escalation of the cost of living to double digit figures. I am afraid that the intellectual climate and public attitudes have been slow to keep pace with the development of events. The favourite prescription of many economists for dealing with inflation only a couple of years ago was to learn to live with it, and it is only recently, when it has shown signs of getting out of hand, that concern about inflation has ceased to be regarded by some as a professional deformity of central bankers. Even now there are those who believe that the over-riding task of public policy is to try, in all circumstances, to squeeze the last bit of potential production out of the economy, without regard to the effect on monetary stability or to the long-run economic and social consequences of monetary instability.

I shall have a bit more to say about this later. I want to revert now to the contrast between the effectiveness of international collaboration and consultation before and after the war. Nowhere is this more striking than in the international financial field. To replace the free-for-all of pre-war days, the International Monetary Fund was established to embody an agreed code of good behaviour by which countries would be guided in their exchange practices. The code of good behaviour was not academic: there was money on it. For those who may not be familiar with the operations of the Fund I do not think I can provide a more succinct summary than that given by Dr. Mackintosh in the 1945 White Paper on

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Employment and Income. "The Monetary Fund," he wrote, "would assure comparative stability of exchange rates and, where change was desirable, would substitute for competitive depreciation of exchanges an orderly process of change following international consultation. It would outlaw the discriminatory practices that turned trade into economic warfare ..... It would assure the convertibility of the ~~process~~ proceeds of our sales abroad into whatever currencies we required for our current needs. It would give to each member country for the purposes of its current balance of payments an assured, though limited, line of credit to serve as a buttress for policies directed to the expansion of employment."

Canada had as great an interest as any country in the establishment of orderly exchange arrangements after the war and the establishment of currency convertibility as the normal rule. Our interest arose of course from the great importance of international trade in our economy and from the structure of our balance of international payments. To a greater extent then even than now we ran a surplus in our transactions with Britain and Western Europe which we needed to convert into cash to help cover the deficit in our transactions with the United States. It was clear that at the end of the war Britain and Western Europe would need help to re-establish their economies, and would have to maintain for a while some of the war-time restrictions. This help was subsequently forthcoming in the post-war loans from the United States and Canada and in the unparalleled generosity of the Marshall Plan. But looking ahead to the post-reconstruction period there was a strong school of thought in Britain which was pressing for that country to continue for an indefinite period of time the cohesion of the sterling bloc with its discriminatory restrictions against imports from the dollar countries. Remember, extraordinary though it seems now, that the

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accepted wisdom with regard to international monetary matters in those days was that of the chronic shortage of U.S. dollars.

It is not surprising then that Canadian officials worked very hard to avoid these developments and played a full part in helping to establish the Fund and its sister institution in the trade field, the Gatt. Dr. Mackintosh was closely associated with this effort. He, Hume Wrong and I represented Canada at the first, and in many ways the most intellectually exciting, of the countless international gatherings to consider post-war currency arrangements - the meeting of Commonwealth officials in London in October 1942 to discuss Keynes's original proposals for an International Clearing Union. He took part, along with John Deutsch, Wynne Plumptre and myself in the first discussions with the Americans on their Preliminary Draft Proposals for a United Nations Stabilization Fund, and he was one of the group which worked over the Tentative Draft Proposals of Canadian Experts for an International Exchange Union which I had drafted in an effort to bridge the gap between the British and American approaches and to add something of our own. This became part of the grist to the mill at Bretton Woods and had some influence on the final result. At Bretton Woods itself, Dr. Mackintosh was Chairman of the important Committee on Operations of the Fund.

During the past couple of years there has been a great deal of discussion of the need for basic reform of the international monetary system and a revision of the Articles of Agreement of the International Monetary Fund. Any institution must of course be adapted to changing circumstances. But it is my view that the Fund served the world well and that it can in no way be held responsible for the present fragility of the international monetary system. Much of the discussion that I hear about the Fund

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involves a deep misunderstanding of what can be expected of any piece of machinery - as distinct from the policies pursued by the countries using the machinery - in achieving a tolerable equilibrium in international payments.

A recurrent theme in international monetary discussions which emerged at the very first discussions of the Clearing Union Plan in London in 1942 and has persisted since then has been the respective responsibilities of deficit and surplus countries to aid in the process of international balance of payments adjustment and the appropriate national and international mix of policies to achieve this. Contrary to what is sometimes believed, the Fund has never stood for exchange rigidity but has encouraged the use of exchange rate changes in appropriate uses. But the Fund does not have the power to impose its views on this or on monetary or fiscal policy on its members. To the extent that the further evolution of the Fund is in the direction of making it a true international central bank its influence will of course be increased.

Meanwhile, no machinery will automatically produce the national policies which are necessary to make the machinery work. No country, however powerful, can - without damage to the system - neglect, beningly or malignly, the impact of its policies on other countries or fail to try to adjust imbalances in its international accounts. The way the smaller countries act does not perhaps matter so much, but the massive deficits of the United States which resulted from the combination of enormous Viet Nam expenditures and continued heavy pressure on resources at home contributed to putting an intolerable strain on the Fund system, as it would have on any other system. I say "contributed to" because some surplus countries, such as Germany and Japan, were also slow to recognize their responsibility to aid in the process of adjustment by raising the value of their currencies and removing import

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restrictions. Though other factors have been at work, the over-all effect of the huge dollar deficits of the past 15 years was of course to add substantially to the world-wide inflationary pressures we are now seeing.

Since the breakdown of the realignment of exchange rates, including that of the American dollar, which was finally introduced at the Smithsonian meeting in 1971, the world monetary system has been floating without an anchor, though fortunately some guidelines have recently been recommended by the Fund Board to members with fluctuating currencies. Speculative movements of funds created very unsettled conditions in the exchange market from time to time and we have seen several financial institutions with heavy losses through exchange speculation. On the surface, the situation at the moment seems to be one of relative calm. So far there has been a remarkable degree of forebearance on the part of national authorities which have resisted the temptation of predatory trade or exchange practices. However, with the threat of recession visible in many parts of the world it will require great vigilance to see that countries do not lapse into attempts to solve their own problems at the expense of their neighbours. The risks of this happening have been greatly increased by the quadrupling of the price of oil and the sudden emergence of huge balance of payments deficits in practically all industrialized oil-importing countries. To give some idea of the magnitude of this problem: it is estimated that the major oil-producing countries will this year have a current account surplus of $60-80 billion, a figure which compares with world gold and exchange reserves of about $150 billion. And there is more to come for at least several years.

I leave the international side for a moment to say one or two things about monetary policy. The 1945 White Paper on Employment and Income had only one sentence on monetary policy. This was an accurate reflection of

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the fact that direct controls, supported by fiscal policy, had been the main economic instruments used during the war. It was generally expected that interest rates would remain at the very low level at which the war had been financed and that monetary policy would remain in the state of "innocuous desuetude" into which it had lapsed during the war. Monetary policy was in fact not revived as a major policy instrument until after the Korean War inflation in 1951.

As matters have worked out in practice, with the unexpected emergence of inflation as a major problem during the past fifteen years or so a great deal of reliance - I would say an excessive amount - has been placed on monetary policy to prevent inflation from developing and to deal with it from time to time when it did develop. Fiscal policy has not invariably been geared to the requirements or potentialities of the economy, and government expenditures have grown rapidly and virtually continuously. Some programmes - desirable in their own right - have been undertaken without searching examination of their future growth or the impact they might have on the economical use of resources, or on the incentive to maximize output.

Apart from the obvious reasons for this growth, I think that the view which is commonly held by economists that you can measure the effect of government expenditures on the economy simply by looking at the national accounts has on occasion been misleading to governments. The national accounts approach is useful, but it pays no attention to transfer expenditures or to the financing of the expenditures of government agencies or for that matter in required levels of taxation. It has to be supplemented, particularly in our situation, by looking at the impact of the financing of the Government's net cash requirements on the monetary situation and to the total level of spending and saving in the economy.

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At the present time we, along with most countries in the Western World, are faced with a situation of unparalleled seriousness and complexity in regard to both inflation and the international monetary system. We are suffering from the aftermath or the presence of three types of inflation - the demand inflation which resulted from the very rapid expansion in the economy in 1973, a cost inflation which is characterized by explosive increases in wages, salaries and professional fees, and increases in the prices of important primary products caused by political decisions, as in the case of oil, or crop shortages, as in the case of grain. At the same time the United States' economy is in at least a minor recession, it seems very likely that the rate of increase in output here will be less over the next year than it was last year, and Japan and most European countries are experiencing abnormally low growth rates. And to this list of problems one must add the precarious and worrying position of the non oil-producing underdeveloped countries who are threatened with a halt to economic advancement.

In this situation some miraculous tight-rope walking is called for if we are to deal effectively with inflation and at the same time avoid a serious economic setback in the developed countries and worse in the underdeveloped countries. It seems to me that the basic problem is the political one of obtaining enough understanding of the position to gain acceptance of the policies needed to deal with it. The extraordinary increases which have been taking place in the standard of living of the industrialized countries of the West in the course of the past two decades - amounting, in the case of Canada to an approximate doubling of the average standard of living, with the greater part of this occurring in the past 10 years - have created a widespread public expectation that this sort of performance can be expected

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to continue at all times, that there is something automatic about it. In these circumstances, many people expect instant solutions to deep-seated problems and public figures find difficulty in confronting the public with the need to take a breathing space in their demands and to be satisfied with something less than all-out expansion of the economy until the inflation can be brought under control.

Yet if we are concerned about being able to resume strong economic growth and rising living standards we have no alternative to trying to deal with inflation; and the only non-catacylsmic way of dealing with it is, in my opinion, to eliminate the inflationary expectations which underly the present spiral of factor costs by adopting less expansionary fiscal policies and persisting in these and in moderately restrictive monetary policies for some time, while addressing ourselves to the particular hardships they may cause. These inflationary expectations have been re-inforced by the observed fact that even in recent periods when restrictive anti-inflationary policies have been applied and unemployment has risen, costs and prices have continued to go up. An incidental and unexpected by-product of desirable social security programmes and certain other socio-logical factors has been that the link between employment and family income has been loosened, and wages and salaries have become less responsive to changes in demand pressure. Unemployment has become a more practical and acceptable alternative to settling disputes at what seem to be less than "fair shares," and also to accepting jobs which for one reason or another are viewed with disfavour. It is for these reasons that the published un-employment rate has ceased to be a reliable guide to the actual state of the labour market or to the over-all demand policies that should be pursued by the monetary and fiscal authorities, though large changes in the figure

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continue of course to be significant.

There is no use trying to deal with inflation by attaching blame for it to particular groups. Once inflation is allowed to take hold to the extent it has, everyone inevitably tries to protect themselves against it or to make up for past losses. At the present time the chief cause of inflation is the increase in costs, but the wage-explosion we are now seeing is partly a reflection of the fact that for a great many workers, take-home pay last year did not keep pace with the rise in the cost of living and union leaders are determined to make up what has been lost and to protect their constituents from the same thing happening again on the assumption that the cost of living will continue to rise at current rates or more.

Similarly, on the profit side the increases, until recently at any rate, look high, and no doubt there are some cases where they have been excessive. But to a substantial extent they represent upward inventory revaluations that are the result of inflation, and to a very major extent, particularly in capital-intensive industries, they are fictitious, as the depreciation charged against the fixed assets is insufficient to replace the capital assets at current prices.

An aspect of inflation that is very worrying for the future is the way it impairs the functioning of capital markets. The basic way to deal with the long-term problem of inflation is to increase the flow of goods to the market in relation to demand. This means that we must be greatly concerned with increasing our productive capacity and productivity. And this necessarily involves encouraging savings and the smooth functioning of the machinery which will put the savings to productive use. Our capital requirements for new projects are enormous, and for existing businesses working capital requirements are increased by inflation and at the same

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time internally generated funds provide a smaller proportion of the funds needed to finance additions to capacity than they have done in the past. More reliance has therefore to be placed on raising capital in the market. Yet the evidence is at hand of the destructive effects of inflation on the equity and bond markets and of the unwillingness of savers to commit their funds except for very short term.

A decision to reduce the rate of growth of government expenditures is not a prescription for a contraction in the economy. Presumably, apart from postponing new large programs, one would have a close look at existing programs to eliminate items that may be wasteful or even inimical to effort and employment. And the steps taken on the fiscal side would provide the opportunity for less stringency on the monetary side, which would have a stimulating effect on the housing industry and encourage capital investment and expansion of capacity. One should, of course, not underestimate the difficulties, or the problems involved in persuading the public that there is no quick or easy solution to the problem of inflation or that if only one's heart were in the right place one would come forward with a painless way of dealing with it. The length of time that it will take to bring inflation under control is unpredictable - it will depend on the reaction of factor costs to the emergence of slack in the economy. Past experience in this regard is not too encouraging and for this reason I continue to feel, as I have felt since I first expressed this view in the Per Jacobsson Memorial Lecture in 1966, that the acceptance by all sections of the community of some guidelines for increases in their incomes, combined with a rigid enforcement of anti-monopoly legislation, to buttress moderately restrictive fiscal and monetary policies, would shorten the period needed to eliminate inflationary expectations and enable us again to turn our attention

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primarily to expansion. I know that this view is unpopular among economists and that there is little history of success in income policies to point to. But a continuation of the struggle of different groups for a larger share of the pie does not make sense if the effect of it is to keep the inflationary spiral going and reduce the size of the pie to be divided.

If one compares the present situation with the one that confronted Dr. Mackintosh in the last stages of the war when he was drafting the White Paper on Employment and Income and participating in the planning for the post-war international monetary institutions, the problems of today look at least as difficult, perhaps more difficult. We have a combination of high inflation and threatened recession, an international monetary system which is fragile at best and now has to bear the tremendous additional weight of the oil payments problem, and the threat of food shortages affecting millions of people in Asia and Africa. The situation clearly calls not only for a fine balance of national policies but for international co-operation on a scale which exceeds anything we have seen in the past. The most hopeful note that I can find to conclude on is that this fact seems to be widely recognized.