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Economic Policy and Inflation

by Professor W. M. Scammell, Hamilton, Ontario

For Canadians inflation is a relatively new experience. Although the postwar period has seen some sharp price increases in Canada—notably in 1948 and 1951—the average annual percentage rate of increase of prices between 1946 and 1964 (excluding those years) was only 2.8 p.c. Even taking the comparison down as late as 1967 the cost of living had risen since 1958 by only 19 p.c. in Canada as compared with 30 p.c. in the United Kingdom, 40 p.c. in France, 16 p.c. in the United States and 24 p.c. in Germany. Thus while Canada participated in the general rise in prices which has taken place during the postwar period the trend had, until recently, been of less than average steepness and, again with the exception of the crisis years 1948 and 1951, had followed the gentler path of the United States rather than the steep one of Western Europe. It has therefore been with surprise and annoyance that Canadians have observed during the past three years the development of an economic malady which they had, somewhat smugly, deemed to be European. Now all is changed. The 2 p.c. annual rate of price increase which the Economic Council of Canada once regarded as “compatible with the country’s economic goals” has been greatly exceeded. The sharper rise in prices began in 1966 and accelerated in 1967 and 1968. Figures for the first half of 1969 recently released by the Dominion Bureau of Statistics showed that consumer prices have climbed at an average rate of 0.5 p.c. per month. The June figure showed the alarming average rate of 0.8 p.c. In the face of these harsh facts economic complacency has given way to a concern which is in some ways more unhealthy than the earlier euphoria since it may well lead to policies of “overkill” which are not in the long-run interest of the country. This article will attempt some diagnosis of the Canadian condition and evaluation of the policies which are being pursued.

To a European it is necessary to remember in approaching the economic situation in Canada certain aspects of the economy which are unique. Four features are important.

Unique Aspects of Economy

The first is the close relationship of the Canadian economy with that of the United States. In this certain indicators are important. The exchange rate between the Canadian and the United States dollar is a determinant of Canadian economic policy and a close watch is kept on the price levels of the two countries with the maintenance of the exchange rate in mind. It should be remembered that it was the management of the United States/Canadian exchange rate which induced the Canadian authorities to embark in 1951 on a tenyear long experiment with a floating rate. It is not our present purpose to evaluate that experiment but merely to point out the importance in Canadian eyes of keeping that rate in appropriate alignment to the rest of the economy. So far in the present case prices in the two countries have moved more or less in parallel and there is no evidence at all that, at the present rate, the Canadian dollar is overvalued. Indeed at some periods in late 1968 and early 1969 there was some indication that the rate might be undervalued since the Canadian foreign exchange reserves rose to the maximum level consistent with the Agreement of 1963¹. Exports in the first half of 1969 rose by 12 p.c. and although imports rose more sharply in the same period this was probably due to the high domestic demand for consumer durables a large proportion of which are imported.

¹ In July, 1963 when the United States Interest Equalisation Tax was imposed to curb United States foreign investment, it was agreed to exempt Canada from the tax provided that a ceiling be placed upon the level of Canadian exchange reserves. Once reserves reached the ceiling the excess was to be used for the purchase of United States bonds.

A second Canadian economic variable which must move in conformity with the United States is that of interest rates. Because of the close proximity and similarity of aims of money and capital markets on both sides of the border and the high mobility of capital between them, Canadian interest rates and indeed monetary policy must be closely harmonised with that of its southern neighbour. Other features which bind Canada to the United States are well known although their influence on a purely short-term situation is problematic: the dependence of Canada upon the United States as a supplier of capital, as the largest of its export markets and as a main controller through subsidiaries of over 50 p.c. of its industry are examples.

Export of Primary Products

A third feature of the Canadian economy is that, almost alone among the rich countries, it is dependent for its overseas trade and prosperity upon the export of primary or near-primary products: newsprint paper, wheat, lumber, woodpulp and ferrous and non-ferrous ores and alloys². Not only does this tie the Canadian economy to the capricious and mercurial world markets for these products but it imposes upon it the peculiar regional variations in income which are often a feature of the "resource" economy.

The fourth peculiarity of the Canadian economy arises from this. Apart from the great band of rich industry which begins at Montreal and sweeps south-west through Ontario (and on into Michigan) much of the rest of Canada is regionalised around the location of resource industries. Not all of these regions enjoy the prosperity associated with Canada: some enjoy it only sporadically. Newfoundland, despite the efforts of Premier Smallwood and his provincial government is a poor province whose fishing and lumber industry doom it to heavy seasonal unemployment and a per capita income barely half that of Ontario. The Maritimes (Prince Edward Island, Nova Scotia and New Brunswick) fare only slightly better although their development policies, contending less than in Newfoundland with harsh climate and geographical remoteness, are slowly showing results. Ontario requires little comment. As the industrial centre of Canada it enjoys its highest per capita income and it responds with little variation to the economic laws which mould great industrial areas the world over. Once more, however, neighbouring Quebec provides stagnant economic areas almost to the fringe of Montreal itself. From the Ontario border to the Rockies the thousands of fertile miles of the prairies with their giant wheat

farms are tied to a world market which in the postwar period has been boyant but which is now in deep trouble. For several years in the middle sixties large Chinese grain purchases aided the prairies but now there are huge surpluses and ominous talk of world demand switching to wheats which the prairies do not grow. Finally, on the Pacific coast resource industries in British Columbia mix with a few new industries and the commercial outlets for Canada to the Far East, to give the second great prosperous region of Canada. From all this emerges a picture of an economy which is far from homogeneous, which is not so much one economy as several, which for regional purposes are governed by provincial governments which range from the economically sophisticated to the downright naive; and which, across a sub-continent, demand a diversity of local policies which must be fused with the policies for the whole by the hapless Federal Government in Ottawa.

Dependence from US Development

The conventional wisdom of these special features on the problem of how to handle Canadian disinflation is, in a nutshell, this: that whatever measures are adopted, they must preserve the present exchange rate with the United States dollar. To do this must not only keep the pace of disinflation similar to that in the United States but must use monetary policy harmonised to that of the Federal Reserve, and must not disinflate the rich regions of the country at the expense of a high unemployment rate in the less prosperous regions. In the light of these facets of policy and of the success of disinflation itself, the recent measures must be judged.

What went wrong in the later sixties to destroy the Canadian assumption that steady growth could be attained without inflation? Once more the parallel of Canadian and United States experience is striking. In the United States 1961 to 1969 have been years of economic advance. During the Kennedy administration the annual rate of increase of consumer prices was a mere 1.5 p.c. — what might be described as a zero inflation rate. In Canada it was at 1.9 p.c. only marginally higher. The heat came in the United States in 1967 when consumer prices rose by 2.8 p.c. and intensified in 1968 to 4.2 and in the later part of the year to 5 p.c. This heating-up of the economy was paralleled in Canada. In the United States the causes of this are well known—the Vietnam War, government spending on the poverty programme and a loss of deftness of touch in economic policy under Johnson—but since these are purely American influences what was their counterpart north of the border? Four influences suggest themselves: cost-push wage advances as Canadian unions attempted, with their lower productivity, to raise Canadian wages in step with those in the

² The importance of vehicles and machinery in the export figures is misleading. The figure is almost matched on the import side. This phenomenon results from location of the great complex of the American motor industry in Detroit, Michigan and South Eastern Ontario. Within this complex cars and parts cross the border in both directions.

United States; a liberal lending policy by the Canadian chartered banks, trust companies and financial intermediaries, as the money supply was allowed to grow³; a demand-pull emanating from growing consumer demand, particularly for consumer durables, from private industrial investment and from spacious capital outlay programmes by the provincial governments; and, finally as excess demand spilled over into imports, a price boost from the rising prices of imports from the United States and Europe after 1968.

Policies of Disinflation

Policies of disinflation are now well under way in Canada, as in the United States, and it is probable that the success of the Canadian measures is likely to be, to some degree, conditioned by those in the United States. The private hope of many is that moderate disinflation will induce a return to the spacious early sixties in both countries, that after this brief interlude of imbalance both countries may, with a rolling adjustment, resume their serene progress. Most Canadians believe that as American counter inflationary policies begin to take effect so, too, may Canadian policies and both economies will fall into step but at a more modest pace. Some Europeans are likely to think differently. Why, they may ask, should Canada accept its fate so complacently? Would it not have been better to have checked the Canadian economy sharply at an early stage, attempted an incomes policy to curb wages and realign them with productivity, brought the budget into balance and checked in 1967 the sharp increase in the money supply — meeting all this disinflation relative to the United States with either a revaluation of the Canadian dollar (itself a disinflationary measure) or a resort to a floating exchange rate? There are two answers to this. First, experience since the war has shown that when an economy overheats the counter measures are always slow in coming unless the inflation produces an early external deficit which cannot be met from reserves. Governments are loth to curb expansion even when it involves price rise. Only when its labour force reacts to a decline in real wages by demands for money wages in excess of gains in productivity or, as an electorate, by a demand to repress inflation, will action be forthcoming. Both these forces operated in Canada only in 1968 when inflation was already well under way. Second, the Canadian balance of payments has been varyingly favourable throughout the critical period. Apart from a sharp dip in reserves in the early part of 1968, which was soon over and after which reserves climbed sharply, there was no warning signal perceptible in the foreign balance. The concurrent inflation in the United States and in other countries prevented this. As for the question of a fundamental break with conventional

policies, a bid for freedom, and a free exchange rate, the prevailing mood in Canada is all against this. The economic nationalist doctrines of Walter Gordon so widely propagated a few years ago are out of fashion. There is no real support for a purely Canadian economic policy in the form described above. There has been some desultory talk about a new Canadian foreign policy but little that is new in economic policy. Growth without inflation goes quite far enough as a slogan in the Canada of Trudeau.

Nevertheless, within its conventional aims, there has been an edge to the sword of Mr Benson, the Canadian Finance Minister, and there are signs that his measures are already taking effect. These measures were in three fields: fiscal policy, monetary policy and foreign trade. In fiscal policy, Mr Benson produced the first budget surplus since Louis St. Laurent's stewardship of 1956—7. At one swoop he budgeted for a surplus of \$250 mn and cut federal government borrowing from over \$1000 mn in the last fiscal year to only \$300 mn in the current one. The bond issues floated after the budget at 7³/₄ and 8 p.c. were quickly taken up and seem to have mopped up some of the surplus bank liquidity. One novel and welcome feature on the fiscal front was the attempt to apply fiscal policy on a selective regional basis. Capital allowances were deferred for two years on construction of commercial buildings in urban centres over 50,000 in population in Canada's growth provinces — Ontario, Alberta and British Columbia. In the monetary field the Bank of Canada has made two increases in the discount rate, one after the budget to 7.5 p.c. and one in July to 8 p.c. These were followed by increases in the chartered banks' prime lending rate and pushed the cost of consumer durable loans and incidentally of housing mortgages to unprecedented levels⁴. In the foreign trade field, Benson announced the immediate implementation by Canada of the full Kennedy round tariff changes which were originally intended to be spread over three years. This will reduce tariff costs by 3 percentage points on an estimated \$2,000 mn worth of Canadian imports. The avowed purpose of this acceleration was to ease strain on prices but a valuable subsidiary effect may be to increase the competitive pressure on a range of Canadian protected industries.

Missing Link of Incomes Policy

In all this the missing link is that of incomes policy. Canadian workers have little "money illusion". In the renegotiation of wage contracts unions have shown the same appreciation of real wage values as workers have in demanding government action to curtail rising prices. There was no prospect here of checking inflation by the conservative method of allowing prices to rise, retard-

³ Between 1964 and 1967 there was a 43 p.c. increase in the total money supply.

⁴ There is already some indication of a decline in housing starts.

ing the growth of real output and forcing workers to accept a cut in real income. This economic realism might be turned to good account by the Federal Government, the Economic Council of Canada and the provincial governments by fixing wage and income guidelines but there has, as yet, been no systematic attempt to do so. Contracts are still concluded without reference to any guidelines save that of screwing out of employers the maximum possible, and although exorbitant wage demands are often bitterly resisted by employers and strikes may be lengthy there is evidence that inflation-conditioned annual increases are increasingly regarded as normal. Before this happens, and before the Canadian economy becomes "locked into" the tyranny of the annual round which has plagued Britain, the Government would do well to seek a viable wages policy by negotiation with the unions. There are faint stirrings of life on this front. The appointment in June, 1969 of a federal commission on prices and incomes under the Chairmanship of Dr J. Young, a well-known academic economist, is a step in the right direction, but it will be some time before the Commission can be observed in action. Moreover,

this body has no powers enabling it to impose solutions. It may nag, criticise, persuade and cajole. That is all.

Nebulous Economic Policy

Trudeau, soon after his election, set out upon his search for a new Canadian foreign policy. Something has emerged. Diplomatic relations with Red China, a more independent and capricious attitude towards the Commonwealth, — these, if they can be called a policy, have so far appeared. On the economic side all is nebulous. It is a pity that when Canada's macro-economic problems come up for consideration the discussion at once becomes polarised. Ranged against the teeming supporters of the status quo there is only Walter Gordon and a few "funnies" — able men in their fields but lacking the expertise or the intellectual cutting-edge to evolve a viable policy. The intricacies of the middle way lie largely unexplored. Canada does not lack economists, indeed it breeds them. Viner, Galbraith, Johnson, Mundell are but a few examples. But it seems they are a strain bred mainly for export.

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