

INFLATION AND TIGHT MONEY:  
WHERE ARE THEY TAKING US

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Canada's current economic and financial environment is not likely to create a feeling of euphoria among Canadian economists, bond traders, securities analysts and other practitioners of the mystic arts. At the risk of driving you immediately into a post-luncheon state of mental depression and physical indigestion, permit me to sketch in briefly the main lines of our present economic scenery.

We look around and what do we see? For one thing we see rapidly rising prices with high unemployment. We also see incredibly high interest rates, tight credit conditions generally, with no relief in sight, and an economy that has for some months been growing at much less than its potential. Looking further we see wage rate increases that are wildly in excess of productivity increases, and price increases following wage increases with almost indecent haste. And as if this were not enough there emerges from Ottawa periodic evidence that the high priests of economic prognosis are quarrelling amongst themselves.

Nor does the scenery improve if you shift your gaze from the forest to the trees. Let us examine a few of the trees. So far this year the consumer price index has been rising at an annual rate of  $4\frac{1}{2}\%$ ---the highest rate since 1951; and the increases for 1966, 1967, and 1968 were also larger than those for any year since 1951. So not only is it a high rate of inflation, but also a very persistent one.

If we examine current trends in wage rates and wage rate settlements we are also forced to conclude that in the absence of strong and persistent anti-inflationary action, current inflationary trends will continue for at least several more years. I recently examined the rate of increase of average hourly earnings over the period 1952 to 1968, and the rate of increase of real output per manhour, and found that the difference between the two ---that is, between increases in money earnings and real output---was about equal to the annual in-

crease in the consumer price index. This suggests that on the average the increase in wages in excess of productivity increases will be accompanied by about an equivalent rate of inflation. I am not now suggesting any particular line of causation here, but merely suggesting a relationship that might give us a rough indication of the rate of inflation that is in store for us over the next several years. Average hourly earnings in manufacturing are now running at about 7 $\frac{3}{4}$ % ahead of a year ago --- which is probably about 4% or more in excess of the trend rate of national average productivity increase. Even more revealing and worrying is the size of wage rate increases in current settlements, since they relate to wage rate increases over the next several years. In the third quarter of 1969 new settlements involved base rate increases of 7.9% compared with 7.7% in the second quarter, 7.2% in the first quarter, and 7.5% in the fourth quarter of 1968. However if we break down the third quarter settlements into one year, two years and three year agreements, it suggests that so far there has been very little slow-down in the rate of increase of wage settlements. For example, one year agreements showed a 9.4% increase, two year agreements showed a 7.5% increase, and three year agreements showed an 8.5% annual increase in base rates. These wage rate increases relate to new settlements covering bargaining units of 500 employees or more but excluding the construction industry. If we take only the third year wage increase of all three year contracts, this shows a per centage increase of 7.9%. The equivalent figure for settlements arrived at in the second quarter was 6.9%, in the first quarter it was 5.7%, and in the fourth quarter of 1968 it was 7.5%.

Now what does that 7.9% increase for the third year of all settlements made in the third quarter of this year imply? Well, if the wage-price-productivity relationship I have just referred to holds in future, and if future settlements were like those of the very recent past, then it suggests

an inflation rate of about 4% or more in 1971 and 1972. This leads me to say to those in charge of fighting inflation; if you wish to reduce the rate of inflation below the 4% level by 1971 you had better soon create conditions in which wage rate settlements are distinctly less generous than they were in the third quarter of 1969.

I do not wish to imply that inflation is accelerating, for that would not be correct. Year-to-year comparisons of both the consumer and wholesale price indexes and manufacturing wages suggest that the rate of increase of wages and prices has been stabilized, and even that it has declined fractionally. The task we face now is the one of reducing significantly the rate of increase of costs and prices.

So far I have not even mentioned bond prices and interest rates. The Government of Canada 4½% bond issue was selling at about \$74.00 in July to yield about 7½%, while now it is selling at about \$69.00 to yield 8.30%. As the optimist said, "that's quite a rally in bond yields". Yields of that magnitude are without precedent in recent history. I attempted to determine when Canada last experienced such market rates of interest and found an article written in 1885 which gives a series of conventional mortgage yields going back to the 1850's. It suggested that the conventional mortgage rate dropped to a range of 9%-10% in 1871, prior to which it had for five years been at 10%. Not until this year did the conventional mortgage rate again exceed the 10% level. So it seems safe to say that current market rates are higher than they have been for about a century.

I suppose the question that we should now ask ourselves is: should we be worried? Are these rapidly rising prices and high interest rates, both of unusual dimensions in historical terms, taking us where we really do not at all want to go? It is of course true that unknown or unfamiliar terrain

always makes one somewhat apprehensive; strange waters do frequently appear a shade darker. But I am naggingly reminded of the unsuspecting boatman, drifting along in leisurely ecstasy, who said just before the falls of Niagara came into sight, "Look how wonderfully swift the water runs". Or as 'Adam Smith' said, rewriting Rudyard Kipling, -that is, the new Adam Smith of the "Money Game", not the old Adam Smith of the 'Wealth Game'-----he said, and I quote, "If you can keep your head when all those about you are losing theirs, you haven't read the news."

Possibly, therefore, I am justified in asking whether we should be worried. It is a complex question because it contains within it a series of additional questions. Will present trends lead to balance of payments difficulties? Will they lead to serious social unrest; will they lead to capital market chaos; will they abort economic growth; will monetary and fiscal policies be successful in reducing significantly the dimensions of the problem of high interest rates and inflation? While I will not pretend to deal comprehensively with each one of these questions, I do believe that some comment is appropriate.

I wish first of all to deal with the matter of social unrest. Some of you may recall that way back in 1958 Professor A.W. Phillips reported on research that seemed to show that periods of high wage rate increases (and high price increases) were usually periods of low unemployment, and vice versa. This finding was a God-send to economists who wished to display their social conscience in public. They could simply argue in favour of high employment, and express indifference over the inflation that would accompany it. Following the Phillips' finding one would now expect that high inflation would be accompanied by low unemployment. Alas, that is not the case. Unemployment so

far this year has been running at 4.7% of the labour force, and most recently at 5.3%. In 1964 when we also had 4.7% unemployment, the consumer price index was rising at only 1.8% per annum; and in 1957 unemployment was 4.6% and prices were rising at 3.2% per annum. So you see the trend has been toward a deterioration of the price-unemployment trade-off position. Is this the price we have to pay for having avoided a recession for a longer period than ever before, excluding periods of war? It is a price that invites social unrest; sooner or later the bill for such unrest will be presented unless we find ways of achieving sustained economic expansion without a high rate of deeply imbedded inflation.

You are all familiar with the standard text description of who gets hurt in inflation --- widows, orphans, pensioners, professors, etc., and I need not discuss that aspect of it. However there are several developments within that this general area [should perhaps be noted. So far in 1969, the share of total income taking the form of wages, salaries and supplementary labour income has amounted to 54.9%, which was well above the 1952-1968 average of 50.6% and also above the 1968 figure of 53.9% ; the proportion of income taking the form of corporation profits before taxes was 10.3%, which was below the 1952-1968 average of 11.0%, and fractionally below the 1968 figure of 10.4%. The share going to farmers and unincorporated businesses has declined. So the current problem seems indeed to be an overly rapid upward thrust in wages and salaries, not in corporation profits; and since this has been accompanied by an increase in unemployment it might even be that the shift in income has partly been from the poor workers to the rich workers, and not from the poor workers to profits. There is then the possibility that the real conflict of interest is now between the elite labour unions such as the United Steel Workers of America and the United Automobile Workers and the unemployed and poorly organized workers, and not at all between such unions and management.

I would like to cite an example to illustrate this possibility. Recently there was a wage settlement in the steel industry which, like a number of others, was so high that it could only be rationalized on the assumption that there would be a high rate of inflation over the life of the contract. It was followed very rapidly by an increase in steel prices. So where is the conflict between the steel workers and management? Presumably the people that will be hurt will be the ones that feel the impact of tight monetary and fiscal restraint necessary to check the inflationary forces that will fan out from that settlement and that round of price increases. We must entertain the possibility that there is very little harmony of interest between the wealthy workers and the poor workers and, indeed, that their interests in the short-run at least may be in conflict with each other. This is a dimension to the social consequences of inflation that should not be ignored.

We live in a period of acute concern over minority groups of one kind and another, and for the most part that is a desirable development. However it does mean that we can no longer assume that minority groups who are caught in the inflationary squeeze will indefinitely remain quiet. I do not wish to over-dramatize the point, but I am wondering whether the Montreal Strike of Policemen for example, would ever have occurred if we had not had an environment of inflation. And what is happening to the real purchasing power of rights under the National Pension Plan, which has only a partial price escalator arrangement within it? How much political energy will be expended when this becomes a political issue of importance--as it likely will. At present I am sceptical of the ability of governmental authorities to avoid deep social unrest if they do not achieve greater price stability and thereby avoid the inequitable and unjustifiable distribution of the direct and indirect costs of rapid inflation.

Another aspect of persistent inflation that should be noted is its impact on the capital market. It would seem that there has in general been a shift

toward short-term financial investments, and away from long-term fixed interest investments. This is not entirely a bad thing. To the extent that present interest rates are higher than they will be in future, this demand for short-term investments reduces the extent to which borrowers are able to lock themselves into a high cost capital structure over future years. I shudder to think what would happen to a company that is highly leveraged with long-term debt at today's interest costs, should we return to more normal interest rates. But an overly large amount of short-term debt creates its own hazards since it makes borrowers vulnerable to short-term market disruptions---as was so clearly illustrated at the time of the Atlantic Acceptance Corporation bankruptcy when even good finance companies faced a closed short-term money market. I only hope that if the volume of short-term debt continues to rise that the Bank of Canada will plan in advance to have available arrangements for making available substantial amounts of lender-of-last resort funds to non-bank borrowers--- either directly, or indirectly through the banking system. In the absence of arrangements of that kind it is not at all outside the realm of possibilities that inflation could generate for us a financial market crisis of the old fashioned type.

Will present inflationary trends lead us into a balance of payments crisis? Here it would seem we are in luck, mainly because the United States has for several years been mismanaging its affairs with about the same degree of efficiency as we have. For that let us be truly thankful. We take our mercies where we find them. Wage cost performance seems to have been worse in Canada until about March of this year, as suggested by trends in average hourly earning in manufacturing, but since then wage increases have been about the same in the two countries. Wholesale prices have risen at about the same rate in the two countries since about mid 1967, and consumer prices have

recently been rising less in Canada than in the United States. However before we congratulate ourselves with too much self-satisfaction, let us remember that we have roughly equalled the U.S. prices and cost performance only after generating a distinctly higher rate of unemployment than the United States has done. But ignoring that uncomfortable aspect of the problem, it would seem that serious balance of payments difficulties would arise only if the U.S. suddenly substantially<sup>a</sup> improved its price performance and we did not -- a possibility, of course, that we should not discard without thought. Some European countries too are experiencing serious inflation, although not all countries are, as take the case of Germany. It is also true that when there is inflation in other countries, particularly the United States, Canada inevitably imports some of it. Canada also feels the impact of anti-inflationary measures taken by the United States. The international dimensions of inflation and its control have become so important that Canada should now perhaps take the initiative to develop international co-operation to deal with it. It is only to highlight the nature of the problem and its importance, it might now be very useful to organize an open international conference on inflation with participants including government and central bank officials and outsiders.

I do not want to leave the impression that our monetary and fiscal authorities are standing idle in the face of current inflationary developments. First consider the dilemma they face. They face cost-pull inflation, not demand-pull inflation (at least not yet), and yet their anti-inflationary techniques -- monetary and fiscal -- are designed essentially for demand-pull inflation. Such techniques can, of course, ultimately control cost inflation too. But how must this happen? Presumably it works this way. Through tight money and fiscal restraint the sales of companies and then their production, slow down. This squeezes profits and creates conditions that make it difficult for companies to improve profit margins by raising prices -- which in

turn will make it impossible for them to grant the wage increases that they would otherwise have granted. Finally lower price and cost increases emerge. But this has happened only after tight money has reduced sales, reduced output and therefore increased unemployment. There is in this anti-inflationary approach a constant temptation to relax restraint because of the unemployment it creates. Yet in the absence of any serious indication that the voluntary restraint programmed of the Prices and Incomes Commission will be considered seriously by unions and possibly even by management, there is no alternative.

The nature of this process helps clarify who the real combatants are in this battle with inflation, and who the casualties are. It is really the Bank of Canada and the Department of Finance in one corner and the labour unions and management in the other corner. The larger are the wage demands and the readier is business to grant them, the more must the Bank of Canada and government restrain spending, create unemployment and in that way eventually cool off wage demands and price increases.

You might well ask: is the Bank of Canada going to win that battle? Some people would argue that monetary policy has not been effective and will not be effective, Others are concerned about how long it will take to become effective. There is also much discussion about the chances of "over-kill" ---a phrase used to describe a depression induced by a policy misjudgment.

I have no doubt at all that if monetary policy remains restrictive long enough it will slow down inflation. The difficulty with monetary policy has been that it has only recently really become restrictive. Let me explain. Until last April the Bank of Canada permitted a relatively high rate of monetary expansion---amounting to a seasonally adjusted annual rate of about 13.6% in the first quarter of 1969. After that, increases were very small ---with recent increases accounted for largely by higher Government of Canada deposit

balances and not general public deposits. So using "money supply" as the criterion of tight money, we can say it began in April -- which is not all that long ago. If we use the criterion of bank loans, the appearance of tight money is even more recent. For a period after April the banks, by reducing their net foreign and other liquid assets were able to continue to expand their loans at a rapid rate. This process ended in July -- which is only four months ago. What if you use the cost of credit as the criterion of tight money? It is here where the most serious misconception exists, in my view. It is true of course that market interest rates have been rising with little interruption since the late summer of 1968. But that was also a period of inflation, and it is highly likely that the increase in interest rates to some extent atleast reflected not tight money but rather inflation. I will be more specific. I computed the annual average yield on a long-term Government of Canada bond for the period 1952 to 1968, and subtracted from it the annual average increase in the consumer price index so as to obtain some sort of "real" interest rate. I found this real rate to be 3.07% for the period 1952-1968, 3.04% for the period 1952-1960, and 3.10% for the period 1960-1968. Now remarkably enough, for the first ten months of 1969 it averaged 3.06%. So, incredible as it may seem, using the rate of interest adjusted for inflation as a criterion of tight money (and I am aware of the limitations of my procedure) we did not really have persistent tight money this year. Looked at in another way, any borrower who felt that current rates of inflation would continue on into the future would not logically regard market interest rates as being high. He would not argue that we had "tight money".

What about right now? The  $4\frac{1}{2}\%$  Government of Canada issue is yielding about 8.33%, while consumer prices are running about  $4\frac{1}{2}\%$  ahead of a year ago ---thus indicating for the first time in many months a very high "real" yield. Also, the consumer price index was no higher in October than it was in August. If by any chance this is the signal for a distinctly lower rate of inflation, then current interest rates would stand very

substantially above the level that could be explained by inflationary forces, and that could be sustained for long.

The implication of this is that in November we really have seen the emergence of tight money defined in terms of the level of interest rates adjusted for inflation. Furthermore, borrowers now face the very real possibility that future inflation will not offset fully the additional costs involved in current high rates for long-term money. Even a  $4\frac{1}{2}\%$  inflation rate in 1971 and 1972 would not seem to justify the  $4\frac{1}{2}\%$  issue selling at its current yield level on grounds of inflation alone.

Monetary policy in other words, seems finally to have created interest rate levels that are more than sufficient to offset current and prospective inflation. That, surely, is something that every long-term borrower should ponder most carefully. I think that if the Bank of Canada maintains its present degree of tightness there will soon be some break in inflation psychology.

This is just as well for I see looming ahead the possibility of a return of old fashioned demand pull inflation. Business capital spending, I think, will have to accelerate before long to meet medium term capacity requirements which, by the way, constitutes a strong bulwark against the dangers of "over-kill". There is urgent need for the Bank and the Department of Finance to break the cost-push cycle before that occurs.

Will the Bank of Canada persist with restraint even if this means more unemployment in the short-run? I of course, do not know. I am certain that we will all be scrutinizing the Bank's weekly statistics most carefully. But in the mean time we should be aware of the strong possibility that restrictive policy, by reducing the rate of expected inflation would actually lead to lower interest rates, more settled capital markets, and more employment; whereas a policy of monetary ease, by increasing the rate of expected inflation, might well lead to more unsettled capital markets and more unemployment.

In this crazy world of paradoxes the possibility should not be discarded that tight money leads to lower interest rates and easy money to higher ones.

Young people use the expression---"Tell it the way it is". I only wish that our official and semi-official authorities would do the same, so as to inform rather than confuse the people. I wish, for example, that the Minister of Labour would stop congratulating himself on achieving wage settlements that have a strong inflationary content; and that he would raise publicly the possibility that some settlements, by necessitating stronger monetary restraint, might actually hurt other workers. I hope the Minister of Finance will spare us taking public pride in the huge sale of Canada Savings Bonds; and worry instead about the flight into demand money that it represents, and about the slow death of the long-term bond market. I hope the Economic Council of Canada can do what has to be done to permit it to stop writing "weasel wordy" generalizations when dealing with inflation, tight money, excessive wage increases and monopoly price behaviour in <sup>its</sup> annual reports. I fervently hope that the reports of the Prices and Incomes Commission will deal effectively and candidly with short-term stabilization problems.

Just possibly, if the public understands the way it is, the country will become more nearly the way we want it to be..