

INFLATION AND BUSINESS INVESTMENT

Remarks by J. Douglas Gibson at the Canadian Club
of Toronto, January 13th, 1975

Inflation is a tiresome and pervasive subject. But like some monumental bore, it simply won't go away. We do not seem to have found any acceptable means of getting rid of it or of escaping from it. Yet we do know more or less why it happens, and we are beginning to realize that high rates of inflation and a good society are not compatible.

Inflation, while it works through the economic system, is a social problem which can only be overcome by political means. The principal reasons that we and most other western countries have failed so dismally in taking the measure of inflation lie in our social and political attitudes and in the expectations related to them. To paraphrase a great statesman, never has so much been expected by so many for so little, and this applies to the so-called rich industrial countries as well as to the poor nations. As a CBC program on inflation put it recently "We want it all and we want it now." We want more welfare, free medical services, better housing, more gadgets, more luxuries and we don't want to wait for them. We are consuming relatively more and investing relatively less. And the inflation itself aggravates the process by making spending more attractive and saving unattractive.

Inflation is a world-wide problem. Apart from the authoritarian communist countries, and some of them have a little difficulty with inflation, the disease varies only in degree. It is

a problem of excessive expectations translated into policy by political action. The way to get elected is to attract the marginal voters by giving them more of what they want, and this usually turns out to be higher social benefits, new welfare approaches, more housing, and so on. Demands have increased very notably.

When it comes to the ability to provide the added goods and services demanded, there is considerable evidence that the will to work has declined - the work ethic is not as widely accepted as it used to be. Moreover, the need to work has been reduced by the development of welfare systems which in Canada and some other countries have substantially lessened the economic disadvantages of not working. So we are caught by social and political forces which are highly favourable to inflation: we want more soon, we think we can get it through our political system and we don't want to work as hard.

Controlling Inflation by Money Supply Superficial

So when someone says that inflation can be readily overcome by restraining the increase in the money supply, one cannot help but feel that the approach is a bit superficial. It seems to imply that there is no great problem of controlling the money supply. Of course, inflation does result from the creation of too much money in relation to the goods and services available, and the logical answer would seem to be to slow the creation of new money. Such a policy would in fact work if it were applied firmly - used alone it might be a painful cure, but it would work. But how can a central bank which does not have sovereign power adhere to such a policy unless government supports it?

Many of you will remember that a Canadian central banker did try to pursue a policy of monetary restraint in opposition to government and this at a time when the inflation problem by present standards was quite mild. He had to retire.

There is no escaping the fact that monetary policy will be influenced by government policies. This is particularly so if government is running a deficit and interest rates are rising and money tight. The central bank simply cannot ignore the government's needs. It is, after all, the government's agent in managing the national debt. A central bank can help to fight inflation, but it won't get far if fiscal policies and exchange rate policies - both responsibilities of government - are not co-ordinated with monetary policy.

What this boils down to is that government has the final say, and this also means the final responsibility. You might say that the answer to inflation therefore is to check government spending and now we are getting closer to the truth. - I really don't think that policies to overcome inflation will have any credibility unless government sets an example and, despite all the talk about inflation, what an example our governments have been setting! Federal outlays are up 110% in five years, and this leaves out the subsidies paid to keep down petroleum prices. Provincial outlays are up just about as much. The new federal budget puts expenditures for the next fiscal year up another 16% which, while not as sharp a rise as that which is occurring this year, is still significantly above the expected rate of inflation. From 1969 to 1974 the proportion of the national expenditure passing through government hands has risen from 34% to 39%. It could be 40% in 1975.

You will observe that I am talking about the growth of government spending - not about government deficits. Deficits in good times are, of course, inflationary, though in a recession they may be unavoidable and indeed necessary. What is of fundamental concern is the huge and rapidly growing presence and activity of government in the economic system. A good many years ago an economist, Colin Clark, suggested that the economic system would begin to creak and groan when the proportion of a country's national income going through governments' hands passed 25%. We are far beyond that but the machinery is creaking and groaning. Relationships change and the old 25% may not have any present validity. But it is evident that for our economy 40% is too high.

Is Government the Villain?

But before we reach the self-righteous conclusion that we have found the villain, we might ask ourselves whether we would re-elect a government that seriously tried to check inflation - that for the time being closed the door on new welfare programs, that did not give strong support for new housing, that generally ceased to initiate new programs for the support of consumption; that in the corporate area kept taxes down, continued fast write-offs, did not tax inventory write-ups, and gave some encouragement to the resource industries in contrast to the recent restrictive policies; and that in addition made a major effort to rationalize existing programs, to remove those no longer needed and to generally reduce staff. This is really what we are talking about - stopping the increase in governments'

share of the national income, much of which is enlarging consumption and shifting resources away from investment in future production and welfare. Inflation could be lessened and perhaps gradually overcome if government felt it would get the necessary political support to go for a more productive and efficient economy in future at the cost of some restraint in consumption and of some economic dislocation now. The process would not be painless.

There was a bit of this in the last budget; in my view not nearly enough. There was some encouragement to saving in the \$1,000 tax free provision for interest receipts, which is later to be applied to dividends. There was encouragement to part of the corporate sector in retaining the 40% tax rate and the fast write-offs, measures which are decidedly helpful in an environment where the capital markets are expensive and accessible only to the strong. On the other hand, the resource industries face a tougher tax environment which, when combined with provincial measures, could be taken to indicate that Canada is not concerned if these industries are unable to respond to a rising world demand. And there is no overall expenditure cut; even allowing for further inflation of 10% the real rate of expenditure will be up significantly.

Gentle Attack on Inflation Won't Work

Federal policy now seems to envisage the defeat of inflation in a very, very gradual way - in a way designed to avoid major political risks and to see that adjustments are made gently. The Economic Council of Canada developed this idea of a gradual and smooth trajectory into a non-inflationary world some years ago.

It is the sort of thing that might make sense in space technology or some rarefied scientific endeavour. But not in politics and economics, not in the disturbed world in which we live. If we don't steer a decisive course, events along the way will push us around until about all we are doing is trying to protect ourselves from the day-to-day crises, and, you know, that is just about what we are doing now.

There was an obvious conflict in the federal budget between the desire to do something about inflation and concern about the developing recession. Any serious program to reduce inflation obviously involves restraint - basically it involves restraining increases in consumption and government programs encouraging consumption. But an effective anti-inflation program at this time also has a positive side, that of encouraging saving and investment - saving because it is postponement of consumption and will provide the resources to finance real physical investment. Physical investment will, in turn, add to production and lessen inflation later, and in the interval will create employment and promote economic recovery. In other words, a program to reduce inflation today involves a shift from consumption to investment which will support the building up of productive capacity to combat inflation tomorrow.

The truth is that we are now faced with a turning in the way. We are in a developing recession which so far is mainly an inventory readjustment reflected in and aggravated by the decline in the world prices of a number of basic commodities. The weaker world market for some of our export products is also having an impact on income, though the accumulated effect of

the earlier sharp increase is still supporting consumption. Housing and automobiles, after several very good years, are sharply off and high interest rates have complicated the housing problem.

Inventory Recession Must Not Turn into Investment Recession

It is important at this stage that the inventory recession does not develop into a recession in business investment as well. In such circumstances, we should have a much more difficult kind of business recession on our hands. If we go ahead now or soon with the standard procedure of trying to bonus consumption through more welfare and other government spending and of pumping more money into the system, we shall not make much progress in overcoming inflation which is the main element undermining investment. Too much consumption supported by government spending is at the heart of the inflation problem and pumping more money in simply lays the groundwork for a later and perhaps more severe wave of inflation. In addition to that, the government spending-monetary expansion program has lost its credibility. Everyone knows, or thinks he or she knows, it will bring on more inflation, so the capital markets, the workers, the businessmen and the public and the politicians will behave accordingly and we shall, in all probability, move toward a more critical situation.

Inflation Undermining Profits

If we try to overcome the developing recession by more government spending and by more money, the risk of a decline

in business investment could well be increased. If many business investment plans are cancelled or postponed the expected recovery in the second half of this year might also be deferred, or it might lack the follow-through which is needed. We face a situation in which the private sector may not be able to build adequately for the future. Inflation is undermining the ability of business to save and to raise long-term funds and to make long-range plans. The popular view that business profits and retained earnings have been increasing rapidly is simply not correct, though the crude dollar figures certainly support it. - Using a calculation made by the Conference Board in Canada from the official statistics, comparing the second quarter of 1974 with the same quarter of 1973, we find that a nominal increase in profits of 40% turns into a decline in real retained earnings of 10%.

Why are the nominal figures so wrong that they suggest conclusions and policies which are totally inappropriate, such as the profits surcharge in the budget? Well, in the first place, they include large amounts of book profits resulting from inventory write-ups; "profits" which are part of working capital and not available for capital expansion. If profits are adjusted for inventory write-up the gain over the year becomes 26% instead of 40%. Then taxes must be deducted, taxes which are swollen by "profits" on inventories and inadequate provision for depreciation. This adjustment brings the profit increases down to 14%. Then we have to allow for the twin facts that money is worth less over the year and depreciation should have been increased to allow for higher replacement costs. When

you make these adjustments, it turns out that real retained earnings are about 10% less than a year earlier.

It would seem that only the businessmen who are wrestling with these facts and the Conference Board which made these calculations have any real idea of what is going on in this area. A considerable part of the public, or so it seems from the media, calls for profiteering investigations and controls and additional taxes. Government listens sympathetically even though their own statistics make mockery of the public impression and show clearly that the proportion of the national product going into business investment is declining. The irony is increased by the fact that we depend upon a heavy flow of business investment to get the production which we need to lessen inflation and to cover the heavy deficit that is developing in our external payments.

The other source of funds for business investment is, of course, the capital markets whose health is anything but robust though, unlike those of England, they are still alive. Individual investors, institutional investors and pension funds - most of those who control financial resources - take a dim view of the outlook for Canadian corporations in an inflationary society. They suffer no illusions about the "excessive" earnings of business and they know that the real internal resources of corporations for investment in 1975 will decline again. U.S. investors are no more pleased with their own or with our prospects - the last story I heard about the New York stock market was - What's the difference between the sinking of the Titanic and the present market? - Answer: They played a band when the Titanic went down.

Capital Markets Still Alive, but Barely.

The fact is that it is very difficult to borrow long-term and even the strongest have to pay high rates of interest. The expectations of stronger bond markets, while confirmed for a while in the late fall, have weakened and faltered recently. Borrowers who have not high credit ratings cannot raise money at all. Equity issues are even more difficult to float and extremely expensive. It is hard to avoid the impression that we are in the sort of position in which Britain found herself a few years ago and which has now led to the virtual extinction of the long-term capital market. It is a sorry day when business has to depend on short-term funds to finance long-term investment and one in which there are great dangers.

I don't suppose it is necessary to remind the members of the Canadian Club of Toronto that the unhappy state of the capital markets resulting from expectations of continued inflation has other unpleasant ramifications. Most important of all is their effect on business investment on which I have dwelt. But don't forget the effects on pension funds in connection with which some of you, like myself, have responsibilities. What kind of a world is it when investment in high-grade bonds has been a losing proposition for twenty-five years, when common stocks, including dividends and capital appreciation, have yielded very little over the last eight years and large losses in the last two, and when short-term money rates are less than the current rate of inflation? It has become a world in which preservation of capital is what most long-term investors must strive for. This again is another way of saying that the capital markets are in trouble. If few investors want to buy

bonds or equities for long-term investment, how does the business sector get the resources it needs?

Must Encourage Business Investment

To sum up, what I am trying to get across is that it is urgently important that we understand the need to revive and encourage business investment. This means removing tax discouragement to the resource industries where exploration is declining rapidly with unfavourable portents for mineral development and output some years ahead. It would be a sad commentary on our capacity to plan if by 1979 or 1980 we found our production of fuels and metals running down at a time when we needed more ourselves and world demand was strong and growing.

Some of you will remember the Paley Report of the early fifties which quite accurately foresaw the growing needs of the United States a couple of decades ahead. The same sort of comment can be made today about the whole world, looking ahead another twenty or twenty-five years. It is surely common sense, and, indeed, our responsibility, to develop the kind of resources with which we are well endowed. Sitting on them simply will not do. It can appear to be a hold-up job; witness the developing feelings toward the Arabs, or it may turn out to be ill-advised if new technologies make possible more efficient alternatives to the development of the sort of low-grade resources of which Canada has plenty.

Serious Anti-Inflation Program the Key

Above all, the revival of business investment depends on a

really serious anti-inflation policy, the core of which simply has to be stopping the growth of the government sector. No new programs, no increases in existing programs, limits on employment are some of the things that need doing. If one of our approaches to the problem of government spending was from the point of view of the number of employees, it might be effective. Ceilings on the number of employees in particular areas and overall could be set at current levels, reducing say every six months by 1% to 2%. This policy would gradually have a real effect and could be carried out entirely through attrition with no general dismissals.

If government developed a serious anti-inflation policy centering on stopping new activities and improving the efficiency of the old, then measures to encourage saving might be effective. In such circumstances, a flat percentage cut in the personal income tax would make sense, and a straight percentage reduction across the board would be appropriate, unlike the modest reduction in the recent budget which is limited to a small maximum dollar figure and therefore makes funds available mainly to those who will spend them rather than save them. But without a determined attack on inflation, tax reductions would be worse than useless - they would add further to spending and little or nothing to saving and thus increase inflation.

In terms of its physical and human resources, Canada is one of the most favoured countries on earth. Despite this, we have a high rate of inflation, a bit better than Britain, about the same as the United States and considerably worse than West Germany. Though we are more or less in balance on petroleum products and are a major producer and exporter of foods and

industrial materials, we are running a large and rising deficit in our current account balance with the rest of the world which means we are going further into debt abroad. Business investment is not on a sufficient scale to provide the growing production needed in future.

Recent Performance Will Not Do

If we want to enjoy a decent standard of living in the years ahead and to play a responsible part in the world, this performance will not do. We shall have to grow during the rest of this decade. We shall need more fuel, more food, more industrial materials and more manufacturing industry. If the private sector is not able to do the bulk of this job because of inflation and government policies, then there will be increasing pressure and temptation for government to move in. The question would then become whether a government bureaucracy could take over in a few years and make as effective and productive decisions as the price system. There is nothing in the record of recent times that suggests this is likely and a great deal that suggests the contrary. We could lose our efficiency and even our freedom during this exercise.

I would not want to leave you with the impression that our problems are open to a ready solution. At this juncture of history, they may not be subject to solution at all, and the fact that most of our friends have the same problems is not reassuring. Yet, I do believe we can do better than we have been and better than other countries including the United States. I am sure we are unnecessarily aggravating the inflation by putting so much emphasis on government spending and consumption.

and so little on investment. We are not engaged in a government versus business argument. We need strong government leadership because strong leadership will not and cannot come from anywhere else. Government does and must accept a degree of responsibility for the business climate. Businessmen must respond to the economic opportunities and respond responsibly - they should build and make profits and plough them back and build again. But the price system or the profit system, whatever you wish to call it, works through incentives and the incentives have been dulled by inflation and deliberately dulled again by government. We should do well to let the price system work.

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