

last two years, unemployment stood at about 7.5 per cent. In 1980, real GNP rose by only 0.1 per cent, the worst performance since 1954. In that same year, housing starts in centres of 10,000 population and more fell to 125,013 units, compared with an annual average of 184,208 in the 1970s. Last month, housing starts stood at 168,000 units, on a seasonally-adjusted annual rate basis, compared to more than 209,000 in 1976, when the rate of inflation was relatively low. In the last three quarters of 1980, and in the first quarter of 1981, capacity-utilization rates in manufacturing industries were below 80 per cent. Our merchandise trade surplus, which was exceptionally high, on a seasonally-adjusted basis, in the last quarter of 1980, dropped by about \$1 billion to \$1.7 billion in the first quarter of 1981. In March 1981 industrial production in Canada and in the U.S. had not yet reached its previous cyclical peak level of October 1979.

In spite of these figures, it is true that the Canadian economy is now on the road to recovery, but forecasters claim that the increase in real GNP will not exceed 2 per cent in 1981, which compares favourably only against the very poor performance of 1980.

The conclusion to be derived from these observations is obvious: contrary to the views expressed by the Bank of Canada, the rapid rise in prices experienced in recent years cannot be explained by an overheated economy and strong demand pressures. More generally, while I recognize that demand-pull inflation has occurred during rather brief intervals in the last 35 years, I claim it cannot account for the accelerating long-term trend of rising prices that has developed, more particularly since the late 1960s.

Supply-Push Inflation

Many economists who do not accept the conventional wisdom have identified another type of inflation, which they have described as cost-push or supply-push. It can be defined as an increase in consumer prices resulting from cost or profit increases generated by the exercise of monopoly power or, more generally, by a regime of administered prices. This concept is not new. It was used, for instance, by Fritz Machlup in an article entitled "Another View of Cost-Push and Demand-Pull Inflation" published in 1960. Professor Machlup, who is of Austrian origin and has taught in the United States for many years, stated:

I believe that for an explanation of the consumer-price inflation from 1945 to 1948, and from 1950 to 1952, the basic model of the demand-pull inflation does as well, or better than, any of the other models, simple or complicated. On the other hand, for the period 1955-59, . . . I am prepared to regard the consumer-price increases of these four years as a result of cost-push inflation.

It is surprising that the phenomenon of supply-push inflation has not yet been more widely recognized. Microeconomic theory since Adam Smith has shown that, contrary to the abstract model of perfect competition, individual suppliers of goods and services enjoying a monopolistic position, or members of a cartel arrangement, can disrupt the free market

mechanism and can, for instance, increase their prices even without a rise in demand, especially if those suppliers are prepared to reduce production and employment. The automobile industry, we all know, goes on increasing its prices, reacting to a fall in demand by cutting production. Three-year labour contracts provide for rising wage rates and cost-of-living adjustments irrespective of demand conditions. Cost-plus and mark-up pricing are widespread practices in the retail business and in other sectors of the economy.

The postwar period has witnessed the accelerated rise of monopolistic power, often supported by government policies, and the diffusion of practices enabling suppliers to control their prices at least within a certain range. Industrial concentration intensified throughout the period, but has accelerated in recent years. The trade union movement became much stronger. Marketing boards and government stabilization programs have multiplied to strengthen the position of agricultural producers. OPEC and other international cartel arrangements have deeply changed the market structure of various commodities.

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Demand-pull inflation is cyclical and, therefore, temporary. Supply-push inflation is structural and, therefore, when it appears, is permanent, unless, of course, the structure of the economy is changed. That is why this second kind of inflation is so worrying. Because it pushes prices up and restrains production and employment, it is the only type of inflation that is compatible with a stagnating economy. Indeed, it is an important cause of stagflation. I claim that it has been the main culprit, rather than demand-pull inflation, during most of the 1970s. This is still true today. In my view, therefore, the Governor of the Bank of Canada has been making and is still making the wrong diagnosis of our price situation when he persists, as he did in his recent annual reports and again when he appeared before the Standing Senate Committee on National Finance on May 26, in describing that situation as demand-pull generated by an overheated economy. He said before the Senate committee:

I think the economy is not that far off being as close to potential as it should be. There are some weak spots . . . If you take that out you will find that the economy is very hard pressed in many areas of the country.

With such statements, as the bank continues to apply the wrong remedy, it is in serious danger, in my view, of completely losing its credibility.

Current Monetary Policy and the Two Types of Inflation

Before assessing in greater detail the soundness of the bank's current policy in the context of the domestic economy, it is useful to recall how monetary policy, in general, operates to influence economic activity and its price parameters. Monetary policy is designed to influence aggregate demand or over-all spending. It can do so, however, only by affecting new domestic borrowings and savings. A tight money supply can reduce the flow of new funds needed by potential borrowers. High interest rates increase the cost of new borrowings but can