# Report of the Standing Senate Committee on National Finance on

# GROWTH, EMPLOYMENT AND PRICE STABILITY



Chairman
The Honourable Douglas D. Everett

Deputy Chairman
The Honourable Hartland de M. Molson

Third Session
Twenty-Eighth Parliament

1971

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Report on growth, employment and price stability.

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# ORDER OF REFERENCE

On April 28th, 1971, the Senate resolved:

That the Standing Senate Committee on National Finance be authorized to examine and report upon the question of methods by which fiscal and monetary policy in Canada may be exercised to achieve full potential growth and employment without inflation; and

Notwithstanding Rule 83A, that the budget approved by the Standing Committee on Internal Economy, Budgets and Administration and printed in the Minutes of the Proceedings of the Senate of 18th March, 1971, for the proposed expenditures of the said Committee on National Finance with regard to its examination of the Estimates laid before Parliament for the fiscal year ending 31st March, 1972, be applicable as well in respect of its examination of the said question of fiscal and monetary policy in Canada.

## Members of the
## STANDING SENATE COMMITTEE ON NATIONAL FINANCE

*(as at 1st October, 1971)*

The Honourable Douglas D. Everett, *Chairman*
The Honourable Hartland de M. Molson, *Deputy Chairman*
and
The Honourable Senators:

| | |
|---|---|
| Aird, J. B. | Laird, Keith |
| Beaubien, L.P. | Langlois, L. |
| Benidickson, W. M. | Manning, Ernest |
| Bourget, M. | *Martin, Paul |
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| Isnor, G. B. | Walker, D. J. |

*Ex officio Member

NOTE: The Honourable Senator J. J. Kinley
Retired—June 12, 1971
Deceased—August 23, 1971

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# CONCLUSIONS AND RECOMMENDATIONS

**The Canadian economy can achieve its full potential growth and the goals of our society without recurrent bouts of unacceptable unemployment or inflation. This report recommends policies to achieve these results.**

**The recent economic moves of the United States will have major effects on the Canadian economy. While as a result there may have to be short-term Canadian policy reactions different from our recommendations, this does not invalidate the basic idea of a properly conceived policy to provide maximum long-term stability.**

**For example, if the United States were to employ more and more stringent wage and price controls over an extended period of time, it is quite possible that Canada would be forced to invoke its own controls. However, this possibility does not cause us to change our conclusion that direct wage and price controls are the least desirable of all economic stabilization tools.**

**Because economic stabilization is a complicated subject we think it wise to provide the reader with a summary of conclusions and recommendations, but we would strongly urge that the full text be examined before highlighting any particular aspects.**

*General*

**1. Even though the Canadian economy is very open to the influences of the world economy there is still significant room for the purposeful management of national economic stabilization policies in Canada. (Page 2)**

**2. There is no simple solution to the problem of economic management, but government does possess powerful policy tools for stabilizing the growth of the economy and important improvements can be made in the use of these tools. (Page 1)**

**3. While government must assume a major role in economic management, the bulk of productive and distributive activity should be carried on by private enterprise units operating in the freest and most competitive possible markets and responsive to consumer demand and the profit motive. (Page 3)**

**4. Keeping the government sector of the economy from growing unduly large should be regarded as an important problem in its own right, distinct from the problem of economic stabilization. (Page 3)**

5. While new forces are obviously at work in our society, the main problems of economic stabilization are still economic in nature. They do not appear to be the result of major sociological changes requiring completely new policy instruments. (Page 4)

*The Goals of Economic Policy*

1. While we do not endorse the concept that "growth for growth's sake" is necessarily good, we favour economic growth which will lead most efficiently to achieving the goals of our society and which will employ our exceptionally fast growing labour force. (Page 7)

2. We endorse the performance goals of rapid and sustained growth; high employment; reasonable price stability; a viable balance of international payments and an equitable distribution of rising income, not as ends in themselves but as means of realizing the longer term achievement goals of humanity such as eliminating poverty, improving health, protecting the environment and making cities more livable. (Page 8)

3. Society must determine what achievement goals it desires in relation to the resources available or risk over-committing our resources with serious effects on economic stability. In order to do this the public must know the extent of the resource pool available; how much of these resources should be devoted to current consumption and how much to capital investment; and how much of our resources are required to meet important goals. (Page 9)

*The Monetary Fiscal Levers*

1. The three big levers of monetary, fiscal and exchange rate policies remain central and indispensable in stabilizing the Canadian economy. (Page 13)

2. The Bank of Canada cannot operate monetary policies on the basis suggested by some monetarists. It must be concerned with such important matters as interest and exchange rate levels, liquidity and the financing of federal government debt. However, it should give more relative emphasis to steadying the growth of the money supply and it should guard against a tendency to be overly reactive to short term indicators. (Page 15)

3. Coordination of fiscal and monetary policies and close cooperation between the Department of Finance and the Bank of Canada in the exercise of these policies are essential. (Page 19)

4. The use of fiscal policy should lean more to adjustments in taxes than adjustments in government expenditures. Despite "tax shifting", (the treating of taxes as transferable costs) tax changes remain a highly effective means of stabilizing the economy. (Page 20)

5. In containing a boom, increases of direct taxes (income taxes, etc.) are more effective than increases of indirect taxes (sales taxes, etc.). But in

**stimulating a weak economy that is still suffering from lagged price increases, decreases of indirect taxes are more effective than decreases of direct taxes. Account should be taken of this in deciding which particular taxes to change for stabilization purposes. (Page 20)**

*Exchange Rate Policy*

**1. Every effort should be made to retain for Canada a floating exchange rate. The rate should, moreover, be able to move up and down in relation to the U.S. dollar as well as to other currencies. (Page 24)**

**2. The floating exchange rate gives Canadian economic stabilization policy a very valuable additional dimension of adjustment. It provides a means of securing a modest and partial, but nevertheless welcome degree of insulation from unfavourable developments in other countries. (Page 25)**

**3. A floating rate does not solve the fundamental economic problem of unlimited needs and limited resources; it is not an open licence to inflate, to export unemployment or otherwise to run the Canadian economy as if the rest of the world did not exist. It may not produce an economic climate that is totally independent of developments abroad. However, it can help to some degree to stem imported inflation and give Canadian policy-makers more scope for dealing with domestic economic problems. (Page 25)**

**4. Even when we have a floating rate it would not be realistic or desirable for Canadian policy makers to leave the rate completely alone. There are times when events will call for exerting an influence on the level of the rate by monetary and perhaps other policies. (Page 27)**

*Lags*

**1. It takes time to collect and interpret statistics. It takes time to implement the appropriate policy response. It takes time for the policy to have its effect. Recognition of these time lags is of fundamental importance in the successful operation of monetary, fiscal and exchange rate policies. (Page 29)**

**2. Lags make nonsense out of attempts to "fine-tune" economy with these blunt instruments. (Page 29)**

**3. Recent research indicates that these lags are even longer and more variable than was previously thought. Canadian economic policy has not taken adequate account of lags, nor are the existence and significance of lags sufficiently known to Parliament and the general public. (Page 30)**

**4. We recommend the following methods of dealing with policy lags:**

**a) More funds should be directed to research into the problems of policy lags and into the development of earlier and better statistics. (Page 31)**

b) Policy should be conducted in accordance with the three rules of lags:

First Rule: Policy should not try to offset short-term wiggles in the economy; it should focus on dealing with larger and more prolonged deviations of the economy from its potential growth path. (Page 32)

Second Rule: If policy is to be timely and effective it must often move on a medium-term forecast and a balance of probabilities rather than on iron-clad certainties. (Page 32)

Third Rule: If a medium-term forecast and its associated policy turn out to be wrong, the logic of lags calls for a prompt policy revision. Expenditure of precious time on justifying earlier decisions is not constructive. (Page 33)

c) There should be a search for new short-lag policy instruments such as anti-inflationary contingency devices for the control of revolving credit plans. In this same general connection we endorse the practice of "mini-budgets". (Page 33)

d) It must be recognized that government's most powerful instruments for managing the economy (monetary, fiscal and exchange rate policies) are subject to long time lags and therefore should not be used to produce instant solutions to instant problems. No effort should be spared to convey this truth to the public. (Page 33)

*Expectations*

1. Psychological expectations are also an important problem affecting economic policy. Policy-makers cannot prevent people from forecasting the economy generally but they can reduce the tendency of people to become overly concentrated on trying to forecast short-term movements in economic policy. (Page 34)

2. Policy-makers therefore should pay particular attention to public expectations generated by their own policy actions. If short-term deviations in policy from a longer term strategy are necessary they should be fully explained. (Page 36)

*Rules*

1. As a broad but valuable discipline and protection for sound fiscal policy the Federal Government should adopt the concept of high-employment budgeting, at least to the extent of always estimating in budget presentations what the budgetary position would be at high employment and of analyzing reasons for changes in the estimated figures since the previous presentation. (Page 37)

2. No simple policy rule such as money-supply expansion rule can be applied to the Bank of Canada, but the Bank needs to develop improved techniques for evaluating, reporting and accounting for its actions. (Page 39)

*Trade-offs and Operational Goals*

1. As between the economic policy goals of high employment and reasonable price stability, Canadian policy-makers face a trade-off dilemma. (Page 46)

2. The trade-off dilemma in stabilization policy should be frankly recognized and this recognition made the basis for developing a more effective long-range strategy against inflation. (Page 47)

3. Although our goal must be full employment, effective policy making in the context of a trade-off problem requires the setting of realistic interim operational goals for the Canadian economy. The Federal Government should commit itself to moving the economy, over some reasonable time period, from the present position where unemployment is in the general neighbourhood of 6% to 7% of the labour force (seasonally adjusted) to a position where unemployment is no more than a range of 4% to 4½% of the labour force. (Page 49)

4. Economic stabilization policy should include proper protections for those Canadians who suffer from less than fully satisfactory performance of the economy. For the unemployed there should be adequate unemployment insurance and unemployment assistance—the latter ultimately developing within the context of broader programmes for ensuring minimum incomes while retaining appropriate work incentives. (Page 51) (See Chapter VII and the next section of this Summary for protection of pensioners against inflation, and for other anti-inflationary safeguards).

5. Meanwhile work should go forward on regional, manpower and other supply and structural policies capable of reducing the policy trade-off problem in the longer run. (Page 52)

*Controls—Guidelines and Other Policies*

1. While we advocate one very special kind of incomes policy for Canada we are in general deeply skeptical about most varieties of controls, guidelines and incomes policies. Their historical record of effectiveness against inflation is poor, and they pose important threats to personal freedom and economic dynamism. They also tend to divert attention from more effective anti-inflationary policies. Problems of public acceptability alone would militate against selective wage/price controls. The control system would likely be either general in its application or a largely meaningless gesture. Controls are one of the least desirable of all economic price stabilization tools. If they are used at all in peacetime it should be on a short-term emergency basis. (Page 53)

**2. If there is a strong national consensus which includes the major interest groups an incomes policy based on general guidelines might be used as an auxiliary to the big levers of fiscal, monetary and exchange rate policies to bring about a short-term psychological adjustment towards a less inflationary climate. However no substantial or long-term reliance should be placed on such a policy. (Page 61)**

**3. We recommend that the Prices and Incomes Commission identify and focus the glare of public attention on situations where price or wage increases occur that are out of line by any reasonable standards. When the structural flaws or other special circumstances have been uncovered that permitted groups to hurdle the barriers of normal market restraint there should be action to keep increases within more acceptable boundaries. If such steps as the removal of tariff protection or of restrictions on the entry of new workers into particular trades would improve matters, these should be recommended to government. (Page 62)**

**4. We do not believe that this spotlighting function need be based on general guidelines. Rather, in light of our medium-term unemployment goal we believe that spotlighting as well as monetary, fiscal and exchange rate policies can be directed towards a reduction of the annual increase in the Consumer Price Index to a medium-term goal of between 2% and 3%. (Page 63)**

**5. For pensioners vulnerable to inflation there should be full adjustment of Old Age Security pensions and of payments from the Canada and Quebec Pension Plans for rises in the Consumer Price Index. (Page 63)**

**6. The three big levers of monetary, fiscal and exchange rates policies primarily focus on the demand side of the economy. They must be complemented by supply and structural policies (such as manpower and competition policies) which encourage growth in the supply of goods and services and which channel resources into their best use. Since these policies act to improve trade-off over the longer term, they should receive heavy emphasis in our economic stabilization strategy. (Page 65)**

*National Policy Making in a Regional Country*

**1. The possibilities of a regionalized monetary policy to assist the development of economically lagging regions are very limited. However, because of Canada's centralized banking system there is some opportunity to exert moral suasion on the chartered banks to adjust their lending policies in favour of such regions thus altering the impact of monetary policy on these regions. (Page 70)**

**2. The possibilities of a regionalized fiscal policy are much greater than for monetary policy especially since the problem of leakage (the tendency of funds to flow freely from region to region) appears to be less acute**

**for fiscal than for monetary policy. Since fiscal policy is a tool used by provincial governments as well as the federal government, improved intergovernmental arrangements for consultation and coordination are required. (Page 70)**

**3. We urge the federal government to intensify its exploration of how much of its decision making and administration now centralized in Ottawa could be done just as well elsewhere. We urge it to set an example in this matter, and attempt to influence national corporations to examine their management structures in the same light and seriously consider regional decentralization. (Page 71)**

**4. We recommend that service industries, whose relative importance in the economy has grown very rapidly, should be more emphasized in regional development policies. (Page 73)**

**5. Federal government purchasing activities should be examined to ensure that they do not discriminate in favour of the central provinces. Consideration should be given to means of reducing the barriers created by the higher transportation costs of potential suppliers outside the central provinces. (Page 73)**

**6. The best regional development policies that man can devise will be of little avail unless national economic policies are sound and purposeful. This is especially true of national policies to achieve good employment performance. (Page 74)**

***Management for Decision Making***

**1. The Economic Council of Canada is admirably fitted by virtue of its expertise and its representative character to perform the important task of examining and reporting on the cost-benefit implications and of suggesting the priority ranking of major achievement goals in relation to our available resources. (Page 78) (The Method of operation of this function is outlined in Chapter II of this Report.)**

**2. The Prices and Incomes Commission should become a federal-provincial body concentrating on identifying and publicly spotlighting price and wage increases that are out of line by reasonable standards. Its recommendations for removal of the circumstances that made it possible to hurdle the barriers of normal market restraint could then be made to the appropriate government. (Page 79) (The Method of operation of this function is outlined in Chapter VII of this Report.)**

**3. We recommend the formation of a Commission for Economic Analysis charged with the responsibility of producing short term forecasts and analyses of economic performance. It should be composed of professional economists not representative of any special interest group, who are ap-**

**pointed for a three year term. The commission should be financed by the federal government and be independent. (Page 79)**

**4. Parliament and Parliamentary Committees should be given a more significant role in economic policy making. The reports of The Economic Council of Canada and The Commission for Economic Analysis should be made to the Privy Council for submission to a Standing Committee of Parliament. Hearings should be held on these reports at which the appropriate Ministers and their officials as well as other witnesses would testify. The Parliamentary Committee should be provided with adequate staff. (Page 79)**

**5. Because of differences in government structures we do not believe that a body similar to the President's Council of Economic Advisers in the United States should be set up in Canada. (Page 80)**

**6. Our economic information should be improved in certain areas. Therefore, we recommend:**

**a) That Statistics Canada be given the support necessary to provide more current, more precise and up-to-date statistics as well as wholly new statistics. (Page 81)**

**b) Improved methods of exchanging economic research and analysis. (Page 82)**

**c) New publications such as a comprehensive Quarterly Economic Review and a Business Conditions Digest. (Page 82)**

**7. We believe that a new openness should be brought to the process of economic policy making in Canada. This means that the direction of important government policies and the impact they have on the Canadian economy should be systematically estimated before and after the event. It means too that Parliament and the public should be told more about these policy evaluations and about the processes of economic decision-making. (Page 83)**

# INTRODUCTION

This Report is about economic stabilization policy in Canada. In other words, it is about the branch of modern government policy that tries to keep down unemployment and inflation, and to hold the economy close to a "potential-path" of steady and otherwise satisfactory growth. In the course of treating this branch of policy, the Report necessarily touches upon a wide range of other government policies—foreign trade policy, regional development policy, social development policy, manpower policy, competition policy, and many more. But the problem of how governments can act to bring about a steadier and less interrupted expansion of the Canadian economy is the central topic.

For some time, it has been recognized that the performance of the Canadian economy has been unsatisfactory. Growth has been too slow and hesitant, and unemployment and inflation have been too high. Canadians have been getting, to some extent, the worst of both worlds. The experience has been painful to the direct victims of joblessness and uncompensated price rises, and has been disturbing to every thoughtful citizen.

To be sure, these developments must be seen in a proper historical perspective. The Great Depression of the 1930s has not recurred, and if inflation has sometimes accelerated in a very troubling way, it has never come close to the "uncontrolled" or "runaway" condition feared by some. The Canadian economy has performed remarkably well in many ways over the last two and a half decades, and it is in part because of the rising expectations engendered by this performance that the recent situation is considered unsatisfactory.

But unsatisfactory it is, and something can and must be done about it. There are many broad, economy-wide reasons for regarding recent rates of unemployment and inflation as unacceptable and for moving purposefully to reduce them. In addition, however, there are more particular human reasons that should carry still greater weight. Even under improved arrangements for unemployment insurance and unemployment assistance, unemployment for most Canadians directly affected by it means a drastic fall in income, and—what is often more damaging in the long run—a loss of confidence and self-respect. Irrespective of much useful intellectual speculation and fashionable conversation about the increasingly leisured character of advanced industrial societies, the work ethic still has a psychological hold on most Canadians (especially those with dependents), and while this has many desirable economic consequences, it also has very bad effects on people subjected to long or frequently repeated bouts of involuntary unemployment. Meanwhile, on the side of inflation, what that phenomenon can do to an elderly person who has only a meagre retirement income to start with is very bad too.

"Doing something" about these evils—doing something more effective than we are now doing—is not easy; if it were it would long since have been done. One important reason why it is not easy relates to the well-known openness of the Canadian economy—an openness of which Canadians have been forcibly reminded by the international economic events beginning in August 1971. The hearings on which this Report is based were concluded before these events; the Report has been written in their shadow.

We do not believe, however, that the economic "guns of August" have reduced either hearings or Report to irrelevance. On the contrary, their relevance has been in some ways enhanced. The frontal attack of the United States on its long-standing international payments problem has raised new difficulties and concerns for Canada. Many important Canadian industries and their employees have been seriously hurt, and the continuance of the sustained and vigorous growth in international transactions that was one of the major accomplishments of the Bretton-Woods era, and that provided so great a support for postwar Canadian economic expansion, no longer looks so assured.

At the same time, however, it may be noted that the expedients used in the past by the United States to contain its payments problem in the era of fixed exchange rates have been a factor of some importance in the less-than-satisfactory performance of economic stabilization policy in Canada. Now at least it can be hoped that the United States and its trading partners, including Canada, will get to the real root of the problem, and thus make possible a more purposeful, co-ordinated and effective set of economic stabilization policies than has been mounted before.

In this sort of favourable international context, the hearings and recommendations of this Committee would have obvious relevance. But even if the international economic weather unfortunately turns out somewhat rougher, the emphasis that this Report places on the specification of realistic operational goals for Canadian economic stabilization, and on a better management-and-review system for developing policies to achieve these goals, should still prove timely and useful. The rougher the weather, the more important it is to have a clear idea of where we want the ship to go and how we propose to get her there. Storms may indeed drive her off course and force the seeking of temporary shelter and other tactical diversions. But there should be an underlying purpose and strategy. Canada has too big and developed an economy to run on a survival or reactive basis—on simply weathering the successive crises that the larger world economy throws at us. We must do that and better, and for this purpose must have economic goals and policies that are in significant measure our own.

A special expression of thanks is in order to our witnesses. Each was asked to prepare a written submission for the Committee and then to appear before us for a half-day or more for oral comments. All performed their task admirably, particularly in view of the relatively short notice extended them. For many, especially those from outside Canada or even North America, the journey to Ottawa was no small personal inconvenience. We are immensely grateful to them for their conscientious and successful efforts to help us. We should also like to thank those others who voluntarily submitted written material to the Committee; they will find in the text of this Report evidence that their submissions did not go unnoticed. This Report is based on the briefs and testimony received from witnesses and others.

The Committee is deeply indebted to its staff under the able leadership of our Study Director, Dr. James Gillies, Dean of Administrative Studies, York University. Members of the staff included Dr. D. L. McQueen, Professor of Economics Glendon College, Mr. E. J. Brower of the Parliamentary Library, Air Commodore L. J. Birchall, Mr. G. Lemire, Clerk of the Committee and Commander A. B. German who acted as Administrator of the Committee and was assisted by Mrs. E. Babbie, Miss H. Baker, Miss J. Fairley, Miss J. Hampton, Mrs. E. Periard, Mrs. E. Robertson, Mrs. J. Walenstein. They were burdened with many complex administrative and technical problems which they have solved with patience, skill and grace.

OTTAWA, November 1971

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OTTAWA, February 1971

# CHAPTER I

# THE CANADIAN ECONOMY

Economic power is a force exercisable by man alone. Not only is the Canadian economy manageable, but it must be managed, for it has no magical powers of guidance other than those we bring to it.

If the power of human management is a plus factor, it also carries with it the risk of human error and misjudgment. Men and their governments have made and will continue to make mistakes in managing economies, just as they make mistakes in managing everything else. Our ability to forecast what may or should happen too often outstrips our ability to make events conform to their predicted course. Our expectations can easily be led astray unless we keep in mind the difference between the outward mathematical elegance of some computer-aided economic projections and the enormously complex and very human processes by which economic realities are achieved.

We must discourage any hope that there exists some simple miracle formula for assuring effective economic management. Useful innovation in economic theory and policy does, indeed, occur, but even when it is on the scale of the "Keynesian revolution", its effective application tends to be gradual and piecemeal, and to throw up some troublesome side effects and leave many old problems unsolved.

Neither the lack of magic cures nor the existence of human error need erase our faith in the powers of economic management—that is, in the capacity of government to establish a framework in which we can achieve our national economic goals. The Canadian economy, after all, has multiplied some 25 times during the past century of nationhood, and not even the most vociferous critic would suggest that this was not due, in considerable degree, to active and constructive economic management.

### *Two Guiding Principles*

Partly in the light of the testimony that we heard, and partly on the basis of our own convictions, we have adopted for the purposes of this Report, two major assumptions and guiding principles concerning the Canadian economy. These principles will be seen to run through all of our main recommendations.

#### (1) *The Open Economy*

The first principle is that the Canadian economy is now, and will continue to be in the future, very open to the influence and tendencies of the larger world economy. To be sure, the general fact of this openness is already excruciatingly well known. What is not always so obvious, however, is its many-channelled nature. In the world of the 1970's, economic "messages", in a very broad sense of that term, are transmitted from country to country in many ways, with great speed and often with great impact. And, of course, Canada, located next door to the United States, is at the northern end of a particularly sensitive and thickly-wired sector of the total transmission network.

It is not just a matter of trade; nor is it just a matter of trade plus parent-to-subsidiary "commands" and other economic messages moving within the structures of multinational corporations and unions based in the United States. It includes two-directional flows of capital in such forms as bonds and bank loans, without direct ownership-and-control implications, and also many highly influential flows of general business information. The latter, embodied in such things as the widespread reading by Canadians of United States business publications, must never be overlooked, for they are a major means by which inflationary expectations and other psychological states of mind of great importance for the subsequent performance of the Canadian economy are transmitted into Canada.

We expect that while certain particular aspects of the openness of the Canadian economy will undergo some change (in the light, for example, of the evolution of government policies affecting foreign ownership), the general condition of openness will remain—indeed, must remain—a basic fact of life for Canadians. But this does not, we should emphasize, lead us to take a hopeless and paralyzed view of the possibilities for national policies of economic stabilization in Canada. Looking back over the record, we are inclined to think that Canadian stabilization policy has on some occasions attempted to do too much—has sometimes tried too hard, for example, to perform a task which in effect amounted to fighting a United States inflation from a Canadian base. On other occasions, however, Canadian policy has not been firm and independent enough.

(2) *The Market Economy*

Our second assumption and guiding principle is that the Canadian economy should remain a predominantly market system, in which government is responsible for a number of critically important economic functions that only it can efficiently perform, but in which the bulk of productive and distributive activity is carried out by private enterprise units responsive to consumer demand and the profit motive.

We have built our recommendation around this kind of economic system firstly, because we believe it is the kind of system most likely to be consistent with maximum political and economic freedom and secondly, because we believe it is the system most likely to produce, under Canadian conditions, a high rate of attainment of the major economic and social goals to be discussed in the next chapter of this Report.

Our statement of principle leaves ample room for necessary government action, both in establishing the framework and conditions within which private and individual decision-making can function and also in supplying a range of "public goods and services that must, by their very nature, be a government responsibility. The implied role of the state in economic management is neither negative nor neutral. There is, rather, a very positive concept of the need for government to seek an overall allocation of national economic resources in keeping with agreed national objectives and to employ actively its various policy levers to translate these objectives into realities.

*The Government Sector and Stabilization*

There must be constant vigilance to ensure that government concentrates its available administrative talent and other resources on those things which government really must do, and that the public sector of the economy is not further distended to cover things which could better be done by private enterprise.

However, we think it wise to do as Dr. Beryl Sprinkel did in his testimony before us, and to treat the size of the government sector of the economy as a distinct and important issue in its own right, deserving of continuing attention regardless of whether or not inflation also happens to be a major problem at the time. Those who, in their concern to restrict excessive growth of the public sector, seize on the desirability of controlling inflation as the best available stick with which to beat the expansion of government spending, are apt to find their arguments considerably weakened at times when the total economy is obviously slack and requires stimulating. There is no need for them to suffer this embarassment, or to be tempted into making more of the threat of future inflation than the evidence really warrants. Proper control of the size of the government sector is a valid, respectable concern and a subject for public debate at all times. Indeed, given that large and complex government programmes often take a long time to mount, substantially modify, or terminate, only such a continuing concern, independent to a considerable degree of the immediate economic weather outside, is likely to prove very effective in practice.

Government spending programmes, therefore, should continually have to justify their existence, quite apart from the general setting of stabilization policies. The best possible evaluative and information-feedback systems should be built into them, and as soon as it becomes clear that they are not efficiently achieving the objectives specified for them by Parliament, they should be changed or ended. Moreover, there should be a constant search for governmental activities ripe to be handed over to the private sector, and it should be a generally respected touchstone that there is never a good time in the economy for government to be doing things that could better be done by others. A modern government has quite enough to do that only it is capable of doing well; it should not, at any stage of the business cycle, be wasting its fiscal receipts and the nation's resources on non-essentials.

We would not rule out some deliberate variation of government expenditures in the interests of economic stabilization, notably where changes in the spending programmes involved are subject to comparatively short time-lags and are also perhaps highly relevant to particular regional or sectorial pockets of unemployment or inflation. In general, however, changing major expenditure programmes is one of the least flexible of the various stabilization tools available to government, and this reinforces the case for regarding economic stabilization and the control of the size of the government sector as in many ways distinct issues. When they come into conflict—when, for example, government decides to terminate a large but redundant spending programme at a time when it is also trying to stimulate the economy—means, such as tax changes, can usually be found to resolve the difficulty.

*Economics or Sociology*

Some of our witnesses suggested that Canada's current economic problems were in part a reflection of new and fundamental forces at work in society—that while they might look like economic problems, they were really more sociological in nature and as yet little understood. When we tried to elicit hard evidence of the extent of economically relevant social change, and of the impact this might have on problems of economic stabilization, we did not have great success. Moreover, some witnesses such as Professor Harry Johnson suggested convincing alternative explanations, couched largely in terms of relatively conventional economic analysis, of some of our recent difficulties.

New forces are obviously at work in our society to some degree, and the development of new and truly useful tools of economic policy is a necessary and desirable activity. But the time is not yet, in our judgment, to be throwing away our present policy tool kit in favour of an entirely new one. Much of our effort should instead be going into learning how to use our existing tools better, and a considerable part of this Report is addressed to how this might be done.

***Conclusions and Recommendations (1)***

**1. Even though the Canadian economy is very open to the influences of the world economy there is still significant room for the purposeful management of national economic stabilization policies in Canada.**

**2. There is no simple solution to the problem of economic management, but government does possess powerful policy tools for stabilizing the growth of the economy and important improvements can be made in the use of these tools.**

**3. While government must assume a major role in economic management, the bulk of productive and distributive activity should be carried on by private enterprise units operating in the freest and most competitive possible markets and responsive to consumer demand and the profit motive.**

**4. Keeping the government sector of the economy from growing unduly large should be regarded as an important problem in its own right, distinct from the problem of economic stabilization.**

**5. While new forces are obviously at work in our society, the main problems of economic stabilization are still economic in nature. They do not appear to be the result of major sociological changes requiring completely new policy instruments.**

## CHAPTER II

# THE GOALS OF ECONOMIC POLICY

In the previous chapter we described the Canadian economy as one in which private enterprise and private decision-making would continue to predominate, but in which government accepted a major responsibility for overall economic management.

It is increasingly a characteristic of modern management techniques in many areas of human activity that they require a fairly explicit spelling out of goals for the organization to be managed. This is not always easy; there are many pitfalls. The delusions of spurious precision, or the ignoring of vital factors in a situation because they do not happen to be readily measurable, can lead to very bad results. But so too can short-run "ad hockery" and management by intuition. Essential to the successful running of the kind of economic system that we have described is the establishment of agreed national objectives to which all of us, in both the public and private sectors, can respond.

*A Growing Economy*

A decade or so ago, the goal of economic growth enjoyed great popular vogue. Today, it is much more questioned. We view growth as primarily a supply matter—as an increase in total productive capacity, brought about by increases in the sheer quantities of labour, capital, knowledge and other productive factors in the economy, and also by improvements in the quality of these factors, and in the efficiency with which they are combined. We do not, however, take the simplistic position that *any* large increase in productive capacity and in the production actually extracted from it is necessarily good. We do not, in other words, worship at the shrine of GNP nor argue that Canadians should direct every available resource towards encouraging the rise of this particular statistic, on the supposed premise that sheer abundance of production will satisfy our every need and want. We are concerned that overcommitment to growth may defeat itself through its impact on economic stability, and that a considerable portion of what goes into the rising GNP statistic may represent a degradation of the environment plus costly efforts to protect ourselves against that degradation.

It has become more evident than it used to be that the growth of modern industrial economies raises some complex and urgent questions. But to answer these questions by simply calling the whole thing off and bidding the economy to cease to grow does not seem a serious and practical solution. Zero growth makes good rhetoric, insofar as it induces people to think about such unquestionably vital matters as the world population explosion, the ultimately limited supplies of fossil fuels and other natural resources, ecology, the balance of nature, the deterioration of the environment, and the increasing unliveability of large cities. But as a practical policy prescription, it is surely unacceptable, if only because doing something effective about the specific problems mentioned seems to call in every instance for increased applications of beneficent technology and other kinds of resources —all of them, of course, costly and all of them, therefore, apt to be more easily accommodated in an economy where total output and income are expanding vigorously. There are also some other strong reasons why the Canadian economy must grow. Irrespective of what happens to the population base from here on, there is already built into the population structure a massive increase in the labour force over the next few years. In spite of all the changes that there may have been in the work ethic, it is as certain as anything can be that a much larger number of Canadians than ever before will want work, and this means tools and other capital so they can work effectively. On this and other important fronts, rapidly growing demands on the Canadian economy may be foreseen, and the economy must adjust to meet them. If it does not, grave social risks will be incurred. These include the risk of increasing resort to authoritarian methods of dividing up inadequate output.

Our position on economic growth occupies a middle ground: we favour, not any and all growth, but most certainly growth which will lead most efficiently to achieving the various goals of our society.

*Performance and Achievement Goals*

In discussing goals it is useful to distinguish between *performance* and *achievement* goals. The five economic performance goals more or less implicit in the legislation setting up the Economic Council, and subsequently elaborated by the Council in various connections, have become widely familiar. They are:

— rapid and sustained economic growth;
— high employment;
— reasonable price stability;
— a viable balance of international payments; and
— an equitable distribution of rising incomes.

We subscribe to these goals, and have taken account of them in shaping this Report. However, none of them must be regarded as an end in itself. Their true role is a facilitating one—that of making possible the attainment of more deeply meaningful achievement goals, the general nature of which is suggested by the following passage from the Economic Council's *Sixth Annual Review*:

> "Such a framework should encompass not only the economy's *performance* goals, but also what may be broadly described as *achievement* goals—that is, goals relating to the ways in which our growing resources are used. Achievement goals—many of which are related to performance goals—range over many areas: advancing education, better housing, the elimination of poverty, improvements in health, the maintenance of national security, increased international aid, rising standards of living and wider consumer choice, and an improved quality of life in our vastly changed and increasingly urban society. Even broader social, cultural and political goals might be included."
>
> "The Council has no illusions about the difficulty of compiling such goals and ordering the priorities among them. But the priorities will be established in any event. The real question is whether they will be established in a comprehensive, systematic and forward-looking manner, or in a wasteful, ad hoc and frequently short-sighted manner."

### *Setting Achievement Goals*

The definition of Canada's national goals and priorities should not be left to any single group, be it a cabinet, legislative chamber or a private institution.

The process of national goal-setting should be broadly based and our political institutions, in particular, must be designed to provide citizens with an opportunity to contribute to the building of a national consensus on the basic directions of society and the allocation of its resources. In order to do this we must have information. We must know roughly the total pool of resources available to us; what kind of growth in resources can be achieved by devoting some percentage of our existing pool to growth itself; and how much of our resources are required to meet important goals. Without this kind of information, any process of national goal-setting will be largely meaningless.

Protection of the environment, to cite just one example, is a goal which wins the support of virtually everyone. We know that deterioration of the environment is imposing large economic and other costs on us. But we also know that significant abatement of that deterioration involves costs.

Even though a higher-quality environment than we have today could make us collectively much better off, there exists some point beyond which improvements in environmental quality gradually become more and more matters of ranking in the general scale of priorities. Thus, if some elements of pollution-abatement virtually impose themselves on our society, others have to be weighed more in the balance, costed out against their expected benefits, and assessed against alternative uses of resources for such objectives as the elimination of poverty. However this is done, whether through direct government planning, or through more indirect devices that make more use of the price system, the relevance of better information about the environment will be obvious. It will be highly relevant information for ordinary consumers and taxpayers if for no other reason than that they will end up paying, directly or indirectly, most of the abatement bills, even as they benefit from reduced pollution.

*Investment*

Good information is also of great importance in another difficult area of social choice: the area of determining how much of society's total resources to devote to current consumption, and how much to capital investment. This literally involves weighing the interests of the present against those of the future, for the rate of capital investment in the present period significantly influences the rate of economic growth later on, although it is far from the only factor. This statement can be made, not only of investment in factories, roads and other physical facilities, but also of education and training—of investment in skill, knowledge, and other forms of "human capital". Better information and analysis relating to this kind of investment is especially badly needed.

The Economic Council has done particularly valuable work in generating more information to inject into the complex socio-political process of determining Canada's longer-term goals and priorities. The future role that we shall later be suggesting for the Council involves considerable stress on this aspect of its work.

It can be seen that we greatly emphasize matters of goals and priorities. They are at the heart of the political process. Our national needs and wants, even our agreed ones, are likely to exceed the resources and abilities available to us. If we do not set priorities for ourselves, we face the danger either of misleading or deceiving people into believing we are about to do something when we are not; or of attempting to try as a society to do too much at once, thus over-committing our resources with inevitable and serious consequences for our economic well-being.

The process of setting national goals is a continuing one. Public attitudes and preferences change, and yesterday's consensus may be anything but tomorrow's accord. The desires and priorities of a generation raised during a depression, for example, are likely to be quite different from those of a generation reared amid the general affluence of post-war Canada. Without a continuous and conscientious effort to keep abreast of the public will, we can find ourselves devoting today's resources to achieving yesterday's goals.

*Conclusions and Recommendations (11)*

**1. While we do not endorse the concept that "growth for growth's sake" is necessarily good, we favour economic growth which will lead most efficiently to the goals of our society and which will employ our exceptionally fast growing labour force.**

**2. We endorse the performance goals of rapid and sustained growth; high employment; reasonable price stability; a viable balance of international payments and an equitable distribution of rising incomes, not as ends in themselves but as means of realizing the longer term achievement goals of humanity such as eliminating poverty, improving health, protecting the environment and making cities more livable.**

**3. Society must determine what achievement goals it desires in relation to the resources available or risk over-committing our resources with serious effects on economic stability. In order to do this the public must know the extent of the resource pool available; how much of these resources should be devoted to current consumption and how much to capital investment; and how much of our resources are required to meet important achievement goals.**

## CHAPTER III

# THE MONETARY AND FISCAL LEVERS

What policy tools are available to a government that is trying to keep a country's economy on a stable course? The literal answer to this question is that hundreds and even thousands of such tools may be distinguished. Almost everything that a government does has some sort of impact on the economy.

When, for example, aggregate government spending on goods and services rises, this reduces the potential amount of goods and services available for concurrent use by private spenders. If the total economy is slack at the time, the main consequence may be increased employment of human and other resources; but if the economy is in a boom and tightly stretched, much of the effect may consist of an inflationary scramble for resources and a bidding up of wages and prices.

The impact of government on economic stability does not end there, however. The very important matter of monetary policy must be considered, and also the receipt side of the government's accounts—the raising of money through taxation and borrowing, with all that this may imply for the economic behaviour of myriad taxpayers and lenders. There are, too, the effects of the government's own lending activities, and of "negative taxation" via family allowances and other transfer payments, whereby the government, having raised money from certain groups of people, pays it out to other groups of people with somewhat different spending patterns.

The fact is that once a government accepts a responsibility for stablizing the economy, the whole range of its policies and programmes becomes relevant to this end, at least to some degree. Programmes adopted to further quite other purposes must also be looked at from a stablization angle, especially if they are widely ramifying programmes, affecting the economic situations of large numbers of Canadians. Some of their impacts on the more detailed structure of the Canadian economy, and even some of their psychological effects, may also have a certain importance in relation to economic stability.

Out of the diversity of views and research results presented to us at our hearings, however, there emerged an almost universal consensus to the effect that the three "big levers" of monetary, fiscal and exchange-rate policy remain central and indispensable in stabilizing an economy such as Canada's. There was noteworthy dispute about which of the three is most significant, and about the way in which each works and relates to the others. But the proposition that unless all three are operated reasonably well, with a reasonable degree of co-ordination among them, there is no other miracle means of keeping an economy on a stable course in relation to its growth path, would clearly command wide assent from our witnesses.

## MONETARY POLICY

### *The Operation of Monetary Policy*

Although subject to important practical constraints, especially in Canada's open economy, monetary policy is nevertheless probably the most powerful single means of influencing total spending and the level of economic activity in Canada. It is operated by the Bank of Canada, with the federal government remaining in some ways at arm's length from the Bank's day-to-day decision making, but in the end accepting ultimate responsibility for the broad policy adopted.

Monetary policy is possible because the Bank of Canada is able by various means (chiefly the purchase and sale of government securities) to control the growth of the total assets and liabilities of the chartered banks. This effectively enables it to control the growth of the money supply, most often defined in Canada to include currency plus deposits at chartered banks, although other definitions are also used.

The Bank's monetary policy operations can, of course, have very noticeable effects in financial markets—effects, for example, on interest rates, on the prices of stocks, bonds and mortgages, and on the cost and availability of credit to various classes of borrower. Their more fundamental effects, however, occur in the "real" world beyond financial markets—in the world of income, saving and spending, and of the total effective demand of millions of Canadians for goods and services. A tightening of monetary policy tends to brake the growth of aggregate demand; an easing tends to speed it up. This is the more true, inasmuch as the initial impacts on demand are enhanced by "multiplier" and "accelerator" effects, whereby one spending change leads to others.

*The Monetarist Challenge*

So much appears to be common ground among most economists today. There is, however, vigorous dispute about how changes in monetary policy should be identified and measured; about the size, character and timing of the effects that flow from these policy changes; and about the interrelations between the "financial" and the "real" effects. We must take care not to exaggerate the practical import of the dispute. It is somewhat reassuring that the actual policy prescriptions of the contending schools of thought do not invariably fly off in all directions. When really major changes in general economic conditions are signalled, protaganists of all schools will more often than not agree that monetary policy should move in a certain direction, and by a large and significant amount.

Thus some of the fighting may be thought to have a certain theoretical or at least conceptual quality about it. Yet this part too is operationally important, for how a decision-maker conceives the working of a process as complicated as monetary policy can make a big difference to some of his decisions. It can affect what signals he watches for as a guide to action, how soon and how much he acts, and how he later evaluates—and learns from—the impact of what he has done.

Having been apprised in advance of the importance of this controversy, we deliberately chose witnesses on both sides of it. Two of these witnesses, in particular, expressed relatively well-defined opposing positions at the policy level of the dispute. The reader should understand that the paper confrontation now to be staged between them has the same oversimplified and potentially deceptive quality as the dramatic juxtapositions of short film footages sometimes used in television news programmes. Subject to this important warning, the following excerpts from briefs and testimony may be found illuminating.

First, for what members of the "monetarist" school would regard as a conventional or establishment view, the Governor of the Bank of Canada, Mr. Rasminsky:

> "Monetary policy operates on the total level of spending by influencing credit conditions, that is, the availability and cost of money, which in turn affect incentives to spend. Changes in the availability and cost of money also have an important influence on flows of interest-sensitive funds in and out of Canada."
>
> ". . . we have not been able to discover through research and experimentation any ascertainable constant relationship between the money supply, however defined, and economic activity for Canada. I know of no central bank that operates strictly on the basis of trying to stabilize the rate of growth of money supply."

Dr. Beryl Sprinkel, by contrast, conceived the relationship between monetary policy and total spending in the economy in these terms:

> "As a monetarist, it is my judgment that the demand for goods and services and assets is determined primarily by prior changes in the money supply."
>
> ". . . to achieve stable and moderate growth in the money supply, the central bank must focus on controlling capital aggregates rather than limiting its action to influencing interest rates only."

"Recently many central banks in the free world have shifted their efforts towards controlling monetary aggregates such as the supply of money. This move, in my opinion, offers the first ray of hope that the present world-wide inflation will be brought under control."

The two witnesses also differed on the importance of fiscal policy in affecting total demand. On this point, Governor Rasminsky said:

"... the other major demand policy is fiscal policy which affects the total level of spending in the economy through changes in the amount of tax revenue taken from the private sector, through government expenditures and using a broad definition, through the important lending activities of the government."

"... the major influence of fiscal policy is the broad one of affecting the total level of spending in the economy, in effect by putting more or less into the economy than it is withdrawing."

To which Dr. Sprinkel "replied":

"... I would contend that changes in fiscal policy exert only nominal influence upon changes in money demand; that is, the size of a deficit in our country—and I have looked at many others—is not closely related to subsequent changes in total spending."

"... the size of the deficit is not important, but the method of financing that deficit is critical. If it is financed primarily by new money and the deficit gets larger and larger, this means the money supply grows more and more rapidly. If, on the other hand, it is financed by new issue sales to the non-banking sector of the economy, it does not increase the money supply. Hence, you will find that it does not have a major bearing on subsequent spending change."

The reader is once again reminded that these are highly selective quotations and that anyone whose interest in the particular views of Governor Rasminsky and Dr. Sprinkel is thus aroused should go to the full published versions of their presentations.

Two of the major disputed issues, it may be seen, concern what is the critical policy variable for monetary policy and what is the chief way in which fiscal policy works. Should the Bank of Canada primarily watch and act upon the growth-rate of money supply, or should its watchfulness and its actions go more to interest rates, the availability of loans, and other aspects of credit conditions? Should fiscal policy be operated—not certainly in isolation from monetary policy—but to a large extent as an important annex to monetary policy, with the financing of deficits and surpluses instead of the deficit and surplus position itself being the key variable? Definite answers to these questions, one way or another, would make large differences to the operation of economic stabilization policies in Canada.

We confess to having been much impressed by the thrust and conviction with which monetarists are able to put forward their views, by the obvious scope of their empirical research, by the amount of historical evidence that they have assembled showing strong associations between major inflations and major monetary expansions in many countries at many different times, by the predictive successes that they interpret some of their econometric models to have had, and by their undeniable impact on the whole field of professional economics and on the psychology of financial markets.

Yet the other, "establishment" side also has impressive things to show: theoretical counter-attacks, different interpretations of the historical record, econometric models like those described to us by Professor T. A. Wilson and his associates which incorporate a relatively conventional concept of how fiscal policy works, and other models in which interest rate changes have a substantial if lagged impact on aggregate demand.

This controversy seems best treated as an on-going, unresolved one. The monetarist case looks very impressive in many ways, but not, at this stage, overwhelming. Many economists of first-rate, world-wide reputation and highly relevant experience remain as yet unconquered by it. For example we had this discerning comment from Dr. Arthur Okun:

> "Judgments about both quantities and interest rates should guide monetary policy. Monetary policy makers need a wide variety of indicators of credit developments to make the best possible judgments. No single beacon can fix their course properly."

Some of these same economists, however, are persuaded that central banks ought to give greater relative importance in their policy-making to the behaviour of the money supply, and to maintaining greater stability in the growth of this aggregate. We commend this view to the Bank of Canada.

We shall necessarily have more to say in later chapters both about monetarism and the running of Canadian monetary policy. Among other things, we shall review the idea of money-supply rules that some monetarists have proposed as a guide for central banks. We shall consider what it is that these rule-advocates are basically after, and how their fundamental objectives might be pursued via other means better adapted to Canadian circumstances.

We shall also, in the next chapter, consider the very important external dimension of monetary policy and its relationship to the exchange rate.

For the present, we confine ourselves to observing that in reviewing with our witnesses the postwar record of monetary policy in Canada and noting the sometimes quite frequent sharp swings of policy direction within relatively short periods, we are led to question whether there has not been a tendency on the part of policy-makers to be overly reactive to shorter-term indicators and to fall somewhat into the pitfalls of fine-tuning with a blunt instrument. Certainly, in looking through the after-the-fact Annual Reports of the Bank of Canada, one finds considerable emphasis on how policy was used to respond to various situations and relatively little emphasis on even medium-term goal setting in connection with the employment of the monetary lever. We would not suggest that many of the circumstances to which monetary policy responded—circumstances such as the exchange crisis of 1968 for example—were not cases of genuine emergency. But we would question, on the basis of the record at least, whether adequate emphasis has been given to developing and maintaining a longer-term strategy.

## FISCAL POLICY

Fiscal policy, operated directly by the federal government and also to some extent by provincial governments, is another powerful tool through which a short to medium-term influence can be exercised on aggregate demand, again with multiplier and accelerator effects broadly similar to those activated by monetary policy.

### *Definition of Fiscal Policy*

Differing definitions of fiscal policy are possible, depending on the range of government activity embraced by it. The Minister of Finance, the Honourable E. J. Benson, noted in his written submission to us that fiscal policy could be exercised through the government's own demand for goods and services, through its tax and transfer policies, or through its lending activities. He confined his definition, however, to "the overall impact of the government's operations upon the economy rather than to the effect of any particular programme upon a segment of the economy."

In the Minister's meaning, then, fiscal policy includes only those expenditure, tax and lending elements which have a broad influence on economic aggregates such as national income and expenditure, employment and the price level. It does not include, even though their economic importance may be acknowledged, special aspects of tax policy such as those involved in the government's current reform bill, or the narrower and more specific ends towards which many expenditure programmes may be directed.

Even within this definition, fiscal policy need not be nation-wide in application. We say this recognizing that provincial and even local governments can exercise some power in this area, but also that the federal government, under the legitimate heading of fiscal policy, can take steps with a deliberate aim of modifying different impacts on different regions of the country.

### *The Operation of Fiscal Policy*

The broad way in which fiscal policy functions is fairly familiar. By increasing its own spending and lending activity, by reducing tax rates, or by both, the government generates additional claims on resources by itself and others—adds, in other words, to aggregate demand. Conversely, by cutting expenditures and lending, by raising taxes, or by both, the government can slow down or even perhaps halt the growth of aggregate demand. Within the basic framework, important options exist as to the methods used, particularly as between the spending and taxing powers. Direct spending changes tend to have less "savings leakage" and thus a greater impact on the economy, and also to provide more control in the sense that the government can more easily be assured that expenditure changes reach a particular target, be it a population group, geographical region or industrial sector. But tax cuts or increases can also have a very major impact (part of it often psychological), and we shall shortly be indicating reasons for favouring somewhat this aspect of fiscal policy.

*The Effect of Fiscal Policy on Monetary Policy*

First, however, we must draw attention to the highly significant linkages that exist between monetary and fiscal policies. As the Minister of Finance indicates in his brief, the practice of fiscal policy is, in one of its key dimensions, a monetary process, involving transfers of bank balances between government and the private sector. Bank balances come into government via taxation and borrowing, and go out again via spending and lending, and the name of the fiscal policy game is to control these flows in the interests of economic stability. The policy must be financed: that is, bank balances must be found to cover government deficits, and something must be decided about the disposition (if any) of the bank balances arising from government surpluses. How the financing is performed has an important influence on the ultimate impact of fiscal policy on the economy, and that brings monetary policy very much into the picture, for one of the available means of financing is to create new bank balances for the government—or to destroy old ones when there is a surplus—through changes in the total money supply. If the amount of resort that there is to be to this and other kinds of financing is not carefully worked out and coordinated by the Department of Finance and the Bank of Canada, in a state of reasonable agreement on basic economic objectives, the effectiveness of one or both policies may be seriously inhibited. Thus close co-operation between the two agencies is essential. Without it, one or both policies may be frustrated, fiscal policy failing to achieve its maximum impact because of out-of-tune monetary management, or monetary policy being hampered by the excessive pressures of financing fiscal policy.

While then we do not go all the way to the monetarist position of regarding the principal economic impact of fiscal policy as really part of the impact of monetary policy, we do strongly emphasize the monetary policy and debt management aspects of fiscal policy, and the need for both major policies to work well together.

As in the case of monetary policy, there is considerable debate as to whether fiscal managers should be subject to some kind of operating rules in their policy-making. We are more favourably disposed to a rule here—a rule taking the form of a broad and flexible application to Canadian circumstances of so-called "high employment budgeting." Our main discussion of this will be found in our later treatment of policy rules in general.

*Tax Changes or Expenditure Changes*

The management of fiscal policy involves options between changes in spending and lending, on the one hand, and changes in tax rates, on the other. Various mixtures of both are also options. We have already indicated our preference for doing more of the changing on the tax side. If fiscal policy may be compared to a pair of scissors with one blade labelled "expenditure" and the other "taxes", we prefer that the tax blade be considered the more moveable one. The reason for taking this view is that taxes are in actual fact more readily moveable, especially when compared with larger and more complex government expenditure programmes which may well have to be changed substantially from time to time for various reasons, but which should not be thrown into grave and ultimately wasteful confusion by drastic overnight revisions in either direction.

*Direct or Indirect Tax Changes*

While at the present time in Canada debate centres on the use of tax reductions as a stimulus to a slack economy, there will be other times when the main issue concerns the use of tax increases to help contain a boom. It has been suggested in some circles that tax increases may be considerably less effective than they used to be because of an increased tendency on the part of taxpayers to treat increased taxes as costs, and to shift them on to others—for example, through price and wage increases. It has long been recognized that taxes can be and are shifted, to varying degrees, but we found no significant support among our witnesses for the idea that the shifting phenomenon had gone so far as to invalidate the use of tax changes as a major tool of fiscal policy and economic stabilization. The consensus was strongly the other way.

We did, however, hear well-supported opinions to the effect that increases in sales and other indirect taxes have a greater tendency to be shifted than do income and other direct taxes. This would indicate that in containing a boom increases of direct taxes may be more effective than increases of indirect taxes, which, though they certainly discourage spending tend to have greater inflationary side-effects on the price-level. Conversely, in attempting to stimulate a weak economy that is also suffering from a hangover of inflationary expectations inherited from some earlier period, decreases of indirect taxes may be more effective than decreases of direct taxes. Account should be taken of this fact in deciding which particular taxes to change for stabilization purposes. Professor T. Wilson and his associates, for example, argued that in present Canadian circumstances, when both unemployment and the rate of increase in consumer prices are above widely accepted target figures, stimulating the economy by reducing indirect taxes was a particulary attractive alternative because it would tend to damp down price increases and even produce some price reductions on goods and services being untaxed, at the same time that also tended to reduce unemployment.

Finally, at some risk of stretching the definition of fiscal policy enunciated by Mr. Benson and adopted by us for this Report, we should like to point out something additional and important that fiscal policy can do which monetary policy cannot. This function was admirably expressed by Dr. Sprinkel when he said:

> "Although monetary policy exerts a decisive influence on final demand, it plays a minor role in determining the capacity of an economy to grow in real terms. More basic influences such as investments in physical and human capital, technological improvements and the innate capacity of a people to work, produce and save are dominant. Fiscal policies designed to encourage production and thrift can exert a beneficial impact."

We commend this passage heartily to the Minister of Finance.

***Conclusions and Recommendations (III)***

**1. The three big levers of monetary, fiscal and exchange rate policies remain central and indispensable in stabilizing the Canadian economy.**

**2. The Bank of Canada cannot operate monetary policy on the basis suggested by some monetarists. It must be concerned with such important matters as interest and exchange rate levels, liquidity and the financing of federal government debt. However, it should give more relative emphasis to steadying the growth of the money supply and it should guard against a tendency to be overly reactive to short-term indicators.**

**3. Coordination of fiscal and monetary policies and close co-operation between the Department of Finance and the Bank of Canada in the exercise of these policies are essential.**

**4. The use of fiscal policy should lean more to adjustments in taxes than adjustments in government expenditures. Despite "tax shifting" (the treating of taxes as transferable costs) tax changes remain a highly effective means of stabilizing the economy.**

**5. In containing a boom, increases of direct taxes (income taxes, etc.) are more effective than increases of indirect taxes (sales taxes, etc.). But in stimulating a weak economy that is still suffering from lagged price increases, decreases of indirect taxes are more effective than decreases of direct taxes. Account should be taken of this in deciding which particular taxes to change for stabilization purposes.**

and services being produced, at the same time that also tended to reduce unemployment.

Finally, at some risk of stretching the definition of fiscal policy enunciated by Mr. Benson and adopted by us for this Report, we should like to point out something so obvious and important that fiscal policy can do which monetary policy cannot. This function was admirably expressed by Dr. Sprinkel when he said:

> Although monetary policy exerts a decisive influence on final demand, it plays a minor role in determining the capacity of an economy to grow in real terms. More basic influences such as investments in physical and human capital, technological improvements and the innate capacity of a people to work, produce and save are dominant. Fiscal policies designed to encourage production and thrift can exert a beneficial impact.

We commend this passage heartily to the Minister of Finance.

*Conclusions and Recommendations (III)*

1. The three big levers of monetary, fiscal and exchange rate policies remain central and irreplaceable in stabilizing the Canadian economy.

2. The Bank of Canada should operate monetary policy on the basis suggested by some monetarists. It must be concerned with such important matters as interest and exchange rate levels, liquidity and the financing of federal government debt. However, it should give special relative emphasis to restraining the growth of the money supply and it should guard against a tendency to be overly sensitive to short-term indicators.

3. Co-ordination of fiscal and monetary policies and close co-operation between the Department of Finance and the Bank of Canada in the exercise of these policies are essential.

4. The use of fiscal policy should lean more to adjustments in taxes than adjustments in government expenditure. Despite "tax shifting" (the floating of taxes in transfer to where the changes remain a largely effective means of stabilizing the economy.

(i) In moderating inflation, increases of direct taxes (income taxes, etc.) are more effective than increases of indirect taxes (excise taxes, etc.). But in stimulating a weak economy that is one which has many unemployed, the cutting of indirect taxes has more effective than increases of direct taxes. Cabinet should be aware of this in deciding which particular taxes to change for stabilization purposes.

## CHAPTER IV

# THE OPEN ECONOMY: THE CASE FOR A FLOATING RATE

One of the basic assumptions of this Report is that Canada has a very open economy that depends heavily on international transactions and is more sensitive than most to economic trends and pressures emanating from abroad. In this context, the Canadian exchange rate—the price at which our dollar can be exchanged with the currencies of other countries—has great relevance for economic stabilization. It has been described by the Governor of the Bank of Canada as a "very important price", that cannot be ignored by policy-makers, "even when it floats".

*The Effect of Movements in the Exchange Rate*

The ultimate effects of major movements in the exchange rate ramify widely through the entire economy, affecting income, employment, prices and many other things. The initial effects, however, tend to be concentrated in the international trade and capital accounts. When the exchange rate rises (when, for example there is an increase in the number of United States cents that it takes to buy one Canadian dollar), it becomes, in general, more expensive for foreigners to buy goods, services and capital assets from Canadians, and less expensive for Canadians to buy these things from foreigners. Conversely, when the exchange rate falls, foreigners' purchases from Canadians become less expensive and Canadians' purchases from foreigners become more expensive.

There is more than one way in which exchange movements encourage or discourage transactions between Canadians and foreigners, as the case may be. For example, when the exchange rate rises some Canadian exporters may increase their quoted prices in United States dollars in order to maintain their per unit returns in Canadian dollars. This will tend to reduce their volume of sales in the United States. Many Canadian exporters on the other hand may try (or indeed may be compelled by strong international competition) to hold the line on their U.S. dollar price quotations; but this will tend to reduce their profit margins on the business and make them less eager sellers. Either way, there is a discouraging effect on sales volume.

Meanwhile, however, the exchange appreciation will be making gainers as well as losers. Among the chief gainers will be Canadian consumers paying less than they otherwise would for many goods and services, especially imported ones. There will also be mixed gainers and losers, such as Canadian manufacturers now faced with stronger import competition in the domestic market for their final products but also able to obtain imported raw materials and semi-fabricated components more cheaply.

Many of these gains and losses take considerable time to work themselves out. For example, the main reduction in some exporter's sales volume following the exchange appreciation may not take place until three or four years later when an aging and obsolescent plant is abandoned instead of replaced as originally planned. Thus time lags are an important consideration in movements of the exchange rate just as they are in the exercise of monetary and fiscal policies.

*Fixed or Floating Rates*

Much of the debate about exchange rates in Canada has focussed on the relative merits and demerits of "fixed" and "floating" exchange rates. As indicated by Mr. Rasminsky's statement, the exchange rate is a major practical preoccupation of policy-makers under either system.

1. *Fixed Rate*

Under the fixed system, in effect in Canada for some years prior to September 1950, and again from April 1962, to June 1970, the federal government obligated itself to maintain the exchange rate within a narrow band extending one percent on either side of a given price for the Canadian dollar in terms of U.S. dollars. This was done in the first instance through variations in Canada's official reserves of gold and foreign exchange, and in drawing rights at the International Monetary Fund. But given the limitations on such reserve movements, an important part of the task of maintaining the fixed rate devolved on other policies—especially monetary policy. In the very open Canadian situation the exchange rate stood highly exposed to the influence of heavy flows of interest-rate-sensitive capital between Canada and the United States, and also on occasion to outright speculative attack. This meant not only that monetary policy must have continuous regard for the state of the reserves and the exchange market, but also that it could not attempt to produce monetary conditions in Canada that were greatly different from those of the United States.

"Fixed" rates were not, in principle, immoveable. Under the Articles of Agreement of the International Monetary Fund, an alteration might be carried out from time to time in order to meet a "fundamental disequilibrium" in a country's international economic position. But such alterations often proved very difficult in practice—more difficult and delayed than was probably envisaged by the founding fathers of the I.M.F. at Bretton Woods in 1944. The greatest difficulty of all, as is now painfully evident to everyone, has proved to be that of adjusting a fundamental disequilibrium in the position of the major "reserve-currency" country: the United States.

2. *Floating Rate*

Under a floating rate system, which Canada adopted in 1970, an earthly paradise is not revealed but there are some important changes for policy. There was a very strong consensus among our witnesses, including foreign witnesses, that the retention of a floating rate would enable Canada to do a much better job of economic stabilization.

Some of the most significant policy lessons of past Canadian experience with a floating rate concern extended periods of time during which fluctuations in the rate were notably modest. The fact that the rate was free to move, subject only to what are believed to have been very short-term "smoothing", operations by the reserve managers, appears to have set up self-adjusting processes in capital markets and to have curbed exchange speculation. The preoccupation of monetary policy with the exchange market and the state of the exchange reserves could thus be less intense, and the policy was freer to address itself to domestic problems and to diverge from the monetary policy being followed concurrently in the United States.

In the present state of uncertainty, it is hard to tell what new system of exchange rates the world may be moving towards or what obligations Canada may be asked to assume as a contribution to the highly desirable maintenance of expanding world trade and stable economic growth. We recommend, however, that every effort be made to retain for Canada a floating exchange rate—a rate moreover, able to move up and down in relation to the United States dollar as well as to other currencies.

*Limitations on Policy Under a Floating Rate*

Realism and caution must be exercised in considering the practical policy possibilities of the floating rate, the advantages of which have sometimes been over-emphasized by its advocates. It does not solve the fundamental economic problem of unlimited wants and limited resources; it is not an open license to inflate, to export unemployment or otherwise to run the Canadian economy as if the rest of the world did not exist. It offers an additional means of adjustment to economic phenomena of both domestic and foreign origin, but the adjustments—especially if they are large—are not painless. As noted earlier, movements in the exchange rate, in either direction, make losers as well as gainers among Canadians.

So far as the important policy issue of the economic "insulating" properties of the floating rate is concerned, the assessment of Professors Reuber and Bodkin seems as thoughtful and realistic as any:

> "We endorse a floating exchange rate for Canada at the present, given the uncertainties in the international monetary system and the desirability for Canada to retain some freedom to follow somewhat independent monetary and fiscal policies. In saying this we do not claim that a floating rate will make it feasible to have a price-employment experience that is totally or even largely independent of developments abroad. The claim is rather that the free rate makes it feasible to gain somewhat greater freedom in the short run and to make adjustments to changing circumstances more smoothly."

Since the economic insulation conferred on Canada by a floating exchange rate is only partial and relative, the question of how much room there is for the practice in Canada of national policies of economic stabilization remains significant, as do the lessons to be drawn from Professor Harry Johnson's analysis of how, in a highly interdependent world system with fixed exchange rates, the post-1965 "Vietnam inflation" in the United States was bound to spread quickly and powerfully through the system and to frustrate many of the attempts of individual countries such as Canada to contain it.

It is, therefore, useful to consider briefly how, using the policy options available with a floating exchange rate, Canada may in future avoid such a bad "trade-off" between little damping down of price increases and appreciable worsening of unemployment.

It is never easy to tell how much of any general inflationary tendency in Canada is of domestic and how much of foreign origin. Appreciably higher rates of increase in United States than in Canadian general price indexes, however—rates such as those which occurred in the late 1960's and early 1970's—do provide one suggestive indicator that part of Canada's inflationary problem may really be an importation from the United States by way of an international transmission mechanism that often seems to work more quickly and thoroughly for price movements, both actual and expected, than it does for other things.

Under the circumstances, it is at least conceivable that Canada might have done somewhat better in this period to have let the exchange rate float up sooner, thus stemming to some degree the importation of inflation from the United States and the rise of Canadian consumer prices. At the same time, an earlier easing of fiscal policy might have exerted a downward push on unemployment.

This is, of course, speculation after the fact but it does illustrate how, with a floating exchange rate, Canadian economic stabilization policy can have a useful degree of independence from United States policy and United States economic conditions. We believe that when the circumstances call for it, this independence should be exploited to the full.

*Controlling the Floating Rate*

Some witnesses advocated that Canadian policy-makers adopt what would amount to a completely "free float" or "hands off" attitude towards the exchange rate but we do not believe this to be realistic. Not merely would it be contrary to human nature; it could, under some circumstances, allow things to happen that were seriously detrimental to Canadian economic stability and the achievement of major economic goals. If the rate moves (or threatens to move) far enough in any one direction to start bringing about relatively fundamental adjustments in the Canadian economy, the question must be asked whether in the light of all the relevant circumstances these adjustments are wanted. Perhaps they are, but if they are not, monetary policy is likely to be the principal indirect means chosen to steady the rate or to move it back at least part of the distance that it has come. Similarly, if the rate has remained fairly stable, but changes in other economic circumstances have rendered it seriously inappropriate, monetary policy will probably be the principal adjustment tool. Thanks to the sensitivity of capital markets this immediate rate-adjustment process appears to be relatively little subject to time lags.

We mentioned earlier the debt-management linkage between monetary and fiscal policies and the necessity for close policy coordination and basic agreement on goals between the Department of Finance and the Bank of Canada. Both the need for coordination and the complexity of determining the correct policy mix become very much greater when the exchange rate is brought into the picture.

***Conclusions and Recommendations (IV)***

**1. Every effort should be made to retain for Canada a floating exchange rate. The rate should, moreover, be able to move up and down in relation to the U.S. dollar as well as to other currencies.**

**2. The floating exchange rate gives to Canadian economic stabilization policy a very valuable additional dimension of adjustment. It provides a means of securing a modest and partial, but nevertheless welcome degree of insulation from unfavourable developments in other countries.**

**3. A floating rate does not solve the fundamental economic problem of unlimited needs and limited resources; it is not an open licence to inflate, to export unemployment, or otherwise to run the Canadian economy as if the rest of the world did not exist. It may not produce an economic climate**

**that is totally independent of developments abroad. However, it can help to some degree to stem imported inflation and give Canadian policy-makers more scope for dealing with domestic economic problems.**

**4. Even when we have a floating rate it would not be realistic or desirable for Canadian policy-makers to leave the rate completely alone. There are times when events will call for exerting an influence on the level of the rate by monetary and perhaps other policies.**

## CHAPTER V

# LAGS, EXPECTATIONS AND RULES

### LAGS

One of the more disconcerting experiences for a concert pianist can be his first encounter with a large old style church organ. Accustomed to the piano, he sits at the more complex yet basically familiar keyboard of the organ and plays one or two notes. Nothing happens. Thinking that perhaps the instrument is not on he reaches out to alter the setting of the stops. At this point, a blast of sound from behind nearly blows him out of his seat. He has discovered that complex mechanisms are sometimes subject to time lags.

The three major tools of economic stabilization are also greatly bedevilled by time lags, which are much more difficult to anticipate and allow for than those associated with musical instruments.

Between an unfavourable change in the course of the economy (say, a slowing down of growth and a rise in unemployment) and receipt of a definite signal that something is amiss, time passes. Between the receipt of the signal, and the implementation of a decision to utilize some policy tool, more time passes. And finally, there is a still further lapse of time between the implementation of the policy decision and the occurrence of its maximum impact on the economy.

With respect to this final stage, many lags are thought to be "distributed". That is, there may be a little policy-impact quite soon but the chief kick may not take place until much later, with additional diminishing effects stretching even further into the future. Economists often go through the exercise of cumulating these predicted effects through time, so that they can say by what future date they think as much as one-half of the estimated total impact of a policy move will have happened. It is not uncommon for econometric models to indicate that the accumulation of 50% effect from changes in fiscal and monetary policy may take long enough that one may talk in terms of years.

A critical implication of research findings about lags is that if policy always adheres to a stately, traditional sequence, with action waiting upon clear and present evidence of trouble and then taking some considerable further while to occur, there is a strong likelihood that it will often be too late to do much good and may indeed make things worse—stimulating an economy that has somehow got through its unemployment difficulties into a new boom that needs restraining; or conversely, administering anti-inflationary medicine to an economy that could by now stand a pick-me-up.

*The Reasons for Lags*

While the measurement and anticipation of policy lags is one of the most intractable problems currently facing economic policy-makers, some at least of the reasons why lags occur are not especially mysterious. Statistical reasons, institutional reasons, and reasons of individual human behaviour all appear to play some role.

1. Statistics like those of the Labour Force Survey take time to collect, process and interpret—and therefore, strictly speaking, inform only about the past.
2. The institution of democratic government is one of the great institutions of mankind but it is cherished primarily for reasons other than speed in decision making which is not always its *forte*.
3. As for the people—the taxpayers, savers, borrowers and spenders whose economic behaviour it is hoped policy will alter—their financial affairs are sufficiently complicated and their experience-based skepticism about the permanency of economic changes sufficiently strong that their reaction may well be a sort of double-take. They may, that is, respond one way initially—then, if convinced that the alteration in their circumstances is here to stay, take the more elaborate and time-consuming actions (such as buying a house) that constitute their longer-term response. The reactions of business firms have something of the same multi-phase characteristic.

*Why are Lags a Problem*

All of this is not new: the essentials of it have been known for years. Why then do we lay great emphasis on it here? There are three main reasons:

1. Recent research evidence, as reported at our hearings and elsewhere suggests that policy lags may be even longer and more variable—

and therefore more unpredictable and otherwise troublesome to policy-makers—than was previously supposed;

2. Though recent Canadian economic policy has shown greater lag-consciousness, it still does not appear to have taken adequate account of the phenomenon; and

3. The existence and significance of policy lags is not as widely known to Parliament and the general public as it ought to be, in part because of the political process and the conventional rules of the parliamentary game tend to sweep the matter under the rug, and instead put pressure on governments to reach into the magician's hat and produce instant solutions to instant problems.

To elaborate slightly on the final point, it may be observed that while parliamentary oppositions do indeed tend to look into the economic future and see dark things, they generally find themselves on better fighting ground when they can talk about how inflation or unemployment or both are demonstrably hurting Canadians *now*. This, especially when it is reinforced by objective evidence, and by friendly warnings from caucuses, constituency groups and individual members of the government party, is a kind of criticism that governments understandably feel keenly, and are strongly tempted to respond to by producing packages of measures that can be alleged to offer fast, fast relief to the economy. But the truth may be that rather little fast relief is actually available. Worse still, the relief nevertheless proffered may have adverse effects later on, when the economic situation has changed. Even knowing this, however, governments may be under too much political pressure not to make decisive-looking policy moves of some sort.

There is here then a serious, compound problem. In part, it is a problem of economic analysis and a challenge to economic research. In part, it is a problem of the institutional structure of government decision-making. But in large part also, it is a political and public information problem, and much of its ultimate solution will have to take place on that front.

*What Can we do About Lags*

1. Research and Statistics

The research aspect is easiest to prescribe for, at any rate in general terms. There must be money, determination, and a refusal to be put off by repeated failure and frustrations. There must be research both inside and outside government. There must be frank public dialogue and generous exchange of information between all the research participants.

Meanwhile, policy must go on being made in whatever deplorable state of incomplete information. The development of earlier and better economic statistics can be of significant help here and we strongly advocate it.

2. Government Decision Making

Further than this, perhaps the most important thing is to draw the right logical conclusions from the existence of long and unpredictably variable policy lags.

A. *The First Rule of Lags*

It has been repeatedly pointed out, notably by the Economic Council, that lags make a nonsense or worse out of any attempt to counter-act minor wiggles in the general course of economic activity. This seems a correct conclusion which we shall call the first rule of lags: "Policy should focus on dealing with larger and more prolonged deviations of the economy from its potential growth path."

B. *Second Rule of Lags*

But it is also vital not to draw incorrect corollaries from a correct conclusion. Such an incorrect corollary would be to argue that since policy must on no account respond to minor wiggles, but only to major divergences, it should never move until the existence of a major divergence has been clearly and incontrovertibly established. This, under some circumstances, could lead policy even deeper into the trap that lags set for it. While debate raged on about whether the observed disturbance was a minor wiggle or a major divergence, the divergence might become very major indeed, eventually putting the government under irresistible pressure to weigh in heavily but too late, thus quite possibly encouraging a subsequent major divergence the other way. Even if governments abjure short-term fiddling, a second rule of lags also applies: "If policy is to be timely and effective, it must often move on a medium-term forecast and a balance of probabilities rather than on iron-clad certainties."

This is a tough rule though not as tough at some junctures as at others. When the economy is far below its growth path, in a slough of softness and unemployment from which recovery can only be prolonged, there is little danger that strong stimulative measures will be untimely (although there may unfortunately be a serious problem of persisting and to some extent self-fulfilling inflationary expectations inherited from a previous period). But when a recovery has gone some distance—has reached, say, a 1964-65 stage, with unemployment down and little obvious sign as yet of serious inflationary trouble—keeping to the rule can be a much more severe test. To see beyond the current best-of-all-worlds and perceive that a modestly unpleasant cautionary move now may lessen the risks both of inflation and of heavy, untimely and unemployment-creating policy reactions to inflation some distance down the road, calls for statesmanship of a high order.

C. *Third Rule of Lags*

The rule of ignoring minor economic wiggles would ban some types of policy move made in the past but would not necessarily make policy moves infrequent—at least during certain periods. If some current economic developments do not appear to cast long shadows forward, others do, and there can be times when assessments of the *medium*-term outlook for the Canadian economy undergo sharp and justifiable changes. Under these circumstances, policy should not be ashamed to respond. We thus have a third rule of lags: "If a medium-term forecast and its associated policy turn out to be wrong, the logic of lags calls for prompt policy revision. Expenditure of precious time on justifying earlier decisions is not constructive."

D. *Short Lag Policies*

For this reason, we endorse the fairly recently introduced practice of bringing down mini-budgets, at times other than the spring. We do this with some misgivings, realizing the temptations that it could offer to misguided fiddling and "fine tuning". But this risk seems outweighed by the desirability of giving policy every opportunity to move promptly when it should move at all.

We also urge a diligent search for additional, supplementary policy devices that are relatively fast acting—have short lags. One such device for use against unexpected escalations of demand inflation might be an up-dated version of consumer credit controls. These have been used before in Canada but the recent rapid growth in the use of revolving credit plans suggests that there may be new ways in which a serious inflationary emergency could be somewhat curbed in the short run.

3. Public Understanding of Lags

These possibilities should not be exaggerated, however. The lags applying to the major instruments of economic stabilization policy will still be there and the great need to improve the state of Parliamentary and general public knowledge about them therefore remains. Pleas for better public information are sometimes little more than vague generalities but not in this case where the state of public understanding is truly critical to the solution of the political aspect of the lag problem. Governments, professional economists and the media can do a great public service by losing no opportunity to propagate the fact that between the action and the event of economic policy falls a time-shadow. The more widely this is known and appreciated, the more will the undue demanding and supplying of instant governmental solutions to instant economic problems be seen and deprecated for what it is: a deception at best and a dangerous piece of counter-productivity at worst.

We therefore recommend that while governments should seek out new and faster-acting instruments of economic stabilization policy, they should nevertheless recognize, publicize, and act upon the fact that their most powerful instruments are still the major levers of monetary, fiscal and exchange-rate policy, and that these are subject to significant time-lags.

## EXPECTATIONS

The problems of expectations in recent economic policy has been in some ways part of the problem of lags. This may at first seem a contradiction since an expectation or anticipation is essentially a thought *before* the event. But what is widely thought to have happened is that variations in peoples' expectations of future economic events—especially their varying anticipations of inflation—have rendered even more uncertain how soon and how strongly they would react to present changes in economic policy. In some cases, even the *direction* of their responses, as well as the length of the time-lags, appears to have become more doubtful.

Some flavour of the feelings of bafflement that this has understandably engendered in policy-makers shows through in the following passage from the brief submitted to the Committee by the Department of Finance:

> "These expectations, held throughout the economy, do not arise inexorably from the experience of the past. They reflect a mood which, like the northern sky at night, is sometimes sombre, sometimes glowing and sometimes shimmering but rarely predictable. Yet the dynamic of the economy, be it vigorous or laconic, depends upon this mood. Government action can and does affect mood and expectations but often not predictably."

As this suggests, it would be foolish to try to lay down broad, general rules for dealing with many of the more esoteric manifestations of expectational psychology that policy-makers encounter. At the same time, however, some very old and simple psychological principles will probably continue to be serviceable. Experience still teaches; people still remember. It seems likely that past economic events still tend to influence future economic expectations (and therefore present economic behaviour) with an intensity dependent in part on two factors: the size and impact of the past events, and how long ago they happened.

Thus it seems at least a plausible hypothesis that if inflationary expectations have been a more marked phenomenon and policy problem in 1970-71 than in the early 1960's, one reason is simply that there has been a fair amount of inflation in recent years, and that Canadians have moved steadily further away in time from their last major experience of relative price stability around the turn of the 1950's. They have moved further still, of course, from the non-inflationary trauma of the Great Depression. And since people sometimes act on inflationary expectations in ways that add to inflation, the expectations may have been in some degree self-fulfilling, thus upsetting policy-makers' expectations of how soon and how much the recent softening of the Canadian economy would lead to a moderation of wage and price rises.

In the current concern over expectations of rising prices, it should not be forgotten that economic behaviour is also influenced by expectations of other developments—by expectations of unemployment and recession, for instance, or of the future setting of monetary policy. If one were to imagine a shrewd and hard-eyed observer looking back over the Canadian economic record of the last twenty years (as outlined, for example, in the charts of Appendix I to this Report), one might suppose that he would, on the past record alone, generate a number of expectations. Creeping inflation—sometimes relatively sluggish, sometimes a little faster—would certainly be one of them. On the other hand, uncontrolled runaway inflation would look like one of the worst possible bets. The record would show that if Canadian policy had sometimes moved late against inflation, it had almost always moved heavily in the end, and that the longer-run Canadian performance on price stability was one of the best in the world.

By contrast, the 20-year record of keeping employment growth close to a sometimes very rapid rate of labour-force growth, and so avoiding periodic lapses into serious unemployment, would seem much less impressive. This, if the hard-eyed observer were connected in some way to a very "cyclical" industry, might argue rather persuasively for a future rule of making hay while the sun shone. If, for example, he were a construction worker, he might conceive a regrettable but understandable penchant for going after the big wage increase so long as there was still any wage at all to be had.

If, to shift the example a little, the hard-eyed observer were a large-scale borrower in financial markets, he would probably be more interested in movements in the money supply and other indicators closely related to monetary policy. Observing a high rate of growth in the money supply over a very recent period, he might be led by his historical researches to worry about what this might portend in the way of future inflation—but also to worry about what the Bank of Canada and other people in the market might make of it, and about what might happen to the cost and availability of credit when the period of rapid money supply growth came to an end. He might conclude that he should borrow now, rather than later. And if enough other borrowers reached the same conclusion, this might help drive up long-term interest rates. The development might nevertheless be interpreted by many financial commentators as largely a matter of *lenders* demanding a higher interest-rate "hedge" against inflation.

This very oversimplified example will serve to illustrate two points. The first is that what are often read as expectations of what the economy is going to do are sometimes, in reality, more complicated and mixed-up expectations not simply of what the economy is going to do, but also of how policy is going to react. The second point is that many of the policy problems arising from expectations and market psychology are sufficiently complicated that they cannot be generally prescribed for, but must be left to experienced practitioners to cope with as they come up.

*What Can We Do About Expectations?*

Nevertheless, on the basis of all that was said to us about lags and expectations by a number of impressively qualified witnesses, one elementary but important notion may be offered. This is that the expectations most within the control of policy-makers, and therefore probably worth their earliest and keenest attention, are those engendered by their own policy action. Needless to say, any policy-maker worth his salt already considers very carefully the likely expectational effects of *individual* policy actions. What we urge, however, is that the Bank of Canada and governments have a more careful regard to how patterns or series of policy actions over time may set up patterns of destabilizing economic expectations. Too jumpy, too nervously reactive a pattern of policy changes over a period may unsettle the longer-run foundations of market and general public psychology in a way that comes back to haunt the policy-maker on various later occasions. He may find the market focussed so intensely on trying to forecast his policy decisions, as contrasted with trying to forecast the economy generally, that his scope for policy decisions is by this fact reduced.

This could be thought of as a supplement to the "first-rule-of lags" argument for ignoring minor economic wiggles and putting more emphasis on trying as far as possible to keep to a relatively settled policy strategy. As official government witnesses pointed out to us, some things must lead to deviations from the strategy. Episodes on the scale of the Atlantic Acceptance affair, or some of the periodic fall-out on Canada from the United States balance-of-payments struggle, clearly required Canadian policy deviations. But as a general future rule, before any deviation is authorized that might cause disturbing gyrations in the money supply or in some of the other main economic indicators that people watch, the question, "Is this trip really necessary?" should be asked more pointedly than in the past. If it is a needed trip, more consideration than in the past should then be given to whether a plain and full public explanation of its purpose and deviational nature (so far as this can be foreseen) would not do more good than harm to the state of expectations. The idea that silence disturbs the market less and keeps more policy options open, while valid in some situations, may be a poor guide in others. If silence generates too high a degree of public suspense and nervousness over what is to happen next in economic policy, it may start closing off options.

## PROPOSALS FOR POLICY RULES

Partly because of the problems arising from lags and expectations some economists have proposed that the makers of monetary and fiscal policies be stripped of much of their present discretionary power and be subjected instead to specific operating rules laid down in advance. The function of the rules would be both prescriptive and expository. That is, they would guide the decision-makers in their actions while at the same time providing legislators and the general public with a readier means of seeing and understanding what was going on.

### *Rules for Fiscal Policy*

In the case of fiscal policy, the usual proposal is that the fiscal levers be so manipulated that *if* the economy were at high employment, the government budget (measured on the national accounts basis) would be in balance or slightly in surplus. The practical effect of following this prescription would normally be that when the economy was in fact well below high employment, the budget would show a large deficit and fiscal policy would be exerting a strong expansionary push towards high employment. When by contrast, the economy was so buoyant that it was trying to press above high employment, there would be a government surplus and a restraining fiscal influence.

Such "high employment budgeting" is advocated for several reasons. It is thought, to begin with, that it would tend to steady fiscal policy, discourage short-term fiddling, and ensure at all times a roughly appropriate amount of fiscal stimulus or restraint for the economy as its circumstances might require. In particular, it would cope with the problem of "fiscal drag" whereby, as the economy moves back towards high employment, its progress may be excessively braked by the act of such income-sensitive "automatic stabilizers" as the progressive income tax and the Unemployment Insurance Fund.

But the rule is advocated for expository reasons also, which can be illustrated in terms of a period of relatively deep recession in the economy. In such a period, the government is likely to be in considerable deficit anyway, if only because of the reverse action of the automatic stabilizers as the economy slides into recession. But more stimulus than this is typically needed, and high-employment-budgeting prevents a government from passing off its automatic deficit as an adequately expansionary fiscal policy. At the same time the high-employment-budget concept provides a good argument to throw back at those who profess to see in a larger and more "activist" government deficit evidence of waste and bad public housekeeping rather than deliberate economic stabilization.

There are also expository advantages in a period of high employment and inflationary boom. The high-employment-budget concept then becomes, among other things, a way of resisting those who argue that more of the government's buoyant revenues should be channelled into their favourite expenditure projects.

The Minister of Finance told us that he discerned some important practical difficulties in applying a high-employment-budgeting rule to the Canadian federal government and he questioned whether the concept would be particularly illuminating to the public or otherwise useful.

We took careful account of the Minister's views on this point. But we could not help observing also that the Ontario government, as well as the United States federal government, has seen virtue in the concept, and that both have found ways of adapting it to their needs. It seems to us that some reasonably flexible adaptation of the concept to the budgeting of the federal government in Canada would also be helpful.

We therefore recommend that the federal government adopt the concept of high-employment-budgeting, at least to the extent of always estimating, in budget presentations, what the budgetary position would be at high employment and of analyzing reasons for changes in the estimated figures since the previous presentation.

This would, we think, leave ample flexibility for necessary shifts in fiscal posture—on occasions, for example, when developments in the foreign exchange market made it desirable to alter the prevailing "mix" of fiscal and monetary policies. Meanwhile, however, one advantage of using the high-employment-budget concept as the basic point of departure would be to facilitate fiscal policy coordination between the federal government and provincial governments using the same concept. The Ontario government has laid much emphasis on this.

It does not seem a proper criticism of the high-employment-budget concept to say that it does not solve all or even a large part of the problems of the makers of fiscal policy. This is not its true purpose, and it can be anticipated that the Finance Department will continue to require the full services of first-rate econometricians and other experts in its work.

The true purpose of high-employment budgeting, as realistically set forth in a recent study for the Brookings Institution by G. L. Bach, entitled *Making Monetary and Fiscal Policy,* is to provide only a broad discipline—an overridable presumption. This presumption would replace the traditional and now long-since-abandoned presumption that the budget should be balanced every year, regardless of the state of the economy. Just as the old-time prescription was not in fact fulfilled continuously, so too would there be departure from the new one. But the need to justify publicly the departures or "overrides" would nevertheless be a useful discipline. Among other things, it would tend to protect sound fiscal policy just a little better from some of the fickle and short-lived political winds that must be expected to blow from time to time.

*Rules for Monetary Policy*

Turning now to possible rules for monetary policy, the type of rule proposed here is nearly always a monetarist one that would require the central bank to expand the money supply at some specified rate geared to the growth of real GNP. The money-supply expansion-rate would not necessarily be identical to the corresponding GNP-rate, and the prescription might allow for a band of permitted rates. But the central bank would not be allowed to break out of this band without special permission.

Commenting to us on these proposals, Mr. Rasminsky argued that a suitable definition of money-supply would first have to be selected from among several possible alternatives, that an appropriately stabilizing rate of increase would then have to be determined, and that careful tests of monetarist hypotheses against Canadian reality indicate no basis for such a determination. (Monetarists, needless to say, dispute this).

It is also argued against a simple monetary rule that even if a good one could be found, the circumstances of Canada's open economy would necessitate so much deviation from it that it would effectively cease to be a rule at all.

We must say that we have a good deal of sympathy with much of what the monetary "rule makers" seem to be trying to do: produce a steadier and more effective monetary policy, improve the visibility and comprehensibility of the policy, and render the policy-makers more effectively accountable to the public. Our recommendations elsewhere in this Report are, we believe, completely in the spirit of these objectives. We must regretfully recognize, however, that the state of the analytical art and the circumstances of the Canadian economy do not at present permit these objectives to be embodied in relatively simple monetary rules. Monetary policy, in Dr. Okun's imagery, can use no single beacon, and it must be free to move quickly against truly major emergencies.

For all that, there remains something more to be said about the expository and accountability objectives of the rule-makers. If it is to be agreed that the Bank of Canada ought not to be subjected to simple policy rules, the Bank should in return feel itself under an obligation to develop improved techniques for evaluating, reporting and accounting for its actions. In this alternative way, it would fill some of the unmet expository needs which have been one major cause of the dissatisfaction leading to the rule proposals.

Above all, these improved techniques should have more and better numbers attached to them. One of the most significant and attractive features of all the policy-rule proposals is that they are firmly based on quantitative criteria. Their numbers may not be the right ones but the idea of having some numerical standards that really mean something and do not vary confusingly from year to year seems fundamentally sound. Good standards developed for expository purposes vis-à-vis the public could turn out to have considerable internal prescriptive value as well.

It is no doubt true that not everybody likes numbers or can be persuaded by them and that, in the final analysis, economic policy is about people, not statistics. But in a policy area of unavoidable trade-off and compromise, the welfare of the Candian people is critically dependent on questions of how much—how much unemployment, how much price increase, how much policy impact over how long a time period to stimulate or restrain the economy. This points ineluctably to quantified policy goals and quantitative assessments of policies to reach those goals, on a fuller and more systematic basis than today. To be sure, greatly improved quantification may well not be possible immediately: too many of the presently available numbers are too "hairy", and the conceptual and technical difficulties of developing better ones are in some cases appalling. But it is in this general direction that policy accountability and reporting should be moving, and the Bank of Canada, while it may be complimented for already doing a good deal along these lines, should be kept under pressure to manifest still further effort and progress.

***Conclusions and Recommendations (V)***

**1. It takes time to collect and interpret statistics. It takes time to implement the appropriate policy response. It takes time for the policy to have its effect. Recognition of these time lags is of fundamental importance in the successful operation of monetary, fiscal and exchange rate policies.**

**2. Lags make nonsense out of attempts to fine-tune the economy with these blunt instruments.**

**3. Recent research indicates that these lags are even longer and more variable than was previously thought. Canadian economic policy has not taken adequate account of lags, nor are the existence and significance of lags sufficiently known to Parliament and the general public.**

**4. We recommend the following methods of dealing with policy lags:**

**a) More funds should be directed to research into the problems of policy lags and into the development of earlier and better statistics.**

**b) Policy should be conducted in accordance with the three rules of lags:**

**First Rule: Policy should not try to offset short-term wiggles in the economy; it should focus on dealing with larger and more prolonged deviations of the economy from its potential growth path.**

**Second Rule: If policy is to be timely and effective it must often move on a medium-term forecast and a balance of probabilities rather than on iron-clad certainties.**

**Third Rule: If a medium-term forecast and its associated policy turn out to be wrong, the logic of lags calls for a prompt policy revision. Expenditure of precious time on justifying earlier decisions is not constructive.**

**c) There should be a search for new short-lag policy instruments such as anti-inflationary contingency devices for the control of revolving credit plans. In this same general connection we endorse the practice of "mini-budgets."**

**d) It must be recognized that government's most powerful instruments for managing the economy (monetary, fiscal and exchange rate policies) are subject to long time lags and therefore should not be used to produce instant solutions to instant problems. No effort should be spared to convey this truth to the public.**

**5. Psychological expectations are also an important problem affecting economic policy. Policy-makers cannot prevent people from forecasting the economy generally but they can reduce the tendency of people to become overly concentrated on trying to forecast short-term movements in economic policy.**

**6. Policy-makers therefore should pay particular attention to public expectations generated by their own policy actions. If short-term deviations in policy from a longer-term strategy are necessary they should be fully explained.**

**7. As a broad but valuable discipline and protection for sound fiscal policy the Federal Government should adopt the concept of high-employment budgeting, at least to the extent of always estimating in budget presentations what the budgetary position would be at high employment and of analyzing reasons for changes in the estimated figures since the previous presentation.**

**8. No simple policy rule such as a money supply expansion rule can be applied to the Bank of Canada, but the Bank needs to develop improved techniques for evaluating, reporting and accounting for its actions.**

## CHAPTER VI

# TRADE-OFFS AND OPERATIONAL GOALS

### TRADE-OFFS

We could not presume to complete even a broad-brush treatment of the major instruments of economic stabilization policy without addressing ourselves to the question of whether there is a "trade-off" in the Canadian economy between the goals of high employment and price stability—and if so, what kind of trade-off.

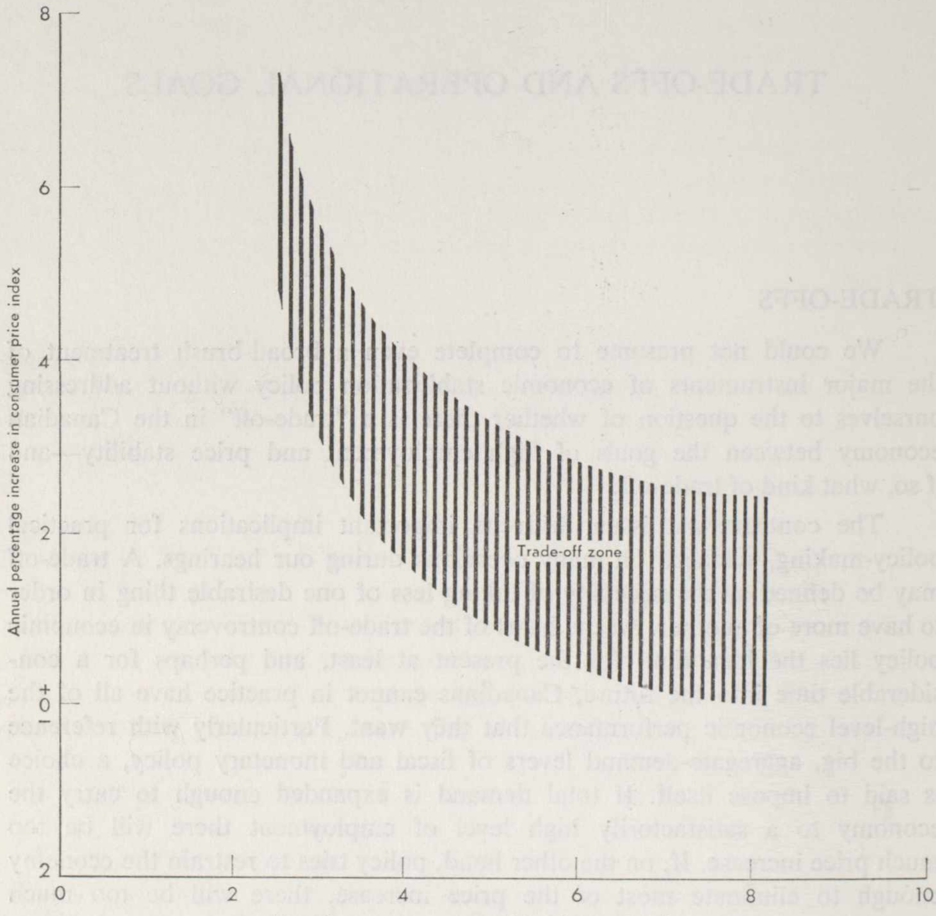
The controversial issue, with its important implications for practical policy-making, surfaced on many occasions during our hearings. A trade-off may be defined as the necessity of taking less of one desirable thing in order to have more of another. At the heart of the trade-off controversy in economic policy lies the idea that, for the present at least, and perhaps for a considerable time into the future, Canadians cannot in practice have all of the high-level economic performance that they want. Particularly with reference to the big, aggregate-demand levers of fiscal and monetary policy, a choice is said to impose itself. If total demand is expanded enough to carry the economy to a satisfactorily high level of employment there will be too much price increase. If, on the other hand, policy tries to restrain the economy enough to eliminate most of the price increase, there will be too much unemployment. Therefore, the best that can be obtained for now is some sort of compromise between high employment and reasonable price stability.

*The Phillips Curve*

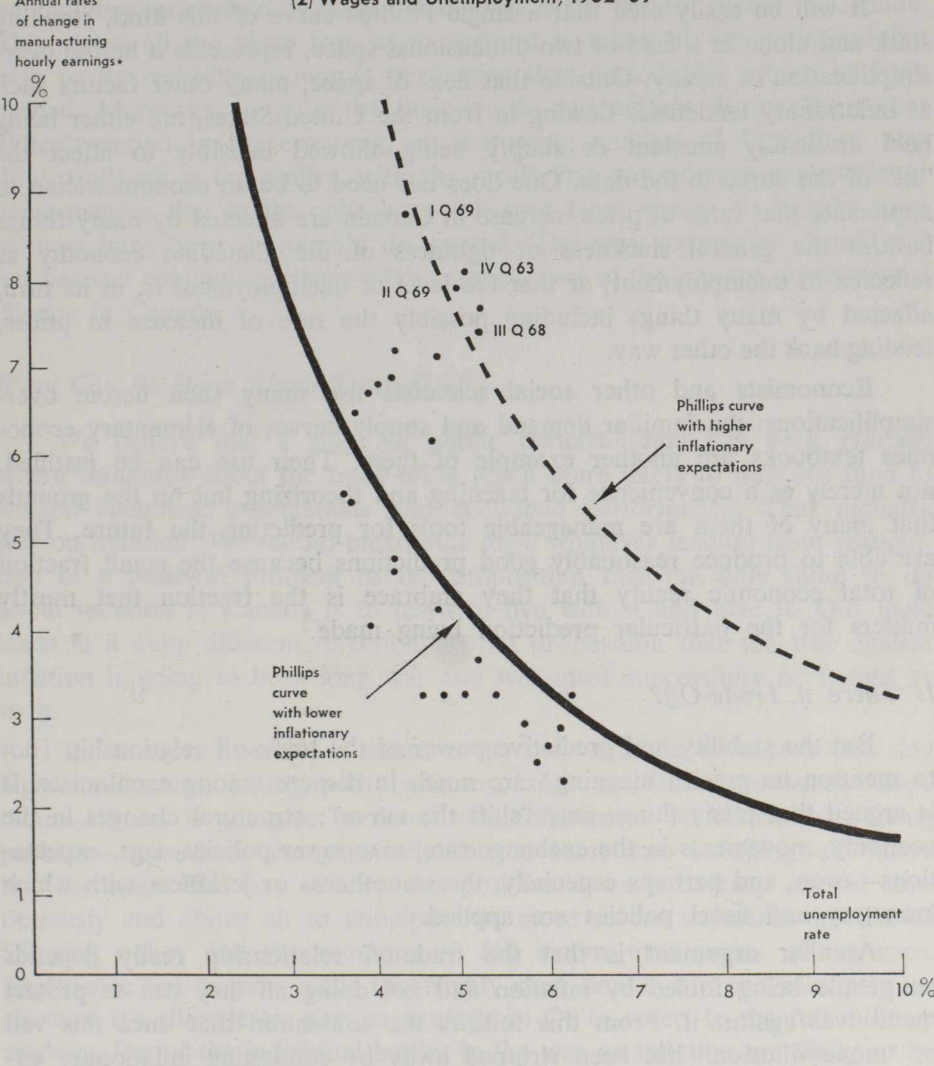
The trade-offs proposition is sometimes put forward with the aid of a "Phillips curve" diagram, relating price changes to unemployment levels on the basis of past observations of the economy. The unemployment figures

ILLUSTRATIVE TRADE-OFF CURVE FOR CANADA

(1) Prices and Unemployment, 1953–65



(2) Wages and Unemployment, 1962–69




Sources: (1), Economic Council of Canada, *Third Annual Review*, Ottawa, 1966, p. 144. The basic data of the diagram comes from G. L. Reuber, R. Bodkin, E. P. Bond and T. R. Robinson, *Price Stability and High Employment The Options for Canada*, Economic Council, Special Study, Ottawa, 1966.

(2), Bank of Nova Scotia, *Monthly Review*, Toronto, September 1969.

may be interpreted as having a kind of double role: they are both an important policy-variable (low unemployment being an obvious counterpart of high employment), and an indicator of how hard aggregate demand is pressing up against available supply with all that that may imply for prices. Two purely illustrative Phillips-type curves are given in the diagrams on pages 44 and 45.

It will be easily seen that a single Phillips curve of this kind, standing stark and alone in a field of two-dimensional space, represents a heroic oversimplification of reality. Outside that field of space, many other factors such as inflationary tendencies flowing in from the United States, are either being held artificially constant or simply being allowed invisibly to affect the "fit" of the curve to the data. One does not need to be an econometrician to appreciate that rates of price increase in Canada are affected by many things besides the general slackness or tightness of the Canadian economy as reflected in unemployment; or that the level of unemployment is, in its turn, affected by many things including possibly the rate of increase in prices, feeding back the other way.

Economists and other social scientists use many such heroic oversimplifications: the familiar demand and supply curves of elementary economics textbooks are another example of them. Their use can be justified, not merely as a convenience for teaching and theorizing but on the grounds that many of them are manageable tools for predicting the future. They are able to produce reasonably good predictions because the small fraction of total economic reality that they embrace is the fraction that mostly matters for the particular prediction being made.

### *Is There a Trade-Off?*

But the stability and predictive power of the trade-off relationship (not to mention its precise meaning) are much in dispute among economists. It is argued that many things may "shift the curve": structural changes in the economy, movements in the exchange-rate, manpower policies, lags, expectations—even, and perhaps especially, the smoothness or jerkiness with which monetary and fiscal policies are applied.

Another argument is that the trade-off relationship really depends on people being fooled by inflation and not doing all they can to protect themselves against it. From this follows the contention that once this veil of "money-illusion" has been stripped away by continuing inflationary experience, peoples' behaviour will alter and the curve will shift radically—perhaps even become vertical. On this point, Professor Johnson's reading of a wide range of recent empirical research is that the long-term relationship is different from the short-term one, but still implies a trade-off.

Here again, then, we find ourselves in the midst of an on-going, incompletely resolved dispute. It seems clear that there are many burning, outstanding questions about trade-off analysis, and that Canadian monetary and fiscal policies are not soon going to be read directly off a Phillips curve. The trade-off relationship may well be a very shifty customer (indeed, we trust that it is, since many of our recommendations essentially amount to attempts to shift it in a favourable direction).

It nevertheless seems to us that over the sorts of time-period that matter for monetary and fiscal policy (lags included), something very like the policy dilemma implied by trade-off analysis is the present reality in Canada. This seems all the more true when account is taken of the undesired but only partly resistible economic tendencies that periodically sweep in from abroad. Moreover, to judge by their words and actions during the recent difficult period in the economy, an increasing number of Canadians also think trade-off is the reality, with the result that any adverse expectational consequences that might once have followed from saying so bluntly must by now have been thoroughly discounted. The very expression "trade-off" has become common parlance—the concept, part of the present expectational climate in Canada.

### *What Can Be Done About Trade-Offs?*

We believe that a stage in public understanding has been reached where frankness about the trade-off is much more likely to improve than to worsen economic expectations and economic performance. That includes war on inflation. We see no inexorable logic whatever leading from recognition of a trade-off problem to the proposition that the only thing to do about inflation in Canada is to learn to live with it and love it. Our logic leads in a quite different direction, to the proposition that the war against inflation is going to be a long war and will most successfully be fought as such.

To be more specific, it seems to us only realistic to expect that any high-employment, high-growth economy, such as Canadians surely hope theirs will be, is going to be faced with inflation as an endemic recurring problem—sometimes comparatively latent; sometimes breaking out more into the open. The way to keep this problem down is to keep after it continuously and above all to anticipate its more severe outbreaks instead of allowing policy and the economy to fall victim to a series of lag-traps. Experience has by now made thoroughly clear how costly and relatively ineffective the short-term, stop-go strategy is. Or to revert to the full military analogy, few of the individual battles in the war on inflation are likely to be won by wild cavalry charges towards sundown: those are apt to be little more than very expensive ways of salvaging some honour from days that are mostly defeats.

It comes back again to the general idea of a more settled, longer-term strategy. How does bringing the trade-off problem more into the open help to further such a strategy? One way it may help is by giving the federal government a better basis, if in its judgment the new strategy and the 3%

long-term unemployment goal of the Economic Council are for some while ahead incompatible, to commit itself publicly (as we shall shortly propose that it do) to a different, interim unemployment goal. Another way is by improving public acceptance of the need to move earlier against inflation and to strengthen longer-run strategic weapons such as competition policy and manpower policy.

*The Present Unfavourable Trade-Off*

It can also be expected, of course, that bringing the trade-off problem more into the open will lead Canadians to ask even more than they now do why the present rate of trade-off in the economy seems so unfavourable. Why, to put it bluntly, does the economy find itself in a position where unemployment has been averaging more than 6% of the labour force, seasonally adjusted, and the 12-month increase in the Consumer Price Index is more than 3%?

We heard a considerable amount of testimony bearing in one way or another on this question. Much of it was very illuminating and useful testimony, but it also left us with a strong impression that this is an economic conundrum to be approached with especially great caution.

One thing that should be said at the outset is that rates of change in economic indicators like the Consumer Price Index vary from month to month for reasons that are in part relatively ephemeral and indicate little about the underlying state of the economy. For example, the supermarket price war of late 1970 had effects on the Consumer Price Index some of which were bound to be short-lived and indeed to be reversed later on. Developments like this are a major reason why, especially in an economic system much characterized by significant time-lags, page-one newspaper stories and parliamentary debates that focus excessively on very short-term statistical movements do no service to the cause of better public understanding of the economy.

But there is obviously more here than short-term statistical illusion. It has been suggested by some that the increased market power of labour unions and large corporations has worsened the price/employment trade-off. We shall have something more to say about this market power in connection with our later discussion of direct controls and income policies but so far as the trade-off is concerned, a major difficulty with this argument is that there is little hard, statistical evidence (for example, in the data relating to union membership and industrial concentration) of a very substantial *increase* in market power over the last decade or so. The power is certainly there, and is very properly a matter for public concern, but it was also there on a significant scale in 1960-61, when by most measurements the trade-off seemed appreciably better.

We are inclined to put more weight on the expectational phenomenon mentioned earlier—on the way in which inflationary expectations may well tend to grow stronger and more self-fulfilling as peoples' experience of price increases in excess of one or two percent per year stretches out in time. Some of our present trouble, in other words, may reflect the fact that in the 1960's, a relatively conventional business-cycle expansion, reinforced by an exchange-rate devaluation, became somewhat overheated and then, instead of turning into recession, extended on into a period when strong inflationary pressures were being generated in the United States by the "underfinancing" of that country's war in Southeast Asia, and when, under a fixed exchange-rate system, many of the resulting price increases were transmitted very readily into Canada.

There seems to be a fair amount of evidence, recent and not-so-recent, to suggest when the experience of inflation lengthens out in this fashion, both inflationary expectations and inflation itself may unfortunately get somewhat embedded in the economy and resist extirpation for a time, even though the economy has since become very notably softer and slacker. It is of some small comfort to note how consistently a high degree of extirpation has eventually occurred, and how fears that Canada was moving into a whole new age of accelerating and policy-resistant inflation—fears of a sort widely entertained in the late 1940's and again in the late 1950's—have been de-escalated by the economy's subsequent behaviour. But it must also be noted that the relative extirpation of inflation has thus far always been a painful and drawn-out process and is proving to be particularly so this time around. We must, therefore, while cautioning against frantic and delusive searches for miracle cures, entertain great respect for those economists who are carefully and thoughtfully exploring various possible ways of effectively speeding up the extirpative process without incurring prohibitive costs in other directions.

We must also recall that the United States too has been experiencing unusually bad rates of price/employment trade-off lately. Under the best of circumstances, much of their problem would no doubt have been "imported" into Canada via the usual transmission mechanisms. As we have stated, however, the circumstances of the 1960's were far, indeed, from the best. Had the exchange-rate been free to float (or even if, under the fixed-rate system, there had been no ceiling on Canada's International reserves from 1963 to 1968), and had full advantage been taken of the resulting scope for achieving partial insulation from inflation by an astute mix of stabilization policies, the Canadian trade-off problem would probably not have been quite so bad.

## OPERATIONAL GOALS

For the present, however, the trade-off problem is still very much with us and must be taken into account in relation to our belief that economic stabilization policy in Canada will do better in future if it is more specifically focussed on realistic operational goals.

The employment and price goals developed by the Economic Council—employment at 97% of the labour force (and thus unemployment at 3%) and the Consumer Price Index rising at an average rate of no more than one and one half percent per year—still appear to be valid goals *for the longer term.* They are, indeed, explicitly regarded by the Council itself as challenging longer-term objectives. Given that a certain minimal amount of structural, seasonal and short-term "frictional" unemployment is unavoidable in any economy such as Canada's; that there are some difficulties in adjusting price indexes for quality changes; and that few modern economies have ever succeeded in avoiding for very long at least a small mount of "price creep", the Council's goals imply extremely good levels of economic performance. Nevertheless, it seems entirely proper to treat them as operational goals in relation to the development of longer-term strategic policies such as manpower policies and regional development policies. Over the longer time-horizon that is in part relevant for such policies, the Council's figures express the sort of Canadian economy at which we should be aiming.

But over the shorter span that is the principal concern of economic stabilization policy, we face a different sort of economy. And to run this economy well requires, in our judgment, interim operational goals, in relation to which policy can be better organized, co-ordinated and explained to the public. We noted with much interest that Professors Reuber and Bodkin, on the basis of long study of the trade-off problem, were prepared to recommend an interim employment goal (or more specifically a target for unemployment as a percentage of labour force) in the following terms:

> "Accordingly, we would argue that the authorities should set their eyes firmly on a target of about 4 percent averaged out over two to three years. When employment is tending to fall below this level, restrictive measures should be applied even if prices are slow to reflect developing inflationary pressures; and when unemployment exceeds this level, expansionist policies should be adopted even though prices may be rising at rates comparable to those experienced in the late 1960's."

We are somewhat more cautious than these two witnesses about the setting of an interim employment goal. But we concur on the principle that such an interim goal is needed—to facilitate high-employment budgeting, to give stabilization policy more purpose and thrust, and to get the Canadian economy moving more decisively out of its present state of slackness.

We therefore recommend that the federal government commit itself to a purposeful attempt to move the Canadian economy, over some reasonable and approximately specified time period, to a situation where unemployment is between 4% and 4½% of the labour force.

In making this recommendation, we are well aware that some will judge that our suggested unemployment range is too low and others that it is too high. To those who might think that a figure more like about 5% of the labour force would be safer from the standpoint of inflationary risks incurred, we would point out that a 5% rate nationally would on the basis of past experience mean rates of well over 6% in Québec and the Atlantic Provinces, and that the difficulties thus far encountered in developing effective policies for reducing regional economic disparities leave few grounds for hope that such wide regional dispersions around a 5% national average would not recur in the near future.

To those who would like the employment goal to be more ambitious and the target unemployment figure to be less than 4%, we would say that we too would very much like a lower unemployment figure and that many of our policy proposals are specifically designed to hasten the day when such a figure can be adopted as a goal. If we have nonetheless recommended the 4 to 4½% range for now, it is because we judge that as things stand in the Canadian economy, a target on this order would be the one most likely to produce a significant improvement in the *average* employment performance of the economy over time. There would, after all, be a certain Alice-in-Wonderland quality about expending great energy in disputes over the relative merits of 3% and 4% unemployment targets at a time when the actual rate is averaging well over 6%. The great immediate priority surely is to move right away from the 6% to 7% zone and *not to be driven back there.* This is what worries us when we consider what happened in the Canadian economy following the two most recent occasions, in the mid-1950's and again in the mid-1960's, when the unemployment rate got down as low as 3½%. It seems to us that not enough has changed in the economy and in economic policy—although we hope that eventually it will—to lessen greatly the risks of recurrence—of being driven back again to unemployment rates of 6, 7 and even 8%. It is this type of recurrence that we want so very much to avoid and this is the basic rationale of our interim goal.

We feel it is of great importance to face squarely the fact that in the world as it is, and in Canada's open economy, the performance of the Canadian economy—although it can most certainly be improved—is likely in the near future to be less satisfactory in some respects than most Canadians would accept in the longer-run. We attach equal importance to making adequate and humane provision for those who may suffer significantly from this fact.

We therefore recommend that Canadian economic stabilization policy include improved arrangements for unemployment assistance. Recent revisions in unemployment insurance will go some distance towards meeting this need. It must be remembered, however, that not all the unemployed have entitlement to insurance benefits, and that unemployment assistance is therefore also required. It may be hoped that as discussion and testing of various types of guaranteed income go forward in Canada, and that as practical policies are developed for ensuring minimum incomes while retaining appropriate work incentives, the certainty and coverage of unemployment assistance will be improved.

Work should also go forward on the more fundamental, longer-term matter of improving the trade-off, and of making possible progressively better economic goals and performance, on a sustained basis, in respect of both employment and prices. This work should include such things as reducing regional economic disparities and improving the efficiency and flexibility of the whole economy. Some proposals relating to it will be found in the next two chapters.

### *Conclusions and Recommendations (VI)*

**1. As between the economic policy goals of high employment and reasonable price stability, Canadian policy-makers face a trade-off dilemma.**

**2. The trade-off dilemma in stabilization policy should be frankly recognized and this recognition made the basis for developing a more effective long-range strategy against inflation.**

**3. Although our goal must be full employment, effective policy-making in the context of a trade-off problem requires the setting of realistic interim operational goals for the Canadian economy. The Federal Government should commit itself to moving the economy, over some reasonable time period, from the present position where unemployment is in the general neighbourhood of 6% to 7% of the labour force (seasonally adjusted) to a position where unemployment is no more than a range of 4% to 4½% of the labour force.**

**4. Economic stabilization policy should include proper protections for those Canadians who suffer from less than fully satisfactory performance of the economy. For the unemployed there should be adequate unemployment insurance and unemployment assistance—the latter ultimately developing within the context of broader programmes for ensuring minimum incomes while retaining appropriate work incentives. (See Chapter VII for protections of pensioners against inflation, and for other anti-inflationary safeguards.)**

**5. Meanwhile work should go forward on regional, manpower and other supply and structural policies capable of reducing the policy trade-off problem in the longer run.**

## CHAPTER VII

# CONTROLS, GUIDELINES AND OTHER POLICIES

There are many ways in which the phenomenon of inflation may be conceived and characterized. One way—a way that has always been popular because it seems to convert inflation from a dry, economic concept into a much more human and personal drama—is to think of it as the aggregate of many individual and small-group decisions to raise wages and prices.

It must be carefully noted, of course, that not all decisions will necessarily be upward and that no wage or price decision is ever a completely unconstrained, free-will decision. All sorts of limiting forces, of widely varying degrees of strength, come into play. In very competitive markets, the pressures of competition will place narrow bounds around the decision-maker's freedom of action. In less competitive markets, these kinds of bounds may be wider. In all markets, however, government policy actions of different types, including movements in the big levers of stabilization policy, will impose further important practical limits on the freedom of private decision-makers.

The case that is made for direct controls, guidelines and incomes policies, all of which belong to the same basic family of economic policy tools, is essentially a case for having government stand closer to the private decision-maker and place narrower and more specific bounds around him. It is a case that argues that in a modern industrial economy, characterized by large holdings of market power, and by inflation much of which is believed to be more of a "cost-push" phenomenon than an immediate or lagged reaction to the excessive pressures of demand on available supply, the big levers of stabilization policy are not enough. Only more direct governmental intervention in the private decision-making process, it is argued, will place a sufficiently powerful check on inflation and produce an acceptable trade-off between the goals of high employment and reasonable price stability.

What counter-arguments can be put up against this case? One of the most important arguments is contained in this characteristic opening paragraph by Professor Milton Friedman:

> "The student of inflation is tempted to rejoin: 'I've heard that one before', to exhortations now emanating from Washington. Since the time of Diocletian, and very probably long before, the sovereign has repeatedly responded to generally rising prices in precisely the same way: by berating the 'profiteers', calling on private persons to show social responsibility by holding down the prices at which they sell their products or their services, and trying, through legal prohibitions or other devices, to prevent individual prices from rising. The result of such measures has always been the same: complete failure. Inflation has been stopped when and only when the quantity of money has been kept from rising too fast, and that cure has been effective whether or not the other measures were taken."

While many economists would agree with this in respect of large-scale inflationary outbreaks, some would want to resort to considerably more qualified language in discussing the kind of inflationary problems that Canada has had since the Second World War.

Even so, Professor Friedman's statement contains two timely and useful reminders. The first is that direct control and incomes policies are as old as money itself, and far older than deliberate control of the money supply by central banks in pursuit of reasonably well-understood objectives of general economic stabilization. The second reminder is that the lengthy historical track record of direct controls and income policies is, on the whole, very bad. They have had a particularly nasty habit of letting down those who trusted in them just as inflationary pressures were mounting to their peak. They are often spoken of as though they were the ultimate, completely dependable weapon against inflation—one that governments can always use effectively if they dare. But the record suggests, on the contrary, that they are no such thing, and that by far the best claimant to the title of anti-inflationary weapon-of-last-resort—the instrument that will always work, however uncomfortably, when all else has failed—is monetary policy.

It will be seen that, like a majority of our witnesses, we are deeply skeptical about most direct controls and incomes policies. We would not wish to rule them out absolutely and we shall indeed be advocating a very special kind of incomes policy. So far as the general run of such policies is concerned, however, we do not think that they are ever likely to work very well for very long and we dislike intensely the threat that they represent to personal freedom and economic dynamism. A lesser but still important threat is their tendency to divert the attention and energies of governments and the public from other, more effective anti-inflationary policies.

But since it seems clear, from public opinion polls and other soundings, that many Canadians regard these devices more favourably and hopefully than we do, we think it proper to take up part of this Report with a somewhat fuller explanation of our views.

## DIRECT WAGE AND PRICE CONTROLS

Because the period of the Second World War provides virtually all of the practical evidence of the past application of direct controls in Canada, it is necessary to say something at the outset concerning that experience. Above all, it should be noted that the observation, "price and wage controls beat inflation during the war", is a misleading over-simplification. The following points, drawn in part from the testimony of Dr. Arthur Smith, give a more accurate sketch:

(1) Inflation was not totally defeated during the Second World War; much of it was only temporarily repressed and shunted on to become a post-war inflation.

(2) Wage and price controls were backed up at numerous points by other control devices, such as foreign-exchange control and rationing.

(3) A larger part of the job of controlling inflationary pressure was done by unprecedentedly severe taxation and highly organized "hard sell" Victory loans.

(4) One of the functions of wage and price controls was the psychological one of providing a highly visible check on profiteering and thus making the economic burdens of the war more acceptable to the public.

(5) Another of their functions was to bear down especially hard on less essential activities, and so help to draw resources into war production and keep them there.

The role that has been suggested for direct controls in helping to cope with peacetime inflation in Canada would obviously be a very different sort of exercise.

It is clear that to use controls as the principal policy tool against inflationary forces of a predominantly excess-demand character would amount to nothing more than a futile attempt to sit on a lid that was bound to come off. The key instruments in such situations are monetary, fiscal and exchange-rate policies, and unless they are properly utilized, the most that controls can do is to delay the boiling over process somewhat and turn it into an explosion.

But what of less extreme situations? For peacetime controls to make any sense at all—and an impressive number of economists see no sense in them under virtually any circumstances—they would have to be employed against an inflation that was convincingly diagnosed as containing a significant element of "cost-push". Not only that but the cost-push would have to be importantly related to the discretionary exercise of market power.

We cannot here open up the whole, vast economic controversy sometimes referred to as "cost-push-versus-demand-pull". We refer interested readers to the record of testimony at our hearings, suggesting that they observe, for example, the extreme qualification and tentativeness with which Professor Lipsey and other witnesses approached the question of just how much of total inflation can be attributed to cost-pushing by unions and subsequent price increases by management.

At all events, one basic condition for the use of peacetime controls would be the acceptance by the authorities of a cost-push inflationary diagnosis strongly related to the exercise of market power. If, instead, much of the cost-push seemed to be arising more from structural shifts and bottlenecks—from the difficulty of transferring manpower and other resources around the economy fast enough to meet the needs of more buoyant sectors of demand—the controls would lose a good deal of their relevance. Worse still, they would almost certainly not be sophisticated enough to avoid slowing down the structural shifts and increasing the number of bottlenecks.

*Selective Controls*

If there is no more than one valid lesson still to be learned from the experience of wartime controls, it is that a high degree of sophistication and sensitivity cannot be expected of a system of direct controls that means to be more than a gesture. Apart from any other factors, there are administrative and public relations considerations of great force that propel the system into being crude, arbitrary and general. Considerations of much the same kind appear to have played a role in the judgment expressed to us by Dr. John Young, Chairman of the Prices and Incomes Commission, that an incomes policy too must be general.

Most individuals would naturally prefer a selective system of controls that did not apply to themselves but only to a few possessors of great market power. Unfortunately, this seems an idle dream—as idle as the dream that the whole Canadian economy is presently run, Mafia-like, by secret orders issuing from a small number of "commanding heights". Not that large and troubling concentrations of market power do not exist; they do indeed. But market power does not end there. All the evidence of wartime controls, peacetime incomes policy and many combines investigations over the years is that market power extends on out, in range upon range of gradually diminishing foothills. Nor is it necessarily a simple function of union or company size. A small chain of service outlets or a construction union operating in a limited regional market may have far more real power over selling price than some large national manufacturer who happens to be up against a lot of import competition. It is well worth noting that a much more than proportionate share of recent price increase in Canada has taken place in sectors like services and construction characterized by a comparative plethora of small units.

This means in turn that setting up a system of selective controls to apply to significant market-power sectors but not to others would be quite an operation. Many economists would probably throw up their hands at it. But the chief factor forcing the controllers to generalize or quit would be public acceptability. Mandatory or not, a system of controls that imposes punishments on people for doing what previously came naturally to them will only survive as an effective force in a democracy on the basis of broad public support and belief in its fairness. What seems fair to an economist will not necessarily seem so to a layman. The economist may see a subtle but supportable distinction; the layman only gross discrimination—'A' getting away with it while 'B' cannot. "Why him and not me?"

There have been cases of relatively long-lived selective controls but their ultimate effectiveness, at least when their chief side effects are taken into account, is questionable. A good example is rent control. The way this gets evaded is not so much through landlords breaking the law as through landlords and other investors increasingly contriving to pull their money out of the controlled housing sector and put it somewhere else. Hence the recurrent association in some countries between rent controls and housing shortages of a much more generalized kind than Canada has recently known.

### *General Controls*

Where the purpose of controls is to hold down the entire price level, the public-acceptability consideration usually forces the imposition of a general system from the outset. Furthermore, the administrative impossibility of trying to decide which of the millions of individual prices and wages in the economy are fair and reasonable and which are not almost invariably compells the initial imposition of a general freeze, as of a certain date. Those who feel especially hard done by as a result are then permitted to come forward and plead their cases.

It would be from the moment that the first few hard cases arrived before the controllers that the public acceptability of peacetime controls would start to come into collision with economic reality. The Canadian economy is a very complicated place—and for all its faults, a very dynamic place. What was an "equilibrium" price yesterday may no longer be so today. If the new market-clearing price—the one that would match supply with demand—were a lower one, well and good; no problem. But if it were a higher one, it would bump into the price ceiling. The controllers might see why this particular price ought to rise. But they would also be aware that the general public could swallow only so much seeming double talk about why 'A' should be granted an exception while 'B' was not. They would know that too many exceptions would give their whole system an increasing outward aura of elaborate farce. Therefore they would tend to be tough about exceptions.

This will suggest broadly the way in which a direct control system starts to bring about economic distortions and indirect evasions of the law, such as the famous wartime shrinkage in the size of the five cent chocolate bar, entertainingly recalled for us by Dr. Raymond Saulnier. More direct evasions also take place as black markets spring up. In wartime, rationing, exchange control and patriotic outrage at cheaters help to make disequilibrium prices sustainable. In peacetime, these reinforcements are wholly or largely absent.

After a certain time, the direct control system, wartime or peacetime, has to start yielding across a broader front. The freeze begins to melt. *Some* penetrations of the price ceiling have to be granted, the cost of living rises, and sooner or later wages and salaries have to be adjusted commensurately. In industries where productivity gains are difficult to achieve, this will mean further permitted price increases, leading to further rises in the cost of living, and so on. Also, in a sustained peacetime control exercise, wage and salary earners will eventually demand, not just cost-of-living bonuses, but also extra compensation for their contribution to productivity increases, thus exacerbating the control problem in industries unable to generate appreciable productivity gains. As yielding continues, and control becomes more and more a matter of trying to keep the retreat orderly enough to preserve some measure of credibility and public acceptability, more than one controller may wryly conclude that his most important piece of office equipment is a good pair of running shoes.

On practical grounds alone, it does not seem to us that a sustained, elaborate control exercise of the general scale and duration of that of the Second World War, and with much the same massive administrative apparatus, is "on" in peacetime Canada. The favourable psychological milieu and the necessary basis for broad and relatively well-maintained public acceptance are too obviously lacking. Mr. J. Douglas Gibson, whose distinguished career in economics and business has included a lengthy spell as a wartime price controller (and decontroller) observed to us as follows:

> "We had awful trouble with some of those controls even with all the heat and patriotism of war, and to think that people would now behave in the way they did then is too ridiculous. They would not. They do not. It is now a different story altogether."

*Freezes*

What is more conceivable in peacetime is something more in the nature of a general but temporary freeze—a quite short-term control exercise with few exceptions and a relatively small bureaucracy to run it. Many of the typical problems of controls would not arise to any great extent because they would not have time to; the freeze would be off again before they had raised their heads very far.

This was the broad character of the 90-day freeze which was imposed in the United States in mid-August 1971, but it is now to be succeeded by something more in the nature of an incomes policy designed to hold the rise in the general price level down to a range of 2% to 3% a year.

In Canada, it is possible to imagine various circumstances in which the federal government might believe that there was some advantage in resorting to controls on a short-term basis. One such resort might be to cope with a sudden, unexpected and very pronounced inflationary emergency, originating largely outside Canada. The sole purpose of controls would then be to hold things somewhat in check until monetary, fiscal and exchange-rate policies had been thrown into emergency and had worked through their lags. Here again, there would be great danger of a wage-price explosion when the controls were lifted, or even before that. It would be essential for the other policies to come through as soon as possible and at least diminish substantially the explosion.

We regard all such possible control-scenarios with the greatest reserve. We regard them with reserve, above all because any general application of direct controls, even for a short time, is a gross interference with economic and personal freedom on which the ultimate returns are in the highest degree problematical. When controls obviously do not work very well, as they usually do not, there are always people to argue that what is needed is still more controls. These people might on some future occasion carry the day. There would then follow a demonstration in depth of why the only kinds of peacetime controls that are administratively possible in practice are a crude, stupid and insensitive way of running the Canadian economy over any extended period.

Whenever controls are proposed for Canada, the main question to be asked is: "Are they worth it?" Remembering especially that even at its worst, Canada's past inflationary record has not been all that bad by world standards, one is not likely to come out with a cost-benefit calculus favourable to controls. To be sure, "emergencies" will occur from time to time in which controls will seem to many the "only" alternative. At such times, it is worth pausing to consider that part of the problem may be one of policy lags, that we already have available a number of powerful economic stabilization weapons whose full potentialities we are still in the process of learning to exploit, and that many if not all of the seeming emergencies of economic policy, as of government policy generally, fortunately turn out to be fairly ephemeral.

It is also worth recalling yet again that Canadians had an intimate and extended experience of direct controls during the Second World War, and when the war was over they scrapped them. We hope that a new generation of Canadians will not have to learn the hard way what is wrong with controls.

We therefore recommend that direct wage and price controls be treated as one of the least desirable of all economic stabilization tools—of dubious efficacity, and carrying a very high cost in terms of interference with personal freedom and economic dynamism. If they are used at all in peacetime, it should be for strictly short-term emergency purposes.

*Tax Alternatives to Controls*

It has been suggested that in an inflationary emergency where a government might otherwise feel compelled to use direct controls, special forms of taxation might be instituted to do much the same job with fewer undesirable side effects. Such proposals usually feature some form of incremental tax on what would be deemed to be excessive increases in income. The tax would severely penalize and deter such increases but still leave it possible for urgently needed market adjustments of individual prices and wages to occur.

Professor R. Bellan outlined for us a scheme of this general type and another was recently put forward by Professor S. Weintraub. These schemes appear interesting but in need of further work and refinement. We would much prefer to do without either direct controls or special taxes but if it ever came to a choice between the two, the more market-oriented alternative of taxes could well save Canada a lot of bureaucracy, loss of economic freedom and inefficient resource-allocation. Therefore, it seems worth developing these schemes further as extreme contingency plans.

## INCOMES POLICIES

Dr. John Young has defined a prices and incomes policy as, "An attempt to use some form of direct public pressure to influence decisions about prices and incomes so that these will conform more closely with national economic objectives". Like controls, it involves government standing closer to the private decision-maker than it does in the case of monetary and fiscal policies, and placing narrower and more specific bounds around him. But the sanctions with which government is armed are less powerful and absolute than in the case of controls.

The sanctions that have actually been used to back up incomes policies in various countries cover a wide range. At one end of the scale are those of so-called "voluntary" programmes under which governments set wage and price guidelines and simply invite labour and management to conform to them as a matter of patriotic duty. It is hard to discern much more effectiveness in such programmes than in generalized "jawboning" by the government about how much better off the economy would be if some people behaved in a more public-spirited manner. Exercises at this level may well arouse suspicions that the government is gently attempting to pass the buck for some of the shortfalls of economic management. As Professor Johnson irreverently put it to us: "It is a strange concept of democracy—though one nurtured in the British Public Schools—to ask everyone to restrain himself in order to relieve the government of its obligation to restrain him".

Some incomes policies, however, have been a good deal less voluntary. They have been backed up by such things as a government's actual or threatened use against economic non-conformists of discriminatory procurement policies and reductions in tariff protection. The device of subjecting specific offenders to unfavourable publicity and the generalized threat of mandatory controls have also been used. In Canada, as Dr. Young pointed out on a number of occasions, the 1970 programme of the Prices and Incomes Commission was designed to be "voluntary" only in the initial stage of mustering commitment to it. Management, labour and government were invited to volunteer their adherence to the programme and to the restraints specified under it. Once commitment was obtained, however, adherence was to be mandatory and governments were expected to utilize various means of penalizing offenders.

When an incomes policy is strongly backed up by governmental sanctions, and when it manages to survive for a while and have some bite on the economy, it begins to show more of its family resemblance to mandatory controls. It usually turns out to have the same need for generality and broad public acceptability as does a system of controls and the same limited tolerance of exceptions. Indeed, the incomes policy may be even less tolerant of exceptions because it relies more on the sheer force of public opinion. Even a mild suspicion of unjustified discrimination may seriously undermine the public's willingness to conform. This is probably why the originally quite sensitive statement of the United States wage-price guideposts of 1962—a statement that provided for a variety of exceptions and special cases—was turned into a much cruder and more unqualified declaration when the government decided to put some muscle behind the guideposts.

The great majority of incomes policies, however, have had great difficulty in even getting started and those that have passed that stern test have rarely survived for long. Thus the potential that incomes policies have for distorting the economy and restricting personal freedom, in the same fashion as controls, is not often realized. Sometimes there can be distortion (and also gross unfairness) when an incomes policy half-works—is effective in some significant parts of the economy but is largely disregarded elsewhere. This really amounts to a discriminatory tax on "good guys", objectionable on grounds both of economics and equity. "Good guys", however, rarely stand still for this kind of thing very long, unless perhaps they are government employees condemned to set an admirable but widely disregarded example for others. In such a case, the economic distortion manifests itself as a growing difficulty in recruiting and retaining adequate numbers of well-qualified government employees. Professor Richard Lipsey told us of this and other difficulties encountered with incomes policies in Great Britain.

### *Guidelines*

The setting of the guidelines or standards around which most incomes policies are built poses a number of problems. One may want, in principle, to set the wage guideline (which will usually have to be a single guideline for public-acceptability reasons) equal to some statistical rate of productivity increase. This raises the problem of frequently revised productivity statistics, and also the same problem that comes up with controls of what to do about industries of low productivity-gain. Then too, if prices are rising briskly when the guideline is instituted, realism may demand that the guideline be set at the productivity rate plus some partial allowance for past price increases. And once such a rate is set, it becomes hard to reduce even when price increases slacken. It can become a sort of floor, impeding rather than encouraging a return to reasonable price stability.

The problems with general guidelines seem endless. This does not in our view totally rule out the possible future use in Canada of an incomes policy of the general guidelines type but it does suggest that no substantial or long-term reliance ought ever be placed on such a policy. It can be at best a very modest auxiliary to the big levers of monetary, fiscal and exchange-rate policies. Conceivably, at certain particular junctures, guidelines might help just a little in bringing about a short-term psychological adjustment towards a less inflationary climate, but beyond that the record indicates a very high probability of breakdown. Even on a short-term basis, getting the policy to work at all is likely to be difficult. The prospects of achieving some modest results are likely to be greater if there is a strong national consensus that something ought to be done, and if major interest groups affected, including organized labour, can somehow be effectively involved in the determination and spelling out of the guidelines.

*Spotlighting*

But while we would discourage the promulgation and publicizing of general guidelines by the Prices and Incomes Commission on any sort of a continuing basis we strongly urge the Commission to mount an effective continuing programme of "spotlighting"—of identifying and researching cases of cost and price increases that are out of line *by any reasonable standards*. We are aware of important situations where normal market forces do not exert sufficient influence on price and wage decisions, with the result that increases occur in excess of any economic or other justification. Such excesses, particularly when they occur in key industries, have obvious cost impact in the industry concerned but their effects do not end there. They tend also to set dangerous and disruptive precedents for other groups about to bargain for wages or to make price decisions. There can be a general raising of sights to unreasonable levels. Dr. John Crispo, in his submission to us, referred to "boat rockers", able to operate outside normal market restraints. He said, in part:

> "There may be something inherently wrong with the competitive pursuit of self-interest on moral or ethical grounds, but economically it is hard to quarrel with the efficacy of this approach as long as there are sufficient checks and balances, either market or institutional in nature, among the various contending interest groups. What we have to avoid are unrestrained power blocs, be they in labour, management, the professions, government or anywhere else. Otherwise, they will be able to extract monopolistic and/or monosonistic returns, thus whetting the appetites of others for less realizable but perhaps equally inflationary, demands".

Like Dr. Crispo, your Committee believes that such "boat rocking" has a negative influence upon the economy. When it occurs—when normal market pressures and restraints are most decidedly inoperative—governments should make every effort to publicize the situation and assert the broader public interest. Some of the more valuable work of the Prices and Incomes Commission, in our judgment, has involved precisely this kind of exercise, focusing the glare of public attention upon such situations and subjecting those involved to the discomfort of scrutiny and criticism by their peers.

But we would not stop there. Excessive wage and price increases should not only be identified and publicized, they should also be researched and remedies should be recommended. When the structural flaws or other special circumstances that permitted groups to hurdle the barriers of normal market restraint have been uncovered there should be action to keep increases within more acceptable boundaries. If such steps as the removal of tariff protection or of restrictions on the entry of new workers into particular trades would improve matters, these should be considered by government. We envisage this type of thing as an important future activity of the Prices and Incomes Commission.

Because of the problems associated with the enforcement of guidelines over a period of time we do not believe that this spotlighting function should be based on promulgated general guidelines. Rather, in light of our medium-term unemployment goal, we believe that spotlighting as well as monetary, fiscal and exchange-rate policies can be directed towards a reduction of the annual increase in the Consumer Price Index to a medium-term goal of between 2% and 3%.

*Protection of Pensioners Against Inflation*

Identifying the main casualties of inflation is a difficult matter that could benefit from a good deal of research. It seems plain enough, however, that old age pensioners are a group particularly likely to be hit by inflation and particularly ill-able to defend themselves against it. Parliament has raised from time to time the rates of pensions under its jurisdiction, and has also legislated some automatic escalation of pensions to the Consumer Price Index, but the escalation is only partial with the result that recipients of these pensions are still being hurt by inflation.

It is sometimes suggested that going to full cost-of-living escalation of government pensions and perhaps also seeing if something could be done for especially defenceless recipients of other pensions, should be ruled out because it might have a serious effect on inflationary expectations—might cause many people to conclude that the war on inflation was all off. This seems to us unacceptable and overdrawn. It is unacceptable because it would perpetuate an obvious inequity, and smacks too much of holding pensioners hostage to the good anti-inflationary intentions of the rest of us. It seems overdrawn because full escalation would force the federal government to find considerably more revenue than it now has to during inflationary outbreaks (involving, perhaps, raises in pension contribution rates) and because the political and economic-policy record of the last few years indicates that far more Canadians than just pensioners are very disturbed by inflation and want governments to do a better job of controlling it.

We therefore recommend that Canadian economic stabilization include full adjustments of Old Age Security pensions and of payments from the Canada and Québec Pension Plans for rises in the Consumer Price Index.

*The Role of the Unions*

This seems an appropriate place to say something about the possible role of the Canadian labour movement in the kind of economic stabilization strategy that we are proposing in this Report.

We do not wish to engage in the popular activity of delivering moralistic sermons to industrial workers about the need for income restraint.

Trade unions and their members are, of course, very far from lily-white in the matter of inflation in Canada. But so are many of their critics. Despite strong efforts to do more, the unions have only succeeded in organizing roughly one-third of the non-farm labour force and among the other two-thirds are to be found many cases of well-above-average income gains over recent years.

The main reason why unions are characteristically allocated blame for inflation is that they go after income gains for their members so very much in public. Other groups are able to do much the same thing more quietly—sometimes almost unnoticed by the public. But collective bargaining is and probably always will be one of the noisiest economic processes known to man and this makes unions especially vulnerable to being designated as major social and economic scapegoats.

Unions also worsen their public image by issuing militant and defiant statements from time to time—statements which are widely read as the contempt of a tightly-knit autocracy for the larger public interest. It is not as generally appreciated as it ought to be that the Canadian labour movement is, for the most part, as far as any human organization can be from an obedient, boss-directed civilian army. It is, by contrast, a profoundly *political* type of organization, loosely federated and wracked by divisive tendencies of all kinds. Many of the strident cries that periodically emanate from its leadership are not primarily for external consumption at all, but are more in the nature of internal rallying cries—evidence of the constant struggle to maintain the minimal degree of unity and control that is necessary for effective organizational survival.

We point these things out, not in order to excuse the unions from any portion of their considerable responsibility for past inflation but in order to lay down a basis of realism for bringing the unions more effectively into the ambit of future economic stabilization in Canada. It must be kept constantly in mind that the typical Canadian union leader is much less a "boss" than a replaceable politician with a difficult and turbulent constituency. This puts him into a very awkward position when, *en route* to the bargaining table, he is resoundingly enjoined to conform to a wage guideline, or at any rate to have a proper regard to the general public interest in a non-inflationary wage settlement. He might well cite the dictum of Hugh Cecil, that unselfishness is inappropriate to the actions of a state and that "no one has a right to be unselfish with other peoples' interests".

But all this having been said, we now strongly urge the Canadian labour movement to consider very carefully and thoroughly the proposals of this Report and the question of how the labour movement might most effectively contribute to their successful implementation. We urge them not to react to these proposals too quickly but to study first the reasons why, for example, we have taken the position that a somewhat cautious interim employment goal would be likely (all the relevant economic and political factors having been taken into consideration) to produce a better average employment performance in the future than in the past. We urge them, on grounds of their own self-interest as well as the broad public interest, to treat the problem of inflation in Canada much more seriously than they have ever done before because if this problem is not better controlled, it will lead inevitably to mounting public frustration and pressures for wage controls and repressive labour legislation.

We are not moralizing; we are just trying to be realistic. We think that if the labour movement approaches our proposals in the same spirit, they will be able to find ways in which they can help convert these proposals into realities.

## SUPPLY AND STRUCTURAL POLICIES

While some economic stabilization policies such as monetary and fiscal policies work primarily on total demand and spending, others work mainly on the supply side of the economy. A supply policy may be defined as any policy that tries to keep down resource waste and increase the amount of goods and services that will be available to meet growing demand. A structural policy is a policy that shifts resources around the economy so that more of total supply will be in the right place at the right time—ready to meet the demand. Manpower policy is a good example of a combined supply and structural policy; among other things it increases through training the supply of skilled labour in the economy and it also helps to move unemployed or under-employed labour out of "soft" sectors of the economy into other, faster-growing sectors where it is more urgently needed.

From a stabilization standpoint, supply and structural policies basically do two things for the economy:

1. They steepen the potential growth path of the economy by increasing the supply of goods and services available.
2. They make it easier for the economy to return to its growth path without serious inflation following a downward deviation into slackness and unemployment. This return to the growth path never occurs evenly across the economy but instead is characterized by particularly rapid demand growth, now in one group of sectors, now in another. Effective supply and structural policies permit it to go ahead more steadily with fewer bottlenecks and "spot" inflationary outbreaks.

In the heat and passion of an economy caught in a serious inflationary lag-trap, these policies have little appeal, which is one major reason why they have not been stressed nearly enough in Canada. The Economic Council put a lot of emphasis on them in its *Third Annual Review,* but by the time that document appeared in late 1966, inflation and inflationary expectations had reached such a state that the Council's recommendations in this area were found by some commentators to be largely irrelevant and an evasion of the main issue. Stronger and more punishing medicine was being called for, and soon. This is the typical political situation, not just in Canada, but in any stop-go economy faced with a serious inflationary outbreak. In such an atmosphere, slower-working policies command little attention and indeed offer little practical escape from the immediate difficulty.

But in the context of a longer-run and ultimately more effective anti-inflationary strategy, these policies come into their own. Far from being irrelevant, they offer perhaps the most important practical way in which government policy can move to reduce the trade-off dilemma between high employment and price stability. And, in sharp contrast to controls, their side effects are mostly good, consisting of such things as higher gains in productivity and living standards.

We therefore strongly endorse the general concept of supply and structural policies, considering them to be an absolutely indispensable part of a really effective economic stabilization strategy.

Competition policy is a member of this group of policies that is much in the public eye at the present time. A good competition policy is useful against inflation and also against certain restrictive practices and structures that reduce the dynamism of a market system and hold back desirable innovation in the service of the consumer. Properly conceived, competition policy involves a certain limited regulation of specific aspects of markets, but this regulation should be sharply different, as to both extent and underlying philosophy, from other forms of government regulation of business. In fact, the philosophy should be in many ways *opposed* to that of other kinds of regulation—should be treated as an alternative and preferable approach. The fundamental philosophy of competition policy should be to interfere in the market only so much as is necessary to make the market work better—to unleash it and give it a chance to show what it can really do by way of making bigger openings for those who have ideas about how to serve the public better at lower cost. This is a philosophy utterly at odds with that of direct wage and price controls. The more competitively the market works and is seen to work, the less attractive will seem the case for direct controls.

In response to accumulated criticisms of various aspects of Canadian competition policy, and following a special report by the Economic Council, the Federal Government has introduced a bill for a new Competition Act embodying such innovations as a partial move away from the present exclusive reliance on criminal law, and the creation of a civil law Competitive Practices Tribunal. Already there has been sharp controversy about many aspects of the new bill. Since, however, the government will not for some while be proceeding with competition legislation in Parliament, there will be ample time for controversy, dialogue and representation by all interested parties.

We therefore urge all those with informed and considered views about the Competition Act to come forward and join the public debate now in progress, to spell out specifically the improvements they would like to see and to keep constantly in mind what should be the fundamental purpose of competition legislation—to make markets work better for the benefit of all Canadians. We urge the government to listen attentively to these suggestions.

Another major supply-and-structural policy likely to be undergoing important changes in the relatively near future is manpower policy. This policy, which may be approximately described as achieving a better fit between available people and available jobs, and assisting and promoting human adjustment to change, furthers the attainment of a number of basic economic and social objectives including equity and economic growth. But it also has an important bearing on economic stabilization and on the achievement of a better trade-off between high employment and reasonable price stability.

Canada has now had an active manpower policy at the federal level for five years and the Economic Council has just published in its *Eighth Annual Review* a thorough going assessment of certain aspects of policy-performance. We urge the federal government to take full account of the Economic Council's analysis of manpower policy, to investigate other aspects of how well this policy has performed, and to institute improvements partly with a view to enhancing the important contribution which this policy can make to stabilizing the growth of the economy.

*Conclusions and Recommendations (VII)*

**1. While we advocate one very special kind of incomes policy for Canada we are in general deeply sceptical about most varieties of controls, guidelines and incomes policies. Their historical record of effectiveness against inflation is poor, and they pose important threats to personal freedom and economic dynamism. They also tend to divert attention from more effective anti-inflationary policies. Problems of public acceptability alone would militate against selective wage/price controls. The control system would likely be either general in its application or a largely meaningless gesture. Controls are one of the least desirable of all economic stabilization tools. If they are used at all in peacetime it should be on a short-term emergency basis.**

**2. If there is a strong national consensus which includes the major interest groups, an incomes policy based on general guidelines might be used as an auxiliary to the big levers of fiscal, monetary and exchange rate policies to bring about a short-term psychological adjustment towards a less inflationary climate. However, no substantial or long-term reliance should be placed on such a policy.**

**3. We recommend that the Prices and Incomes Commission identify and focus the glare of public attention on situations where price or wage increases occur that are out of line by any reasonable standards. When the structural flaws or other special circumstances have been uncovered that permitted groups to hurdle the barriers of normal market restraint, there should be action to keep increases within more acceptable boundaries. If such steps as the removal of tariff protection or of restrictions on the entry of new workers into particular trades would improve matters, these should be recommended to government.**

**4. We do not believe that this spotlighting function need be based on general guidelines. Rather, in light of our medium-term unemployment goal, we believe that spotlighting as well as monetary, fiscal and exchange rate policies can be directed towards a reduction of the annual increase in the Consumer Price Index to a medium-term goal of between 2% and 3%.**

**5. For pensioners vulnerable to inflation there should be full adjustment of Old Age Security pensions and of payments from the Canada and Québec Pension Plans for rises in the Consumer Price Index.**

**6. The three big levers of monetary, fiscal and exchange rate policies primarily focus on the demand side of the economy. They must be complemented by supply and structural policies (such as manpower and competition policies) which encourage growth in the supply of goods and services and which channel resources into their best use. Since these policies act to improve the trade-off over the longer-term, they should receive heavy emphasis in our economic stabilization strategy.**

## CHAPTER VIII

# NATIONAL POLICY-MAKING IN A REGIONAL COUNTRY

We could hardly have attempted any discussion of economic stabilization policy in Canada without some reference to regional aspects of that policy. Almost all countries are "regional" to some degree, but Canada is more regional than most, and nowhere is this more true than in economic life. It was thus virtually inevitable that policies for regional economic development and the regional aspects of other policies should have been the subject of considerable comment by many of the witnesses who appeared before us.

Even the broadest economic policies have different impacts on different regions. For example, it has long been recognized that import tariffs have different impacts on some regions than on others (although, as we shall note, recent research has led to some reinterpretation of the nature and size of these differences). Across-the-board reductions in personal and corporate income tax rates exert propotionately more of their stimulating effect on regions of high income and large-scale corporate activity and less on other regions. And federal cost-sharing programmes such as those to provide low-income housing may have differing regional impacts because of the differing abilities of provincial governments to finance their share.

In recognition of such facts, the federal government has more and more sought to adjust national policies to regional circumstances and to employ, in addition, special programmes and policies tailored to the needs of particular regions. The system of tax equalization payments provides an obvious and relatively straightforward example of an interregional economic transfer. Another good example is the system of grants and loans to industries locating in designated "slow-growth" areas.

But what of the big levers of economic stabilization policy? What role, if any, can they play in evening out regional economic disparities and encouraging the development of less favoured regions?

*Monetary Policy and Regions*

So far as the regionalization of monetary policy is concerned, most witnesses who testified on this matter could discern only limited possibilities. Money and credit markets, it was argued, are national and international in scope. Thus attempts to build special channels for the direction of funds to particular regions are likely to suffer from massive "leakage". The funds, that is, will not stay where they are directed but will have a tendency to end up where they would have gone in the first place without governmental intervention.

As a general proposition, this is hard to quarrel with. Nevertheless, we received testimony indicative of *some* possibilities for exerting a deliberate influence on the cost and availability of credit in particular regions. The Governor of the Bank of Canada noted that, "when credit conditions have been tight, we have tried to shield to what extent we could the impact of this on the slow-growth regions by asking the banks to take a particular tender view of applications for credit from the slow-growth regions". A similar picture of very limited but useful possibilities emerged from the submission of the Canadian Bankers' Association. While arguing that the regional distribution of loans and deposits is "determined essentially by customers", the banks also said that they gave "special attention" to the needs of slow-growth areas through concessions on the terms and risk-standards applying to loans in such areas.

Because of Canada's centralized banking system it appears that there is some opportunity to alter by "moral suasion" the impact of monetary policy on particular regions and in this way to contribute to regional economic development objectives. We urge that this opportunity not be overlooked.

*Fiscal Policy and Regions*

The possibilities for regionalizing fiscal policy seem a good deal brighter. We received much testimony to the effect that fiscal policy already does a fair amount to promote the attainment of regional goals, and that it can do more in future. This is not too surprising a conclusion, given the fact that spending on goods, services and transfers by all levels of government is currently equivalent to roughly 35% of GNP. Governments are thus in a position to influence considerably, via this route alone, the regional distribution of resource-use. It must be noted too that more than half of total government expenditure is now accounted for by provincial and local governments, many of which have an especially strong commitment to the reduction of regional economic disparities.

To be sure, we indicated earlier some preference for the use of the tax rather than the expenditure blade of the fiscal-policy scissors. The main point, however, of referring here to the size of government expenditures in relation to GNP is to recall the large relative size of the government sector which, in the context of regional economic objectives, is just as much a factor on the tax as on the expenditure side. Even where fiscal policy changes are occurring mostly on the tax side, there are important opportunities for differentiating these changes from region to region. Also, it may be recalled that we did not entirely rule out expenditure changes as a fiscal policy device and that we made special mention in this connection of short-lag expenditure changes designed to deal with particular regional pockets of unemployment or inflation.

As in the case of monetary policy, a regionally differentiated fiscal policy is likely to encounter the problem of interregional "leakages". Some of the resources that policy is attempting to direct to less favoured regions may, once again, end up elsewhere. The problem may well be somewhat less acute for fiscal than for monetary policy, however. Professor André Raynauld referred us to some interesting recent research evidence suggesting that more of a given fiscal stimulus to such a region as Québec or the Atlantic Provinces might "stick" to that region than had previously been supposed.

But while there seem to be good possibilities for regionalizing fiscal policy to a significant degree, the ability of policy-makers to exploit these possibilities fully through present mechanisms is another question. Since fiscal policy is a tool used by provincial governments as well as the federal government, good inter-governmental arrangements for consultation and co-ordination are an obvious requirement. Fiscal co-ordination has been strengthened in various ways during recent years, notably by the development of regular series of federal-provincial meetings at both the ministerial and the official levels but there is room for further improvement. The more general use by the federal and provincial governments of high-employment budgeting might considerably facilitate better fiscal co-ordination.

In general we recommend that the potential regional dimension of fiscal policy be well exploited and that fiscal co-ordination between the federal and provincial governments be improved.

*Regional Decentralization*

(a) *Decision-Making*

Without attempting to cover the broader spectrum of regional development policies, we should also like to draw attention to one or two unjustly neglected possibilities in this domain. The first concerns the managerial, decision-making and service functions of large corporate and governmental entities.

A century or more ago, the state of transport and communications was such that a great deal of industrial and governmental activity had to be relatively local and decentralized. As transport and communications improved, however, such organizational forms as the large national and international corporation became increasingly possible, and both corporate and governmental decision-making became markedly more centralized. It was during this period that a large proportion of economic decision-making in Canada, together with back-up services such as finance and advertising, became concentrated in the three metropolitan centres of Montreal, Ottawa and Toronto. Given the state of technology as it evolved through this period, the economic forces making for such a concentration were strong.

Now, however, the further progress of transport and communication technology—as exemplified notably by jet air travel, the computer and modern telecommunications—may well have created a more "open-option", "either-way" situation. An even *greater* geographical concentration of decision-making and associated functions is certainly *possible*. But it may not be nearly so economically "*necessary*" as the earlier concentration. On the contrary, the new technology may also have rendered possible a substantial degree of *decentralization* of decision-making in Canada, without great economic cost and even, in some cases, with economic and other gains. Many activities in Canada today could be effectively run from any one of a variety of possible locations across the country and greater advantage might well be taken of this fact to develop nodules or "growth-poles" of governmental and corporate decision-making, higher education and other supporting activities in presently less-favoured regions.

At any rate, this possibility seems to us worth serious investigation. We urge the Federal Government to intensify its exploration of how much of its decision-making and administration now centralized in Ottawa could in fact be done just as well elsewhere. We urge it to take a lead and set an example in this matter, and to exercise "moral suasion" on corporations to investigate their management structures in the same light and consider the possibilities of regional decentralization more seriously.

So far as the Federal Government itself is concerned, its ultimate decision-making apparatus must continue to be centred around Parliament, both geographically and in other ways. But this still leaves many decision-making functions of departments, crown corporations and other bodies that might well be joined to the main apparatus via modern communications links without the necessity for geographic proximity to the centre. There might be little if any serious loss of efficiency in moving some of these functions to areas outside central Canada, and there might be quite useful effects in terms of regional economic development and the establishment of more direct and meaningful relationships between the Federal Government and certain parts of the country. And if this kind of shift worked out well, it would encourage a similar trend in the private sector.

(b) *Service Industries*

We recommend that service industries, whose relative importance in the economy has grown very rapidly, notably in terms of employment, should be more emphasized in regional development policies. This is in no way meant to imply that the importance of primary and secondary manufacturing industries in regional development should be down-graded. But there should at the same time be a keener realization that service industries have great employment potential and that many of them serve markets that are not just local but national and even international. Moreover, if they are established on a large enough scale, they tend to attract other industries. This seems to be notably true of "knowledge-stores" such as medical centres, computer centres and university-and-college complexes. It has also long been true of large financial institutions.

(c) *Purchasing*

Another aspect of regional development worthy of greater attention concerns Federal Government purchasing. Such purchasing has been an effective tool of regional development policy in the United States. We are, of course, very much in favour of spending the Canadian taxpayer's dollar wisely and efficiently. We wonder all the same whether the Federal Government may not, like other large organizations, have developed some tendency to favour traditional and reliable suppliers in central Canada to whom it has grown accustomed. The extent to which secondary industry has grown up in other parts of the country is not always recognized and the Federal Government might find it rewarding to take some pains to ensure that this new industry is kept fully informed about government requirements and is given full opportunity to compete for the business. This should be kept all the more in mind when the Federal Government is buying goods and services for use in the same region.

Partly because of the greater distances involved, but partly also because of oddities in freight rate structures, transportation costs often make it difficult for suppliers outside the central provinces to compete with suppliers in the central provinces. In its purchasing policies the Federal Government should, where appropriate, consider making allowances for these additional transportation costs so that suppliers in all parts of Canada can compete on a more equal basis.

(d) *Tariff Policy*

Finally, we might recall that the tariff remains an issue of importance in regional economic development. Public consciousness of it is still evident in regions which buy heavily from tariff-protected industries in central Canada and sell heavily into competitive world markets. Recent economic research work has caused the issue to change its appearance somewhat by throwing doubt on the proposition that the economic cost of the tariff to the eastern and western ends of the country has been counterbalanced by specific economic benefits to central Canada. The tariff may, in fact, have held central Canada back economically—for example, by impeding the development of greater scale and specialization in manufacturing production and instead encouraging short, high-cost production runs of too many different things. Over the last few years, the general desirability of greater scale and specialization in Canadian manufacturing has been accorded growing recognition, notably in respect of the automobile industry, but the implications for long-standing issues of regional economic development have not been as widely noticed, although they were examined in the Fourth and Fifth *Annual Reviews* of the Economic Council, among other places.

*Regional Policy: Conclusion*

This chapter has not been an attempt to give an outline of the whole of Canadian regional economic development and policies relating thereto. It has sought rather to make recommendations about some of the regional implications of economic stabilization policies at the national level and to draw attention to certain particular kinds of aid to regional development that appear to have been insufficiently utilized up to now.

We must add one cautionary note: that the best regional development policies that man can devise will be of little avail unless national economic policies are also sound and purposeful. This is especially true of national policies to achieve good employment performance. Administrators of programmes to help lagging regions can furnish many examples to show what a difficult and often losing battle they fight so long as the Canadian economy as a whole is too slack. Only when the national level of employment is raised to a reasonable level can regional development policies exhibit their real capabilities.

***Conclusions and Recommendations (VIII)***

**1. The possibilities of a regionalized monetary policy to assist the development of economically lagging regions are very limited. However, because of Canada's centralized banking system there is some opportunity to exert moral suasion on the chartered banks to adjust their lending policies in favour of such regions thus altering the impact of monetary policy on these regions.**

**2. The possibilities of a regionalized fiscal policy are much greater than for monetary policy especially since the problem of leakage (the tendency of funds to flow freely from region to region) appears to be less acute for**

**fiscal than for monetary policy. Since fiscal policy is a tool used by provincial governments as well as the Federal Government, improved inter-governmental arrangements for consultation and coordination are required.**

**3. We urge the Federal Government to intensify its exploration of how much of its decision-making and administration now centralized in Ottawa could be done just as well elsewhere. We urge it to set an example in this matter, and to attempt to influence national corporations to examine their management structures in the same light and seriously consider regional decentralization.**

**4. We recommend that service industries, whose relative importance in the economy has grown very rapidly, notably in terms of employment, should be more emphasized in regional development policies.**

**5. Federal Government purchasing activities should be examined to ensure that they do not discriminate in favour of the central provinces. Considerations should be given to means of reducing the barriers created by the higher transportation costs of potential suppliers outside the central provinces.**

**6. The best regional development policies that man can devise will be of little avail unless national economic policies are sound and purposeful. This is especially true of national policies to achieve good employment performance.**

# CHAPTER IX

# MANAGEMENT FOR DECISION-MAKING

Throughout this Report we have attempted to develop a number of general themes which underpin our view of effective economic management in Canada. We have stressed the theme of greater steadiness in the use of the major economic levers, not by shackling them to any very hard-and-fast set of rules but relating them to operational goals and discouraging any temptation to fiddle or "fine-tune" with what are broadsided tools subject to important time-lags. We have argued for more hard-headed realism in some of our economic policy-making—in accepting for example, the limitations on our ability to douse imported inflation with domestic water and in urging more open acceptance of the existence of a trade-off between the goals of high employment and reasonable price stability. And we have urged realism and caution, together with some stubborn faith in the potentialities of a free market economy, in the attitudes of policy-makers towards recurrent proposals for wage and price controls and various forms of incomes policy.

To the extent that these themes constitute arguments for change, it is primarily a change of attitude or viewpoint. We have as yet advocated no new structures or mechanisms but only some differing degrees of emphasis in the use of existing structures.

There are areas, however, where it seems to us that more than just a change of attitude or viewpoint is required. We see a need for new structures or institutions, or at least revised roles for some existing ones. We base this conclusion on a clear consensus among our witnesses that Canada currently lacks a fully adequate structure for proper economic analysis and decision-making. To be sure we have heard of Parkinson's Law and we attach considerable weight to the views of those who feel that new and larger bureaucracies already have become an over-used answer to Canadian problems.

In this case, however, we would claim that economic policy-making is so central and crucial to the entire operation of government—and to the welfare of every Canadian—that it warrants some limited, but significant, addition to the management structure.

*The Economic Council of Canada*

In Chapter II, we drew a distinction between performance goals for the economy and more fundamental achievement goals for our society. We consider this a matter of such importance as to warrant specific priority and attention within the Canadian economic-management structure.

We advocate that one institution within that structure should be dedicated to the crucial function of analyzing our available national resources and the priority and cost-benefit implications of major achievement goals.

While we note and support the Federal Government's intention to help set up a new Institute for Research on Public Policy, we judge that the body best suited for the goals assignment still would be a slightly amended version of the Economic Council of Canada.

The Council, under the able leadership of Chairmen Deutsch and Smith, already has made a significant contribution to the policy-making process through its longer-range economic projections, through its various reference studies on such things as consumer affairs and competition policy, and through its efforts in its Annual Reviews to focus greater attention on such major issues as poverty, health care and education. Where the Council may have been less productive is in its attention to shorter-range problems of economic performance. This stems directly from the terms of reference given the Council by Parliament but it has lessened somewhat the impact of the Council's stimulating work on longer-range issues.

The Council is a representative body including members from business and organized labour as well as other elements of the community. Criticisms of it often refer to this fact, and it may well be that its representativeness gives rise to certain difficulties in the area of short-term economic forecasting and policy research. But this very representativeness ideally qualifies the Council for the kind of informational, analytical and consensus-building role that we would allocate to it in the field of longer-term national objectives and allocation of resources. These are questions which can be resolved only with the agreement of a broad cross-section of opinion and the Council should have an especially good feel for this. We recommend that, if necessary, the Council's terms of reference be amended to strengthen and clarify its mandate in this area and that its budget and resources be sufficiently strengthened to permit it to pursue this most essential of national undertakings.

*Prices and Incomes Commission*

In Chapter VII, we endorsed the activity of the Prices and Incomes Commission in identifying cases of wage and price increases that are far out of line by any reasonable standards, and then focussing the glare of public attention on such situations.

We went further and suggested that such increases should also be researched and remedies should be recommended to government to remove structural flaws or other special circumstances that made it possible to hurdle the barriers of normal market restraint.

In many cases the necessary action will fall within provincial jurisdiction. We therefore recommend that the Prices and Incomes Commission be a federal-provincial agency with representation from all provinces and the Federal Government and that it report accordingly.

*Commission for Economic Analysis*

We recommend the formation of a new agency which we would call the Commission for Economic Analysis. If the Economic Council is to concentrate on the longer-term questions of achievement goals and resource allocation, there would be nowhere within the Canadian economic management structure an independent body assigned to and capable of producing analyses and forecasts of economic performance in the shorter-term. We agree with Dr. John Deutsch's views on the need for such a body:

> "... there is an urgent requirement in Canada for an independent body devoted to the analysis and forecasting of economic developments. Such a body, composed of experts and independent of both government and particular interests, would issue frequent periodic reviews and forecasts of the operation of the economy and of the significant factors affecting it. Such improvements in information are vital to the formulation of appropriate policy by both governments and private bodies."

We support Dr. Deutsch's suggestion as to the character of this body. If the role we would assign the Economic Council would positively benefit from a representative group, there would appear to be no similar requirement inherent in the tasks we would allocate the Commission for Economic Analysis. Rather, we would see it as a body of professional economists appointed for three year terms, less concerned with contributing to the development of public consensus on goals than with providing governments and the public with an independent source of economic information and advice. It would be important that this Commission have a considerable degree of independence from government.

*A Stronger Role for Parliament*

Parliament figures prominently in our concept of the future roles of both the Economic Council and the Commission for Economic Analysis. A particular problem for the current Economic Council has been the lack of any organized procedure by which government might deal with and respond to its Annual Reviews. They have been directed to no one in particular; no one in government has been required to respond to them—and few have; and no group has had any special mandate to pursue the issues and questions raised in them. As a result, these documents have tended to be 24-hour wonders when they merited a much better fate.

To correct the shortcoming, we recommend that reports of both the Economic Council and the Commission for Economic Analysis be made to the Privy Council for submission to Parliament. We would have a Standing Parliamentary Committee receive these documents and hold hearings on them in a manner somewhat akin to the West German system described to us by Dr. Herbert Giersch. The appropriate Ministers and their officials would appear before the Parliamentary Committee in question to provide government comment and reaction on the issues raised in these reports. This Parliamentary Committee should be provided with adequate staff to ensure that its hearings are comprehensive.

Dr. James W. Knowles, Research Director of the Joint Economic Committee of the United States Congress and thus a witness of special interest to us as legislators, stressed this need for a high quality and balanced staff as a prime requirement for a successful Committee operation in this field. He placed emphasis on "a high degree of non-political professional objectivity" in such Committee operations, and the need for the Committee to "lead both in being ahead of opinion on major issues and in being an innovating institution in terms of techniques and procedures". As Dr. Knowles put it:

> "... the legislative committee can contribute to improved economic policy largely through gradually raising the intellectual level of policy debate both within the legislative structure itself and among the public media at large. Its hearings and studies must, therefore, explore problems or issues before they become the subject of immediate legislative or executive action. Long-run success depends in part on diligence in pursuit of such unglamorous tasks as improved economic information systems and modernization of government organization."

Glamorous or not, that is an eminently worthwhile undertaking for a Committee of the Parliament of Canada.

*The Government's Internal Structure*

Establishment of a structure in which the Economic Council concentrates on longer-term strategy and goals, while a Commission for Economic Analysis provides analysis and forecasting in the shorter-term, would offer useful additional inputs to economy policy-making in Canada. Since both the Council and the Commission would be independent agencies and thus outside the government's line structure, a good deal of their value and benefit would be felt outside the government *per se,* in the form of a contribution to greater public information and understanding.

We have given considerable thought to the internal policy-making structure of government and to possible improvements in that area. We were urged by some witnesses to consider creating a group similar to the Council of Economic Advisers in the United States which, as well as providing public information and commentary, could also make a significant direct contribution to policy formulation within the government. The suggestion was that such a Council, composed of an eminent group of economists and business leaders be appointed by the Prime Minister and provide advice directly to him as an additional or countervailing source to the Department of Finance and other traditional economic advisers.

In our view, such a Council could not function successfully within our system of government. Unlike United States practice, which accepts that the President, in particular, will have his own independent source of advice, our tradition is that the Prime Minister and his Cabinet rely on the Minister concerned to canvass available opinion, whether from his Department or some advisory group, and then to bring before them a policy recommendation for decision. Ministers certainly are accustomed to having their colleagues raise questions about recommendations brought before Cabinet and even to debate and disagree with them. But they are not accustomed to having the Prime Minister—or any other colleague—equipped with his own expert advisory group in their area of responsibility. If such a Council were created to provide the Prime Minister with independent advice on economic policy and if its advice differed from that of the Minister of Finance to any significant degree, the Minister would soon find himself in an impossible position, particularly if at some juncture the Council issued a public report on its views. If, on the other hand, the Council went to some length to avoid disagreement with the Minister and his senior advisers, then its value as an independent advisory group would be sacrificed. Accordingly, we reject the idea of a Prime Minister's Council of Economic Advisers.

*Better Information*

Another recurrent theme during our hearings was that no economic institution can function properly without adequate information. Even if we are able to ease or eliminate the worst of the stop-go elements from the Canadian economic cycle, we still will have to some extent a cyclical economy and thus we still will need to know more swiftly and more precisely where we are in that cycle. As already noted, we require a great deal more knowledge about such phenomena as lags and expectations. Dr. Deutsch, out of his long and distinguished experience as an economist and public servant, put it this way:

> "...The experience of the past 25 years has shown that our knowledge of the course of the economy at any given time is woefully deficient. As often as not, the assessments and guesses have been mistaken. Almost invariably we have not known where we were and what was actually happening until many months later. Consequently the timing and degree of government interventions in fiscal and monetary matters have often been wrong or poorly gauged to the circumstances. This has

been true not only in Canada, but in virtually every other country as well. If we are to have more success in the years ahead, we have first of all to do a big job on our economic information."

We require better statistics. That is not meant as a particular criticism of Statistics Canada; on the contrary, we accept the word of experts such as Dr. Ostry of the Economic Council that Canada's present data-gathering system compares very favourably with the efforts of other nations in this field. What we are saying is that the time period taken to collect and analyze data is unquestionably part of the lag process and one which we should be making continuous effort to reduce. We are saying that the meaning of some statistics, such as price and unemployment statistics, requires constant review and elucidation in an evolving society. For example, it is possible that because of improvements in compensation for the unemployed and because of the changing make-up of the labour force, it may be more difficult than before to match a person with a job at the pay and location that he or she will accept. If this is a fact, it should perhaps find more reflection in the unemployment statistics, or at any rate in their tabular presentation. So should any clear and substantial changes in future patterns of work and leisure.

We also need some new statistics. We noted with envy, for example, the significant information that Dr. Okita was able to extract from comparisons of Japan's consumer and export price indexes on the effect—or lack of it—of that country's domestic inflation on its international trading position. In Canada, unfortunately, we do not publish a regular, reliable price index of merchandise exports; we could use one.

There also is need for a more organized and co-ordinated system of information-exchange among those working on economic research and analysis both inside and out of government. There is room somewhere in the system for a central economic library where one can turn to find at least bibliographical direction on the latest tapes, programmes and published and unpublished research developments in any area of economic activity. We see merit in Dr. Clarence Barber's suggestion that Federal Government research be decentralized through the creation of a number of small regional centres which could support other regional agencies or offices of the central government as well as maintaining more effective contact with activity in provincial governments and in the various universities across Canada.

In addition to improvements in the flow of information within the economic research community, the dissemination of such information to the public at large should be strengthened. It is our strong belief that public interest and understanding of this area of activity is much greater than is often supposed. The prominence of coverage and quality of reporting given our own hearings by the news media are testimony to the media's ability and willingness to transmit such information to the public. What is most required now are improved sources upon which the press and the public can call for information. Neither the Department of Finance nor the Bank of Canada has ever devoted anything but the most minimal staff resources to this area of public information. And neither of these sources—nor any other Canadian one for that matter—has yet attempted to publish a quarterly economic review of the quality and usefulness of those turned out by the United States Federal Reserve System and the Bank of England. A useful addition to present publications would be a statistical review in the format of the Business Conditions Digest published by the United States Department of Commerce.

*Evaluation and Openness*

Much of what we have recommended in this chapter is related to the twin principles of evaluation and openness. Both must be relative, rather than absolute, standards and be applied with a strong dose of common sense. They should exert a greater influence on economic policy-making in Canada than they have in the past. If they are permitted to do so, policy-making will be the better for it. By evaluation, we mean that the direction and size of the impact important government policies have on the Canadian economy should be systematically estimated, both before and after the event. By openness, we mean that Parliament and the public should be told more than they are now about these policy evaluations, about other "in-house" research, and about the institutional structures and processes of government decision-making.

We repeat that the public and their Parliamentary representatives are mature and experienced enough to appreciate that economic policy-making is an on-going learning process, subject to trial and error. The people have a right to be told more about this process because its outcome so greatly affects their jobs and living standards. Those who may be inclined to treat greater openness in these vital matters as an invitation to the mounting of personal vendettas and the practice of various forms of petty political opportunism will find the gains much less than they expected, if indeed they reap any net gains at all.

The stock response to any proposal to throw more direct light on governmental decision-making in Canada has always been to observe that, however admirable in many ways may be the relatively greater openness with which the United States—sooner or later—conducts its national affairs, this process could not possibly be duplicated in Canada, given our British type of Parliamentary system with its strong traditions of Cabinet solidarity and ministerial responsibility. There is something in this, and we would not recommend anything approaching an exact duplicate of the United States system here. We are well aware that the greater openness of the United States system has provided no guarantee against some rather striking failures of economic policy in that country.

Canada's Parliamentary system is not a stone monument but a living tradition. The secret of its longevity has been a remarkable power to adapt itself progressively to an ever-increasing weight and complexity of governmental activity. The principle of ministerial responsibility (sometimes in the past interpreted as virtually equivalent to the adoption in public of an artificial pose or dramatic convention of ministerial infallibility) is among those things which have shifted. For example, the practice has recently grown in Canada of publicizing complex legislative proposals at an earlier stage, in White Paper or preliminary draft form, and inviting broad public debate, sometimes leading to important changes in the proposals. Not only that, but senior civil servants have to some extent participated in the debate. Whatever one's views about the final legislative outcome in any particular case, it is at least clear that greater openness has been practiced, the meaning of "ministerial responsibility" has been significantly modified, and the walls of Parliament have not come tumbling down as a result.

We therefore urge a greater measure of openness in the making and evaluation of Canadian economic policy, via procedures such as we have advocated. There are risks involved: risks of short-term political opportunism and of the exposure of highly competent economic analysts, dragged from their computers and back room "think tanks", to the kind of flamboyant and specious techniques sometimes employed by courtroom lawyers to destroy the credibility of expert witnesses. Public servants might grow more self-protective and less creative and be less frank and communicative with each other and with their ministers.

But there are also risks the other way and when these are taken into account, the case of more openness seems to us to emerge the victor. For economic policy to be made too much in the dark increases the risks of political over-cleverness at various levels and of the indulgence of dubious personal opinions, intuitive flashes and intellectual hobby horses. Operating in an excessively protected and confrontation-free environment, key participants in the decision-making process may be placed under insufficient pressure to spell out plainly the policy goals and premises they are really using, to back up their judgments with solid evidence and argument of a kind that can stand the light of day eventually, and to face their past mistakes squarely and learn from them.

It must be clearly understood that we are not here aiming specific accusations at anyone. We are discussing only generalized risks, based on a wide range of practical experience, recent and not-so-recent, in Canada and elsewhere, concerning the influence that an overly secretive operating environment can have even on people of first-rate character and ability. For some unusually striking and tragic examples of this, one need look not further than the "Pentagon Papers" recently published in the United States.

To be sure, government cannot always tell everything important about its economic decision-making — not, at least, at the time. One cannot, in the words of one official witness, "let it all hang out". If an untimely disclosure would wreck a delicately balanced international negociation, or precipitate a quite unnecessary and economically disturbing upheaval in the securities and foreign exchange markets, no sensible person would want it to be made. In a world much given to financial speculation, there are excellent down-to-earth reasons why such people as Prime Ministers, Ministers of Finance and Governors of the Bank of Canada must be careful about saying or even appearing to imply certain things about the future.

But this still leaves room for considerably greater official candor and a better-informed public dialogue about economic policy than we have had in the past. There is much to indicate that the Canadian public has reached a higher level of economic sophistication than it is sometimes given credit for. To take an example from our own experience as a Committee, we found it possible to engage in useful and informative dialogue with witnesses who had been employing some of the latest and most high-powered computerized techniques for the analysis of how government policy affects the economy. These witnesses talked to us not only about their results but also, to some degree at least, about their analytical techniques and problems, and while we had not the slightest illusion that we were on the road to becoming trained econometricians, we felt that we profited from the experience. We think that other Canadians could profit from it too and that Ministers and officials should in future bring more of their own "in 'house" research directly before the public. Again on the basis of our own experience, we would say that if by this process it is revealed that mistakes and disagreements can occur, and that high-powered techniques sometimes fall flat on their faces, compelling their practitioners to return to square one, this will not necessarily shock grown-up people clean out of their minds. A much more shocking revelation would be that analytical techniques giving any important promise of bettering the performance of economic policy, and consequently the welfare of the Canadian people, were not being actively experimented with. We hasten to add that no such revelation can now be made, since some very interesting experimentation along these lines appears to be taking place both inside and ouside government.

In pondering understandable anxieties about how Parliament, the media and Canadians in general would react to a more open process of economic policy-making, governments may find reassurance in the views of those psychologists who argue that peoples' behaviour is often greatly influenced by the expectations that other people entertain for it. For example, if people are treated as children—given minimal information and denied participation in decisions importantly affecting their lives—they may, in their frustration, react in ways that do indeed seem childish. But if they are treated more as adults—told more and involved more—they may rise quite surprisingly to the occasion, exhibiting a greater-than-anticipated realization that perfection is not to be attained overnight, and that even experts may be pardoned for making honest mistakes now and again.

Every effort should be made to get Parliament and the people more involved in decision-making about economic policy. If they are so involved they will respond constructively.

*Conclusions and Recommendations (IX)*

**1. The Economic Council of Canada is admirably fitted by virtue of its expertise and its representative character to perform the important task of examining and reporting on the cost-benefit implications and of suggesting the priority ranking of major achievement goals in relation to our available resources. (The method of operation of this function is outlined in Chapter II of this Report.)**

**2. The Prices and Incomes Commission should become a federal-provincial body concentrating on identifying and publicly spotlighting price and wage increases that are out of line by reasonable standards. Its recommendations for removal of the circumstances that made it possible to hurdle the barriers of normal market restraint could then be made to the appropriate government. (The method of operation of this function is outlined in Chapter VII of this Report.)**

**3. We recommend the formation of a Commission for Economic Analysis charged with the responsibility of producing short term forecasts and analyses of economic performance. It should be composed of professional economists not representative of any special interest group, who are appointed for a three year term. The Commission should be financed by the Federal Government and be independent.**

**4. Parliament and Parliamentary Committees should be given a more significant role in economic policy-making. The reports of The Economic Council of Canada and The Commission for Economic Analysis should be made to the Privy Council for submission to a Standing Committee of Parliament. Hearings would be held on these reports at which the appropriate Ministers and their officials as well as other witnesses would testify. The Parliamentary Committee should be provided with adequate staff.**

**5. Because of differences in government structures we do not believe that a body similar to the President's Council of Economic Advisers in the United States should be set up in Canada.**

**6. Our economic information should be improved in certain areas. Therefore, we recommend:**

**Statistics Canada be given the support necessary to provide:**

**a) More current, more precise and up-to-date statistics as well as wholly new statistics.**

**b) Improved methods of exchanging economic research and analysis.**

**c) New publications such as a comprehensive Quarterly Economic Review and a Business Conditions Digest.**

**7. We believe that a new openness should be brought to the process of economic policy-making in Canada. This means that the direction of important government policies and the impact they have on the Canadian economy should be systematically estimated before and after the event. This means that Parliament and the public should be told more about these policy evaluations, and about the processes of economic decision-making.**

## APPENDIX I

# CANADIAN ECONOMIC PERFORMANCE

The purpose of this appendix is to give the reader a few ready references, chiefly in graphic form, to the performance of the Canadian economy over the last two decades. These references will help to illustrate some of the points made in the main text of the Report.

The reader in search of a more intensive and thorough going treatment of the past performance of the Canadian economy and of Canadian economic policy may be directed to a number of sources. First, of course, there are standard official sources such as Budget Speeches and Budget Papers of the Federal Government, and the Annual Reports of the Governor of the Bank of Canada. Then there are the retrospective economic surveys to be found in the reports of various Royal Commissions and Task Forces; the reports of the Royal Commission on Banking and Finance and of the Royal Commission on Taxation contain particularly noteworthy surveys of this kind.

Mention should also be made of the postwar economic survey contained in the *First Annual Review* of the Economic Council of Canada, and of the later surveys of Canadian economic performance that the Council has subsequently published, either in its *Annual Reviews* or as separate documents.

We would also direct the reader to some of the written submissions made to this Committee, and to the published record of testimony. For fairly comprehensive analyses of economic-policy developments over the past several years, the written submissions of Professors G. Reuber and R. Bodkin, and also of Professor T. Courchene, may be noted.

Finally, there are certain previously published works that will give the reader a helpful overview of economic policy and economic performance in the postwar period. The article entitled, "Stabilization Policy in the Postwar

Period", by Lawrence Officer and Lawrence Smith, included in the volume *Canadian Economic Problems and Policies* edited by the same two authors (McGraw-Hill of Canada, Toronto, 1970), may be mentioned. So also may be H. Scott Gordon's article, "A Twenty Year Perspective: Some Reflections on the Keynesian Revolution in Canada", included in the volume *Canadian Economic Policy since the War,* published by the Canadian Trade Committee of the Private Planning Association of Canada (Montreal 1966).

Since few things having to do with Canadian economic policy and performance are uncontroversial, resort to a range—even if only a small range—of the above sources is highly recommended.

Turning now to some brief comments on the appendix charts, we should first express our sincere thanks to the Bank of Canada for supplying charts 1 to 7 inclusive, and also chart 10; and to the Economic Council of Canada for supplying charts 8 and 9. In both cases, the basic Canadian data used in the charts are published series of the Bank of Canada and Statistics Canada. The United States data were also obtained from standard official sources.

*Charts 1-a and 1-b* give a general impression of what has happened to the broad aggregates of production and income in Canada since 1949. The economy has certainly grown, but not evenly or uninterruptedly. The unevenness is indicated by the variations in the year-to-year changes in GNP. The interruptions show through more clearly in the periodic recessionary declines in the more sensitive Index of Industrial Production.

To run very briefly over the succession of recessions and expansions: the economy emerged from the recession of 1948-49 and about a year later was caught up in the world economic boom associated with the outbreak of the Korean War and the stockpiling of primary commodities. A mild recession in 1953-54 was followed by a major capital investment boom in 1955-56. This gave way to recession in 1957, to a short-lived, "aborted" expansion in 1958-59, and to another recession in 1960.

Early in 1961, the economy began the longest of its postwar expansions, extending through the next decade. In the late 1960's and early 1970's, the pace of the expansion slackened, and was associated with growing unemployment. This slackening was not technically termed a recession, because some of the business-cycle phenomena by which recessionary turning points are dated did not occur; hence the lack of recession shading in this area of the charts.

*Charts 2-a and 2-b* show labour-force, employment and unemployment developments over the same period 1949-71. The growth of employment in Canada has been rapid on average, but has faltered at times and has not always kept pace with a rapidly growing labour force. Up to the mid-1950's, unemployment only twice briefly rose above 4% of the labour force and averaged well below that figure. But after declining to $3\frac{1}{2}$% in 1956, the rate rose steeply, exceeding 7% in 1958 and again in 1960-61. In the first half of the 1960's, unemployment fell fairly steadily, reaching 3½% of the labour force in 1965. Thereafter, it tended on the whole to rise, with a particularly sharp jump in 1970 carrying it over the 6% level.

*Chart 3* shows the two most commonly-used indicators of general price levels, the GNP Deflator and the Consumer Price Index. Canada's sharpest experience of postwar inflation occurred in 1950-51, at the time of the Korean War and the associated "take-off" in world commodity prices. This died away fairly quickly, however, assisted by the appreciation of the floating Canadian exchange rate after September 1950. Price increases were very modest until 1955, but again became greater in the later stages of the mid-1950's investment boom and continued as a lagged phenomenon to arouse considerable public concern through the subsequent recession and the short-lived expansion of 1958-59. But by the early 1960's, price increases had again dropped away to modest levels. From there on, however, they grew gradually larger, reflecting, among other factors, the return of the economy to higher levels of employment and capacity utilization, and the lagged effects of the devaluation of the Canadian dollar to a "fixed" rate of 92.5 United States cents in April 1962. Through the latter part of the 1960's, price increases remained historically high, notwithstanding the emergence of considerable slack in the economy. Inflationary developments in the United States were more of a factor in Canadian price movements during this period than they had been in the first half of the 1960's. By 1970, some deceleration of prices was noticeable, with the early effects of the "floating-up" of the exchange rate in June 1970 probably being one of a number of factors accounting for this.

*Chart 4-a* shows some commonly used measures of labour-earnings, productivity and unit labour costs in Canadian manufacturing. Over much of the period from 1949 to 1970, productivity ("output per man-hour") by and large kept pace with rises in wages-earnings, so that unit labour costs were relatively stable. The two major exceptions to this were in the very early 1950's and in the late 1960's and early 1970's. In the latter period, the marked increase in unit labour costs ("labour income per unit of output") reflected both a speed-up in the rise of average hourly earnings and a slowing down of productivity increases. Such a slowing down is fairly typical of recessions or other periods of slack in the economy and seems to be more an effect than a cause of faltering total output. When output growth recovers, productivity growth usually recovers along with it.

*Charts 4-b and 4-c* show the behaviour of very broad shares of "labour", "capital" and other productive elements in national income. A difficulty of interpretation here is that over the last 20 years, there has been a major secular shift of human resources out of farming and other types of unincorporated business enterprise (included in "all other" in chart 4-b) into corporate industry and government. For this reason, chart 4-c on the right probably gives a *somewhat* better reading of what has happened to the relative shares of labour income, corporate profits and other investment income. Over a period of some years following the inventory disturbances of 1950-51, the labour and profit shares fluctuated within relatively narrow ranges, although there set in a rising trend in the share of other investment income. Beginning in the mid-1960's, however, there was a marked rise in the labour share and a marked decline in the profit share. It is difficult to say how "permanent" this movement may have been, and it should be interpreted with great caution. Profits have always been particularly sensitive to general slow-downs and speed-ups in the economy, so that a brisk future expansion of business activity might well bring a sharper rise in profits than in other types of income. Developments in the early 1960's, when profits rose more rapidly than labour income and thus increased their share of total income while the labour share declined, are suggestive in this regard.

*Charts 5-a and 5-b* give some insight into the fiscal posture of governments, although it should be carefully noted that the deficits and surpluses, computed on the national-accounts basis in order to fit into an acceptable framework of general economic analysis, reflect the action of "automatic stabilizers" as well as more deliberate fiscal-policy changes by governments. Thus, for example, the succession of deficits in the late 1950's and early 1960's was to a considerable extent an "automatic" result of the generally slack state of the economy at that time. Interpretation of the figures for the late 1960's is affected by controversy over whether the Canada and Québec Pension Plans should be included in the government sector for purposes of economic analysis; the surplus and deficit figures are shown both ways. Either way, there was a notable swing to substantial government surplus in 1969, then an alteration of posture in the other direction in 1970.

*Chart 6* relates to monetary policy and shows the growth of the "money supply" by two of the more widely used definitions of that aggregate. Fluctuations in rates of growth from year to year may be readily traced in the bottom part of the chart.

*Chart 7-a* also relates importantly to monetary policy and is largely self-explanatory. The generally rising trend of long-term interest rates may be noted, among other developments. Changes in lenders' and borrowers' views about inflation are generally thought to have been a significant influence on the behaviour of long-term rates.

*Chart 7-b* shows the movements of Canada's exchange rate and of official reserves of gold and foreign exchange. The floating up of the Canadian dollar in the early 1950's, the decline prior to the return to a fixed rate in 1962, and the upward float of 1970 may all be noted.

*Chart 8* shows the Economic Council's figures of "potential output" over the 1956-70 period for which the Council has made this calculation. The downward deviations of actual output from this potential-path, in the late 1950's and early 1960's, and again in the late 1960's, may be noted.

*Chart 9*, also based on Economic Council calculations, shows the Council's estimates of what the fiscal position of all levels of government would be at "full employment". The concept of high-employment budgeting is discussed in Chapter V of the text of this Report.

*Charts 10-a, 10-b and 10-c* give some very general comparisons of broad economic developments in Canada and the United States. Careful note should be taken of the fact that the figures of chart 10-a are in index form, for purposes of illustrating *relative* movements. In *absolute* terms, the total GNP of the United States is of course several times that of Canada, while per-capita GNP runs roughly one-quarter higher in the United States than in Canada. Taken together, the three charts indicate that while movements in the Canadian economy follow those of the United States fairly closely, some significant divergence has occurred.

CHART 1A

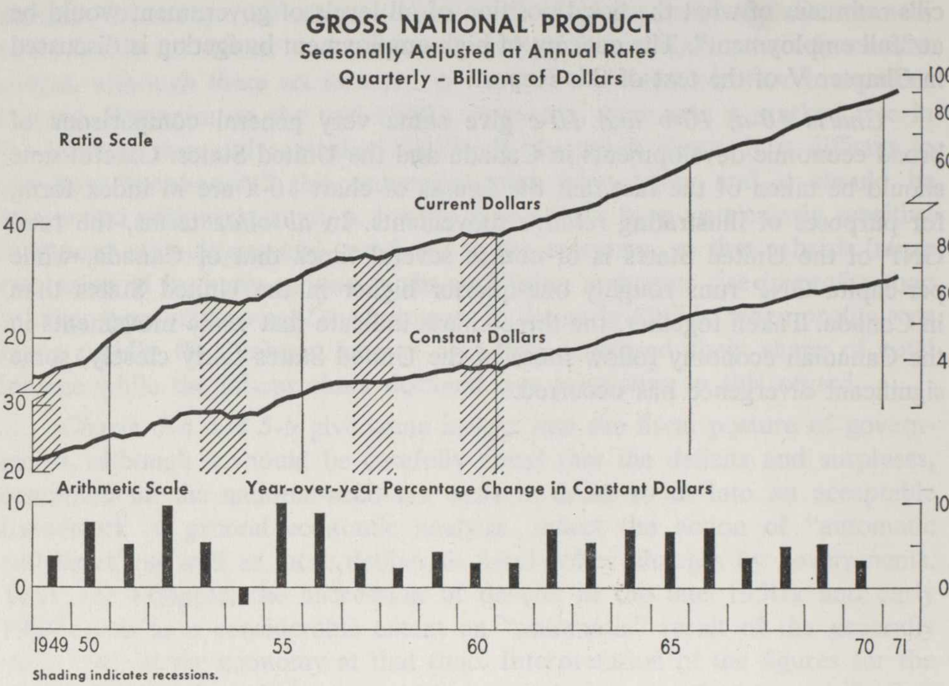



CHART 1B

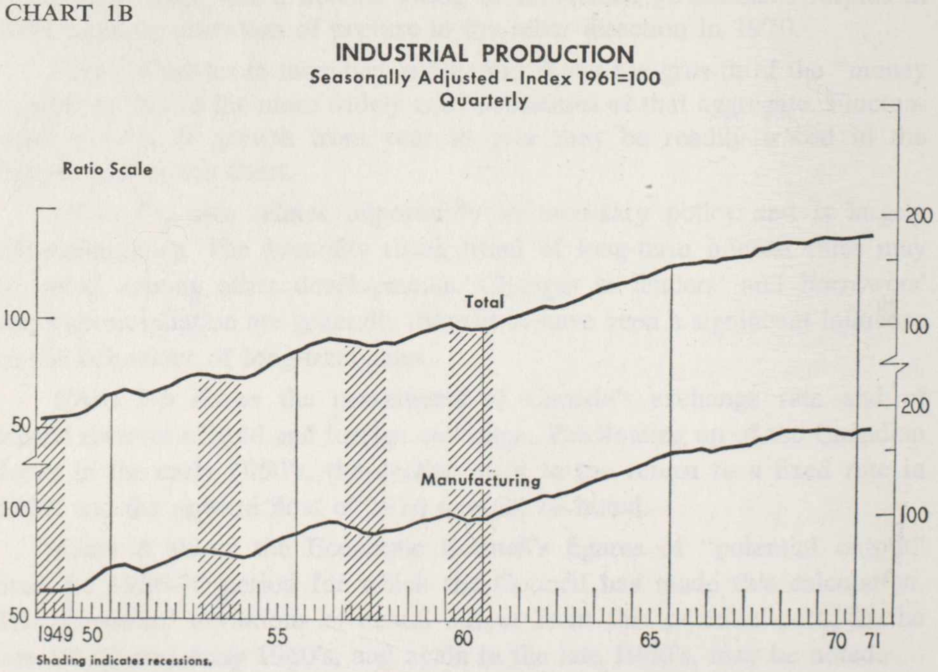


CHART 2A

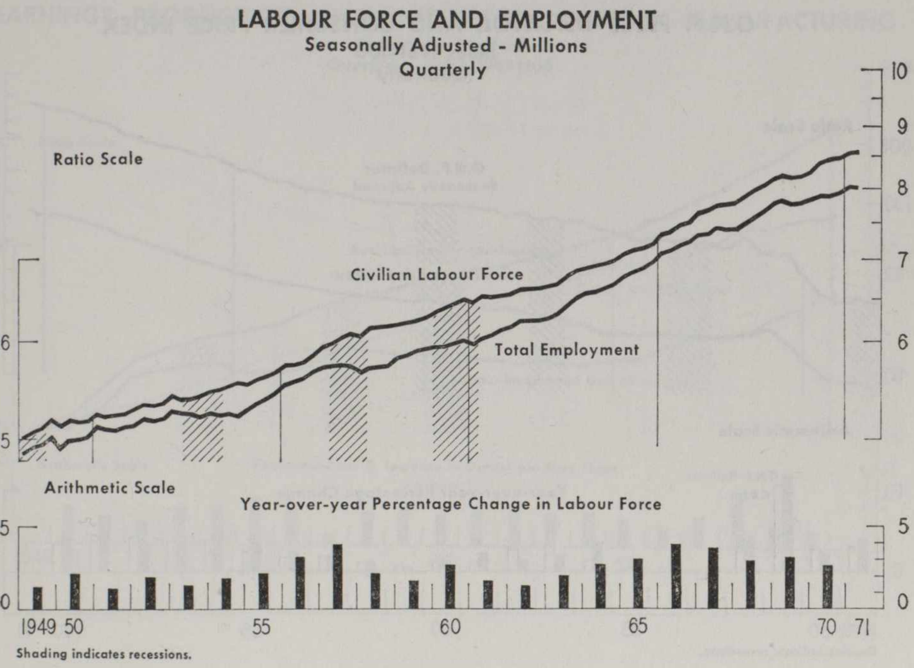



CHART 2B

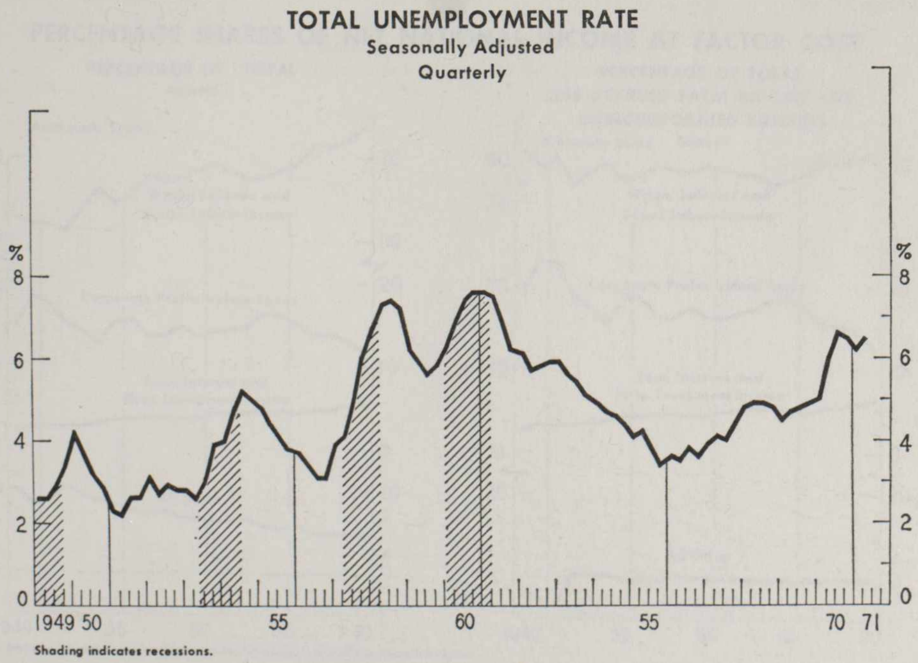


CHART 3

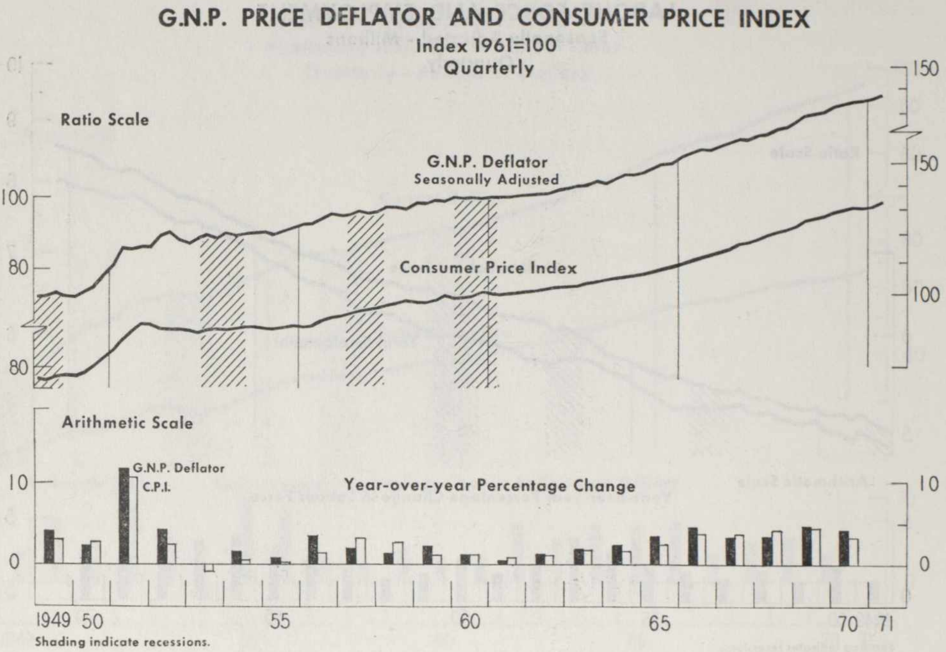

G.N.P. PRICE DEFLATOR AND CONSUMER PRICE INDEX
Index 1961=100
Quarterly
Ratio Scale
G.N.P. Deflator
Seasonally Adjusted
Consumer Price Index
Arithmetic Scale
G.N.P. Deflator
C.P.I.
Year-over-year Percentage Change
150
100
80
10
0
1949 50
55
60
65
70 71
Shading indicate recessions.

CHART 4A

## EARNINGS, PRODUCTIVITY AND UNIT LABOUR COSTS IN MANUFACTURING

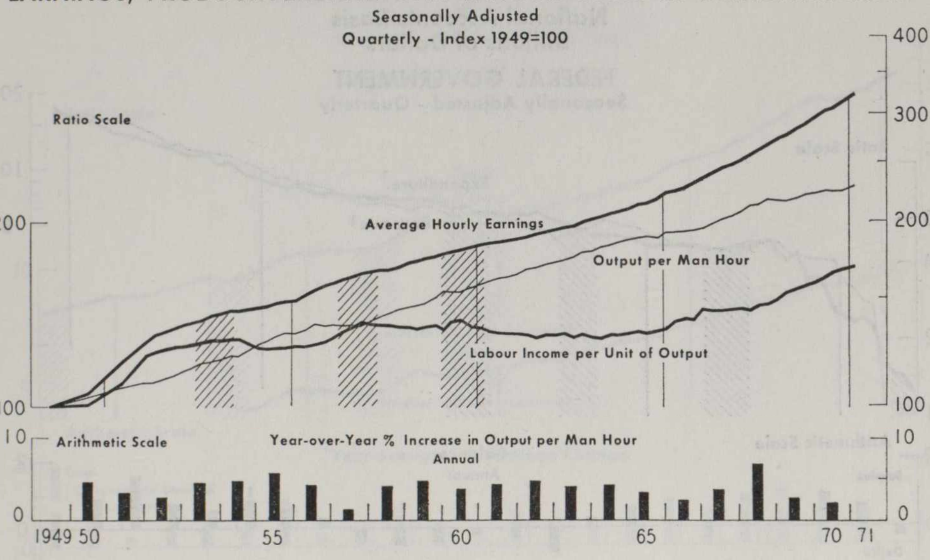
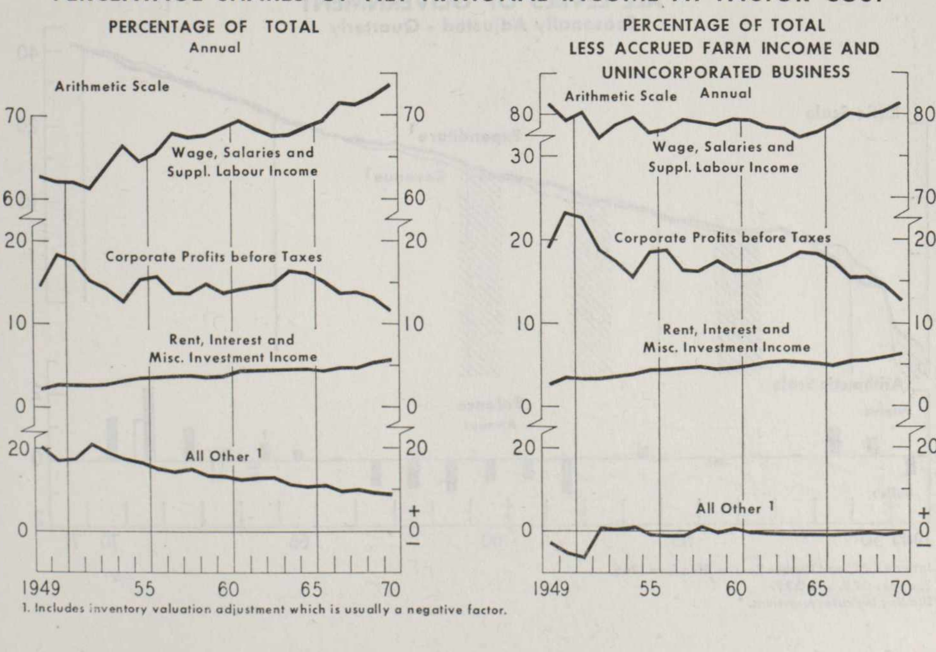



CHART 4B and 4C

## PERCENTAGE SHARES OF NET NATIONAL INCOME AT FACTOR COST




1. Includes inventory valuation adjustment which is usually a negative factor.

CHART 5A

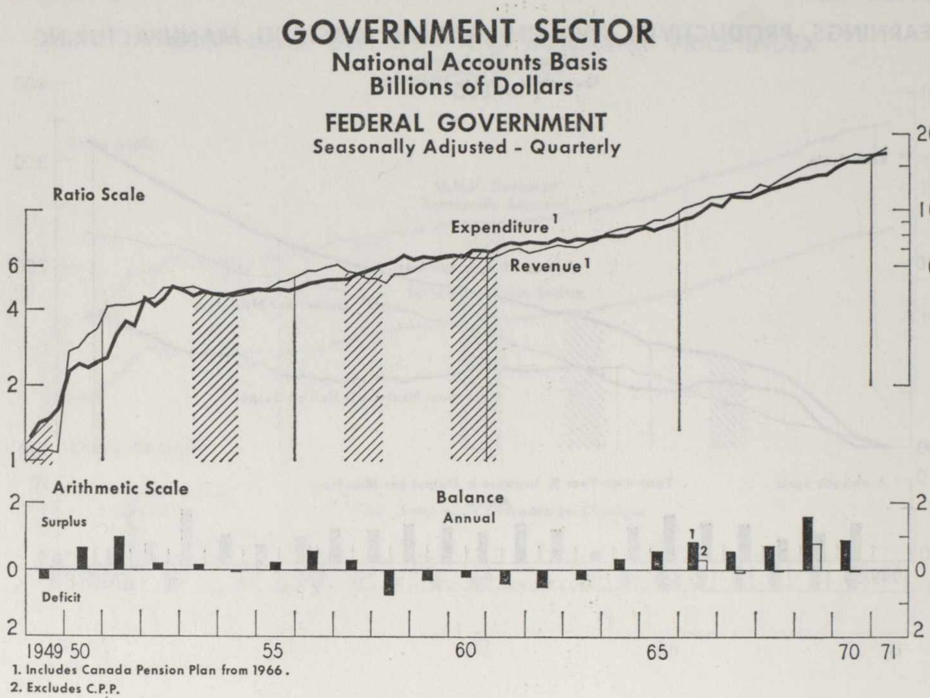



CHART 5B

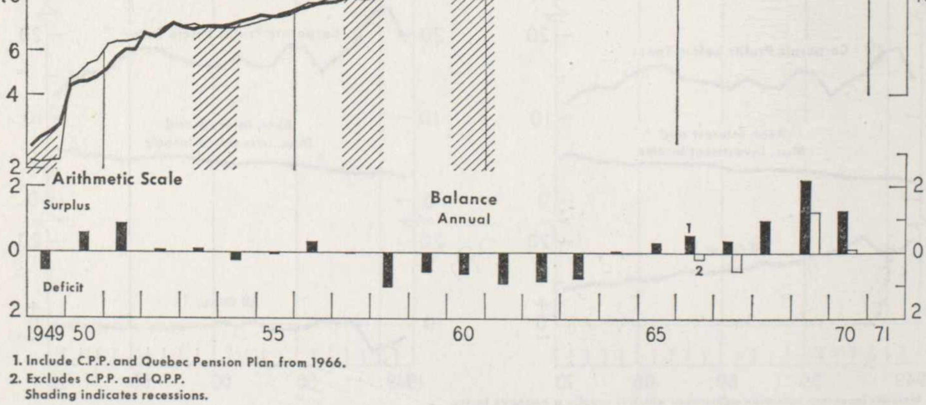


CHART 6

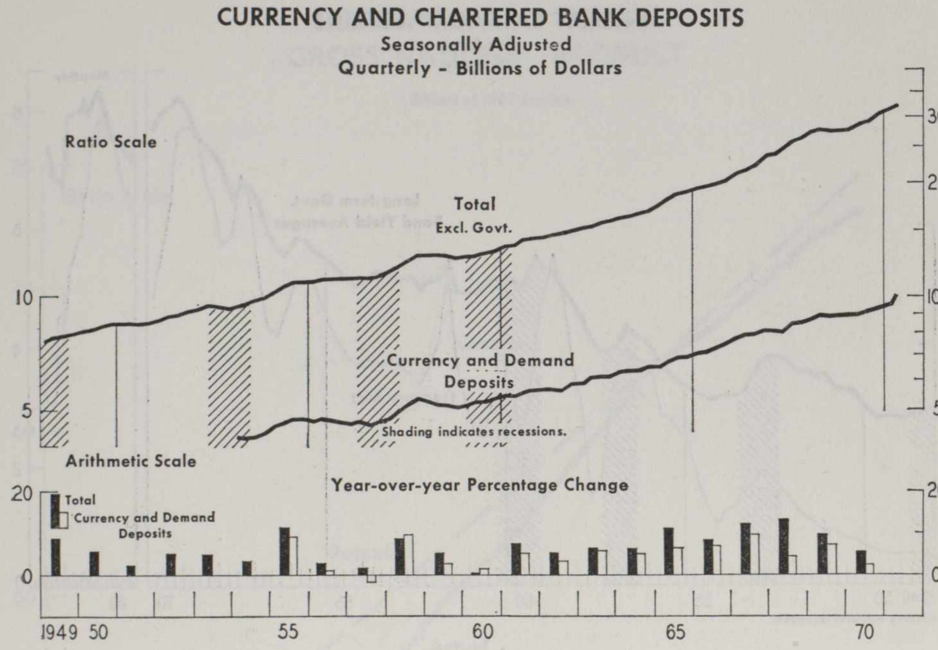

CURRENCY AND CHARTERED BANK DEPOSITS
Seasonally Adjusted
Quarterly - Billions of Dollars
Ratio Scale
Total
Excl. Govt.
Currency and Demand
Deposits
Shading indicates recessions.
Arithmetic Scale
Year-over-year Percentage Change
Total
Currency and Demand
Deposits
30
20
10
5
0
1949 50
55
60
65
70

CHART 7A

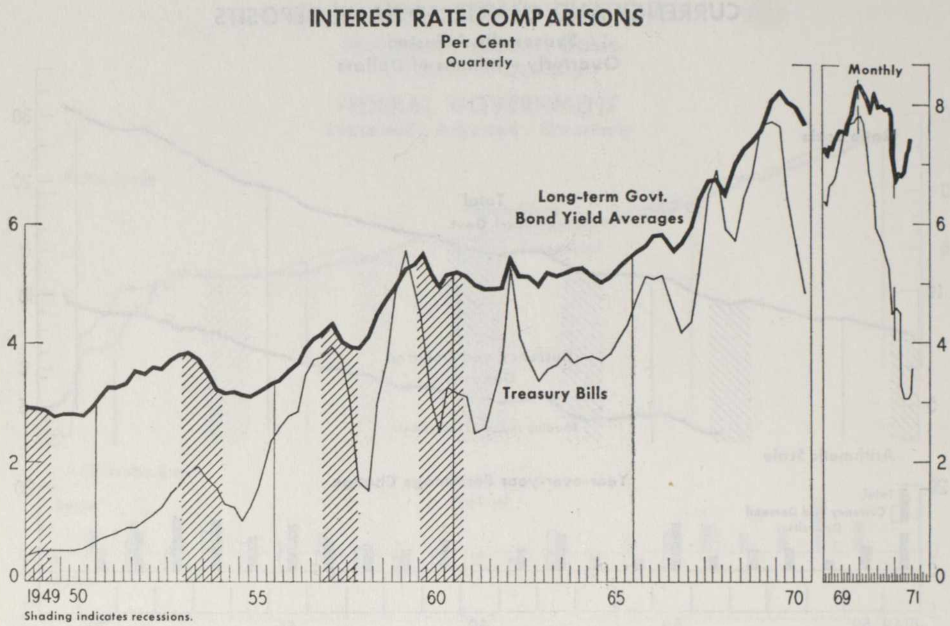



CHART 7B

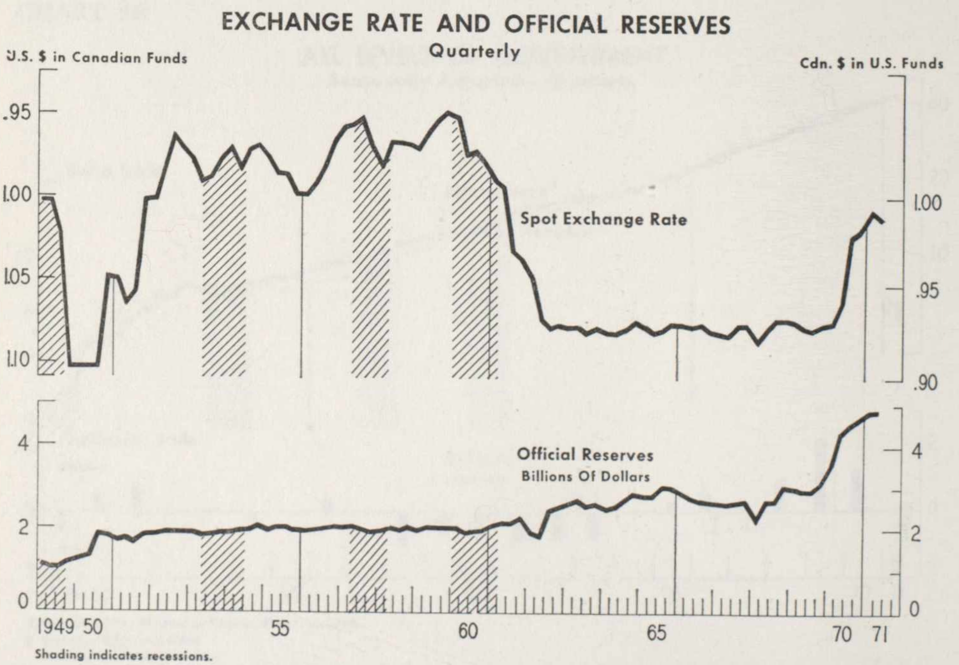


CHART 8

POTENTIAL AND ACTUAL GROSS NATIONAL PRODUCT

Billions of 1967 Dollars

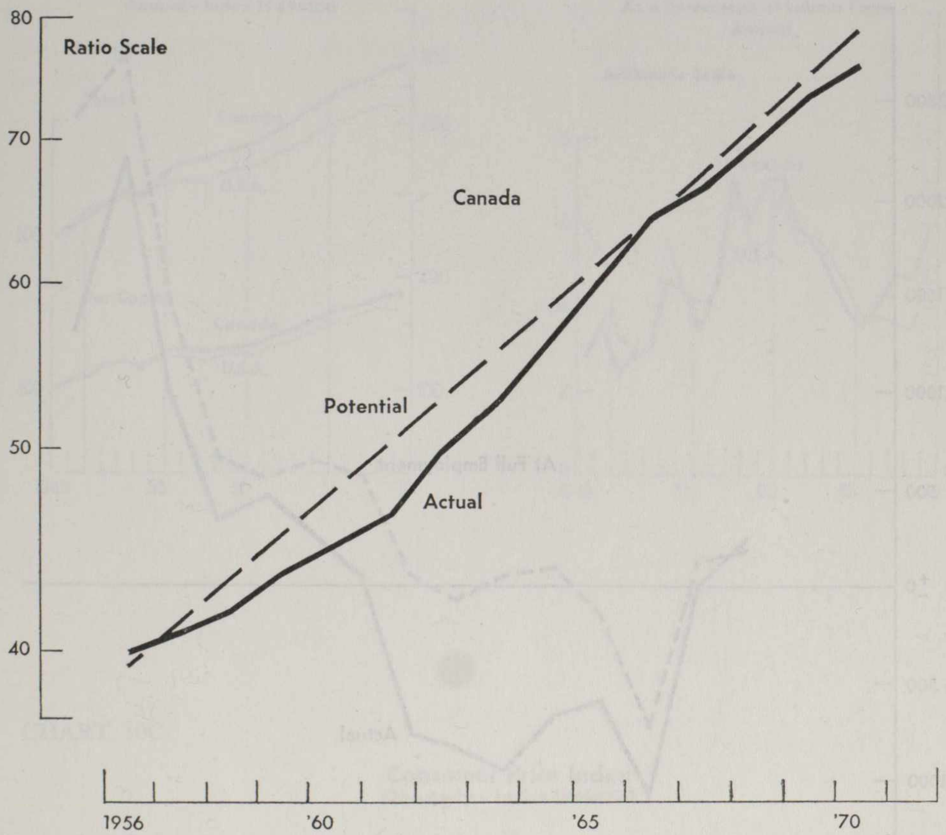


CHART 9

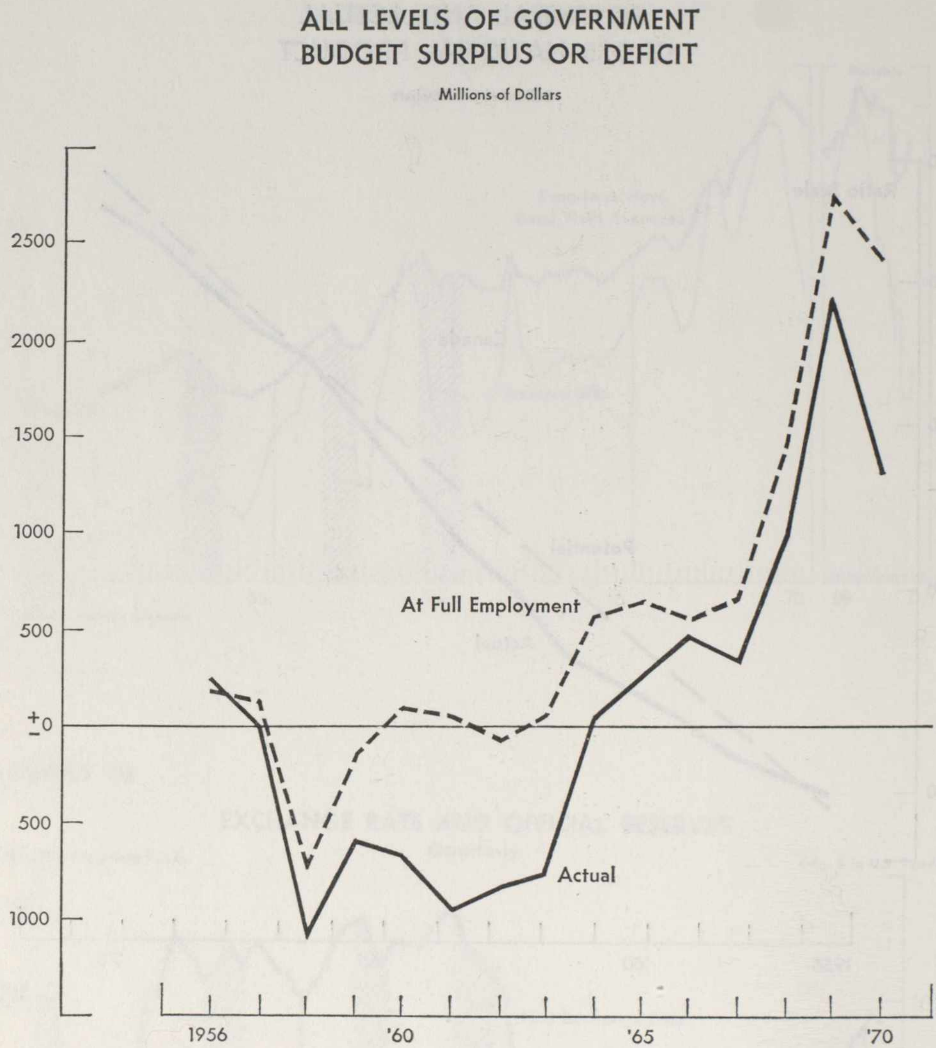

ALL LEVELS OF GOVERNMENT
BUDGET SURPLUS OR DEFICIT
Millions of Dollars
2500
2000
1500
1000
500
+0
-
500
1000
At Full Employment
Actual
1956
'60
'65
'70

CHART 10A and 10B

## ECONOMIC COMPARISONS
### Canada and United States

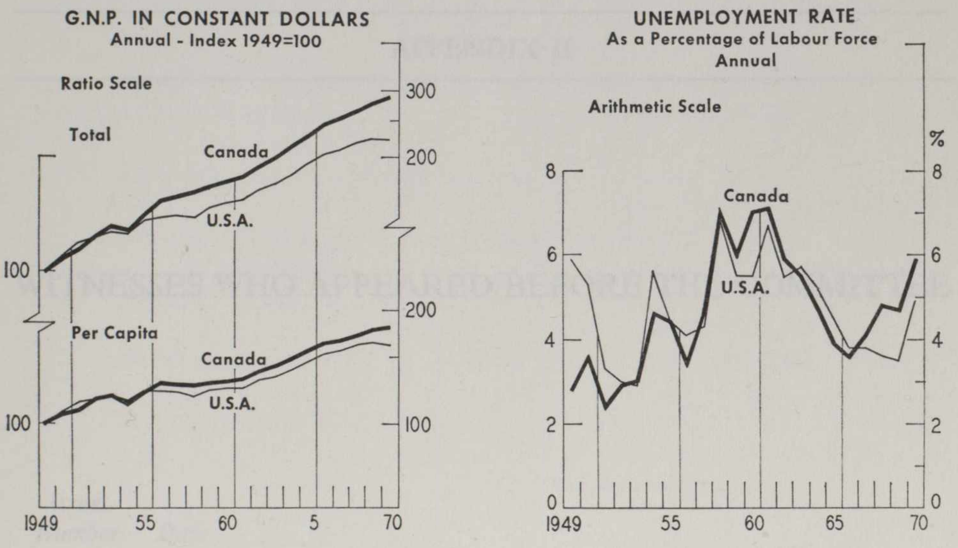
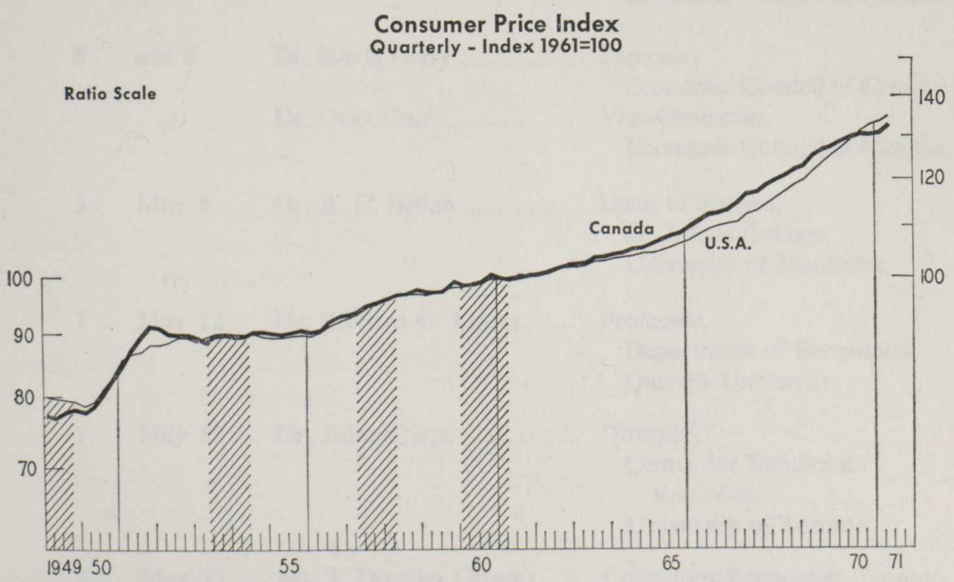



CHART 10C



## APPENDIX II

# WITNESSES WHO APPEARED BEFORE THE COMMITTEE

| *Issue Number* | *Date* | | |
|---|---|---|---|
| 4 | May 4 | Sir Roy Harrod.................. | Department of Economics, University of Maryland. Professor of Economics, Christchurch College, Oxford |
| 5 | May 5 | Dr. Arthur J. R. Smith....... | Chairman, Economic Council of Canada. |
| 6 | and 6 | Dr. Sylvia Ostry................. | Director, Economic Council of Canada. |
| | | Dr. Otto Thur..................... | Vice-Chairman, Economic Council of Canada. |
| 5 | May 5 | Dr. R. C. Bellan.................. | Dean of Studies, St. John's College, University of Manitoba. |
| 7 | May 12 | Dr. Richard G. Lipsey........ | Professor, Department of Economics, Queen's University. |
| 7 | May 12 | Dr. John Crispo................. | Director, Centre for Industrial Relations, University of Toronto. |
| 8 | May 13 | Mr. J. Douglas Gibson...... | Consulting Economist, Toronto. |

| *Issue Number* | *Date* | | |
|---|---|---|---|
| 9 | May 19 | Dr. Saburo Okita | President, Japanese Economic Research Centre. |
| 9 | May 19 | Dr. Anthony Scott | Professor, Department of Economics, University of British Columbia. |
| | | Dr. R. A. Shearer | Professor of Economics, University of British Columbia. |
| 10 | May 20 | Dr. Grant L. Reuber | Dean of Social Science, University of Western Ontario. |
| | | Dr. R. G. Bodkin | Professor, Department of Economics, University of Western Ontario. |
| 11 | May 25 | Dr. John J. Young | Chairman, Prices and Incomes Commission. |
| | | Mr. G. V. Haythorne | Commissioner, Prices and Incomes Commission. |
| | | Mr. G. E. Freeman | Commissioner, Prices and Incomes Commission. |
| 12 | May 26 | Dr. Keith Acheson | Professor, Department of Economics, Carleton University. |
| | | Dr. John F. Chant | Professor, Department of Economics, Queen's University. |
| 12 | May 26 | Dr. Harry G. Johnson | Professor, Department of Economics, University of Chicago. Professor, London School of Economics. |

| *Issue Number* | *Date* | | |
|---|---|---|---|
| 13 | May 27 | Dr. C. L. Barber | Professor, Department of Economics, University of Manitoba. |
| 14 | June 1 | Mr. Russell Bell | Director of Research, Canadian Labour Congress. |
| 15 | June 2 | Dr. Raymond J. Saulnier | Chairman, Department of Economics, Barnard College, Columbia University. Former Chairman, President's Council of Economic Advisers |
| 15 | June 2 | Mr. René Leclerc | President, The Canadian Bankers' Association. |
| | | Mr. N. E. Currie | Vice-President and Economic Adviser, Bank of Montreal |
| | | Mr. R. M. MacIntosh | Deputy Chief General Manager. Bank of Nova Scotia. |
| | | Mr. J. E. Morgan | Deputy General Manager, Royal Bank of Canada. |
| | | Mr. J. H. Perry | Chief Executive Director General, The Canadian Bankers' Association. |
| | | Mr. S. Sarpkaya | Economic Adviser, The Canadian Bankers' Association. |
| 16 | June 3 | Dr. Herbert Giersch | Professor, Department of Economics, University of Kiel, West Germany. Former Chairman, West German Council of Experts on Economic Development. |

| *Issue Number* | *Date* | | |
|---|---|---|---|
| 17 | June 8 | Dr. Thomas A. Wilson....... | Director, Institute for Policy Analysis, University of Toronto. |
| | | Dr. J. A. Sawyer................ | Professor, Institute for Policy Analysis, University of Toronto. |
| | | Dr. G. J. Jump.................. | Professor, Institute for Policy Analysis, University of Toronto. |
| 18 | June 9 | Dr. John F. Graham......... | Professor of Economics, Dalhousie University. |
| 18 | June 9 | Dr. André Raynauld........... | Professor, Department of Economics, University of Montreal. Chairman-designate, Economic Council of Canada. |
| 19 | June 10 | Dr. Beryl W. Sprinkel......... | Senior Vice-President, Harris Trust and Savings Bank, Chicago. |
| 20 | June 16 | Dr. Arthur M. Okun.......... | Brookings Institution, Washington. Former Chairman, President's Council of Economic Advisers. |
| 20 | June 16 | Mr. James Wiley Knowles.. | Director of Research, Economic Committee of the Congress of the United States. |
| 20 | June 16 | Dr. John J. Deutsch........... | Principal and Vice-Chancellor, Queen's University. Former Chairman, Economic Council of Canada. |
| 21 | June 17 | Mr. Louis Rasminsky......... | Governor, Bank of Canada. |

| *Issue Number* | *Date* | | |
|---|---|---|---|
| | | Mr. J. R. Beattie | Senior Deputy Governor, Bank of Canada. |
| | | Mr. G. K. Bouey | Deputy Governor, Bank of Canada. |
| | | Mr. B. J. Drabble | Advisor, Bank of Canada. |
| 22 | June 29 | Hon. Edgar J. Benson | Minister of Finance. |
| | | Mr. Simon Reisman | Deputy Minister of Finance. |
| | | Dr. William Hood | Assistant Deputy Minister, Department of Finance. |

# APPENDIX III

## PRIVATE SUBMISSIONS

List of those individuals and organizations who submitted briefs, proposals and comments to the Committee. Their interest in the work of the Committee and the scope and content of their ideas made a significant contribution to our work.

| | |
|---|---|
| Mr. D. A. L. Auld | University of Guelph |
| Mr. W. A. Beckett | Toronto, Ontario |
| Mr. E. A. Beder | Toronto, Ontario |
| Mr. G. Bélanger | Laval University |
| Mr. D. J. Bigio | Ottawa, Ontario |
| Mr. E. R. Blainey | Markham, Ontario |
| Mr. R. W. Bonner, Q.C. | Vancouver, B.C. |
| Dr. E. J. Chambers | University of Alberta |
| Dr. K. J. Charles | Lakehead University |
| Prof. M. Chossudovsky | University of Ottawa |
| Dr. T. Courchene | University of Western Ontario |
| Mr. W. E. Cowie | Ottawa, Ontario |
| Mr. G. E. Creed | Stoney Creek, Ontario |
| Mr. J. G. Dahin | Chilliwack, B.C. |
| Mr. J. R. Ferguson | Ottawa, Ontario |
| Mr. P. C. Fergusson | Victoria, B.C. |
| Mr. J. N. Franklin | Baie D'Urfé, P.Q. |
| Mrs. Y. Gauvin | Allardville, N.B. |
| Mr. A. G. Greenaway, Q.C. | Willowdale, Ontario |
| Mr. J. A. Harris | Winnipeg, Manitoba |
| Mr. J. M. Hattersley | Edmonton, Alberta |

| | |
|---|---|
| Mr. C. N. Hegewald | Belleville, Ontario |
| Mr. C. M. Humphrys | Vancouver, B.C. |
| Investment Dealers Association of Canada | |
| Dr. E. Jaques | Brunel University, England |
| Dr. H. Jenkins | Toronto, Ontario |
| Mr. G. P. Kelson | New Liskeard, Ontario |
| Mr. A. LaCroix | Québec, P.Q. |
| Dr. A. Lermer | Sir George Williams University, Montréal P.Q. |
| Mr. M. McCarthy | School of Economic Science, Rexdale, Ontario |
| Hon. W. Darcy McKeough | Treasurer of Ontario and Minister of Economics |
| Mr. F. L. W. McKim | National Research Council of Canada |
| Mr. D. W. Miller | Vancouver, B.C. |
| Mr. C. H. Morrow | Willowdale, Ontario |
| Mr. F. P. O'Hearn | Scarboro, Ontario |
| Dr. S. G. Peitchinis | University of Calgary |
| Mr. W. Pelech | Edmonton, Alberta |
| Mr. C. Pfeifer | Calgary, Alberta |
| Mr. D. Piper | Toronto, Ontario |
| Mr. W. H. Pope | Ryerson Polytechnical Institute, Toronto, Ontario |
| Mr. E. Pos | Delhi, Ontario |
| Mr. E. Reford | Montreal, P.Q. |
| Mr. E. F. J. Rettig | Bradford, Ontario |
| Mr. A. C. Robertson | Almonte, Ontario |
| Miss M. E. Robertson | Perth, Ontario |
| Mr. E. Schiff | American Enterprise Institute, Washington, D.C. |
| Mr. B. Sevack | Chairman, The Canadian Research Committee on Taxation |
| Mr. I. Shuster | Toronto, Ontario |
| Dr. G. Sinclair | President, Sinclair Radio Laboratories Limited, Maple, Ontario |
| Mr. W. A. Stewart | Toronto, Ontario |
| Mrs. J. Stolte | Sudbury, Ontario |
| Mr. C. R. Vint | Willowdale, Ontario |
| Mr. J. Walker | Toronto, Ontario |