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PRICES AND CREDIT

An address by The Honourable Douglas Abbott, Minister of Finance, at the Semi-Annual Meeting of the Academy of Political Science, New York City, April 1, 1948.

When I accepted the kind invitation of your President to speak to you on this subject of Prices and Credit, I assumed that what you would expect me to do would be not to attempt any economic dissertation on the controversial causal relationship between credit and prices but rather to give you some of the facts and the lessons of Canadian experience in this field.

Problems connected with the practical aspects of price control and price decontrol and the adaptation of fiscal and monetary policies to the changing economic situation have occupied a very large proportion of my waking hours during the last two or three years. Nevertheless, I am a layman and I have no desire to split hairs with the economists in a field of doctrine concerning which, as one of them has said, not more than a half dozen economists are able to argue with any real comprehension of what they are talking about! Therefore, I shall not take sides in the controversy as to whether it is expansion in the supply of money or credit* that drives up prices or whether it is rising prices that force expansion in the supply of money or credit. I suspect that at certain times the primary impulse comes from the money side and at other times from the goods side but I am confident that whichever comes first, a point is reached where each feeds upon the other. That, it seems to me, is what is important from the practical point of view of those of us who are concerned with policies and remedies.

The most conspicuous economic fact of the last two years has been the upward spiralling of prices all over the world. It is not a local problem. It is not confined to any one country or to any group or class of countries. It is a world-wide phenomenon. It appears to be the inevitable sequel to the physical destruction, the disruptions of production and trade, and the enormous credit expansion caused by war, for, as night follows day, this type of phenomenon has followed each of the four major wars of the last century and a half. Thirty months after the end of World War II, the world from the price point of view stands very much where it stood a short time after the Napoleonic Wars, after the U.S. Civil War and after World War I.

We in Canada have not been able wholly to escape the effects of this world-wide epidemic, although our economy was untouched by the physical ravages of the war, we succeeded in increasing our production of goods enormously, and we vigourously pursued bold anti-inflationary policies. In the first war budget, delivered on September 12, 1939, the day after Canada

* In this paper I shall use these two terms interchangeably.

declared war, the Canadian Government committed itself to a pay-as-you-go policy carried to the farthest practicable limit. Arguing that the real resources required to fight a war must come almost wholly from current production, the then Minister undertook to finance Canada's war effort by raising taxes to the highest tolerable point and by borrowing as much as possible of any needed additional funds out of current savings rather than by the inflationary expansion of money and credit. At that time no one dreamed that Canada would find it necessary or even possible to mobilize the war effort which was later to be her share. It became an all-out effort and it cost Canada something of the order of $20 billion. It was extremely fortunate therefore that from the very start of the war Canada was committed to this type of financial policy.

Those who are familiar with the record will agree, I think, that the policy was carried out with great vigour and determination. New and higher taxes were imposed with a Draconian severity and in the end over 53% of all government expenditures during the war was financed out of tax revenues. Similarly, the record achieved in mobilizing the savings of the public was a good one. A nation-wide and increasingly efficient organization was developed which in two War Loan and nine Victory Loan campaigns succeeded in raising over $12.2 billions of new cash. It was, however, impossible for the Government to avoid some use of the banking system as a direct source of borrowing, and the public was also responsible for an expansion of bank credit through temporary borrowings to assist in Victory Loan purchases and through some selling of bonds to the banking system in between loan campaigns. However, according to the calculations of the Bank of Canada, the total increase in money supply between the end of 1939 and the end of 1945 was only $2.1 billion, or roughly 156%.

It was this fiscal and financial policy that, by "mopping up" surplus purchasing power, really made possible the success of our direct wartime controls of prices and wages. In the late thirties, prices had not recovered from the disastrously low levels of the depression. The outbreak of war, with its threat of commodity shortages, stiffened prices sharply all over the world and in our case the price rise was amplified by a 10% reduction in the external value of the Canadian dollar. In the summer of 1941, as Canada and other countries began to cross into the zone of full employment, inflationary pressures began increasingly to assert themselves. It was under those conditions that in October of that year Canada imposed its complete, overall ceiling on prices. At the same time a ceiling was placed on wages and salaries and a little later the excess profits tax was raised from 75% to 100%. For successful administration it became necessary to supplement the price ceiling program with a vigorous combination of supply controls, production directives, export controls, bulk purchasing, subsidies and rationing.

This "tough" and realistic policy, ably administered and firmly enforced, succeeded in holding the general level of retail prices in Canada almost completely stable for more than four years. From October, 1941, to December, 1945, the index of the Canadian cost of living rose by only 4% and the rise in wholesale prices was only 10.6%. Our wartime policies had thus succeeded to a remarkable extent in holding the evils of inflation in check. We had enormously increased our production and maintained a reasonable balance in our economy. By preventing a headlong upward rush of prices, we had kept down the money cost of the war and the continuing burden of war debt, safeguarded the economically vulnerable members of our population against acute hardship, and avoided the acute social unrest, with its damaging effect on output, which is the product of sudden and drastic price changes. In particular, we had avoided the fantastic distortions of the price structure which the inflationary financing of the first World War had caused and which had led inevitably to a painful, corrective process of deflation and readjustment.

After the war ended we were anxious to maintain indefinitely as much of these solid gains as was practicable in a world in which no nation any longer lives unto itself alone. We were hopeful, therefore, that throughout the world the pressure of inflationary forces could be held in check-- by expanding output, by appropriate fiscal, monetary and economic policy in all countries, and by constructive international co-operation. We believed in a free economy and in the effective working of the price system and we realized that even if we wished to do so we could not under ordinary peacetime conditions maintain that practically unanimous public support upon which the successful administration of price control is dependent. At that time also it was widely believed that a fall of moderate proportions in the world price level was likely in the relatively near future. Therefore, as our price level was below that of most other countries, we hoped that we would be able to tie on to the probable new world level of prices without too great an upward adjustment in our own prices.

When we first began to think of the problem of decontrol, away back in 1944, we felt that our plans for dismantling our wartime restrictions should be spread over a period of at least two years. While always ready to adapt our plans to unforeseen developments -- and having to do so on more than one occasion -- we have nevertheless kept pretty well to that original schedule. Our supply controls were relaxed very quickly and by the end of 1945 most of them had disappeared. Price and rationing decontrol, however, was not even begun until February, 1946, and for more than a year after that it took place very gradually and cautiously. Not until the spring of 1947 did we begin to decontrol and de-ration the staple constituents of the people's food, clothing and shelter. The elimination of subsidies was a necessary prerequisite to the decontrol of prices. It began early in the postwar period and was accelerated after about the middle of 1946. By that time, U.S. price controls had been substantially eliminated and it had become clear that there was little hope of subsidies being eliminated by external prices moving down to the Canadian level and that as the remaining subsidies were withdrawn price increases would follow in most cases.

During the year 1947 the removal of subsidies and the decontrol of prices proceeded apace and we had in mind the possibility, if not the probability, of complete decontrol by the spring of 1948. That has proved somewhat optimistic but by the beginning of this year all that remained of price control were the ceilings on wheat, sugar, oils and fats, soap, shortening, tin, and primary iron and steel. In addition, we continued and still continue our rent and eviction controls. Under its emergency powers the Government still retained the power to reimpose price ceilings whenever conditions warranted, and the sharp further upswing in prices early this winter caused the Government to exercise these powers in the case of butter, cabbages and most canned fruits and vegetables. The Government has also requested and received from Parliament the right to continue its price controlling powers for another year, that is, to March 31, 1949. It has made it very clear, however, that it regards these as emergency powers and that it does not intend to go back to any general or over-all system of price control. It is using its powers only to place specific controls on those sections of the price structure which appear to be getting out of line.

This program of decontrol, we believe, has been an orderly and well-considered one. It has followed a logical pattern and avoided the two extremes: on the one hand, the extreme of sudden withdrawal of all controls, leaving economic forces to adjust themselves to the new situation overnight and therefore chaotically; and on the other hand, the extreme of retaining for too long a full-fledged control program with its probable inevitable effect in restricting production and aggravating the problems of readjustment that must ultimately be faced. However, despite the orderliness and the gradualness of the decontrol program, it has been accompanied by an increase in the price level of fairly sizeable proportions. Between December, 1945, and February, 1948, the index of the Canadian cost of living increased by 25%, and the index of wholesale prices by 41.8%. These increases are somewhat higher than the corresponding increase in a few other countries during the same period, but this is a reflection of the fact that Canada, at the end of 1945 and in relation to pre-war levels, showed smaller increases than almost any other country. Last December, in respect of our cost of living index we were still below all the other fifty countries for which figures are reported in the United Nations Monthly Bulletin of Statistics, excepting only Australia, New Zealand, Southern Rhodesia and the United Kingdom.

This suggests that the major explanation of our recent price rise lies in price-raising factors outside our borders. Canada ranks as the third largest importer and exporter of goods in the world. In these circumstances we could not hope under normal conditions to insulate ourselves from the effects of the inflationary rise in prices throughout the world. With the coming of peace, the elaborate system of controls and subsidies, both on domestic goods and on imports and exports, with which we had safeguarded ourselves during the war had had to be withdrawn, piece by piece, and the Canadian structure had therefore been left more and more exposed to external influences.

I have no desire to belittle the domestic factors which contributed to the over-all result. A considerable part of the rise in the cost of living index over the past two years has been due to the cessation of subsidy payments and the widening of dealers' and manufacturers' margins following the release of controls. The most important factor, however, has been the boom which has been developing in my country as in yours. Despite the magnitude of the industrial reconversion problem with which V-J Day confronted us and the large number of enlisted men and of war workers for whom new peacetime occupations had to be found, Canada made the transition from a wartime economy to a peacetime economy with astonishing speed and smoothness. In a little over a year we were again passing into a zone of full employment and since then we have been witnessing a real economic boom, particularly in the field of consumer goods and industrial capital expenditures.

It is a boom of unprecedented proportions even though the public does not seem to be aware of it -- thanks largely, I suppose, to the abnormal way in which the usual barometer, the stock market, has been acting. Our gross national production has increased from $11.6 billion in 1945 to over $13 billion last year -- in 1938 it was $5.1 billion. Personal expenditure on consumer goods and services increased from $6.8 billion to $8.7 billion in the last two years. In 1947 the grand total of new capital investment in Canada, including investment by industry, institutions, governments, farmers and housebuilders reached the unprecedented total of $2.4 billion. A recent survey, based on current intentions, forecasts a comparable figure for 1948 at $2.8 billion. To convert into your terms, these figures would have to be multiplied by about 18.

Activity of this degree of intensity naturally exerts a severe strain on our economy and on our cost and price structure. Particularly in the case of labour, materials and equipment used in capital goods expansion, the pressure of demand has been and still is intense. This level of demand is not too concerned about price and therefore not too inclined to resist the upward trend in costs and prices. Capital expansion and high industrial activity in Canada always mean heavy imports of U.S. machinery, equipment and materials -- chiefly coal, cotton and petroleum products. High incomes in Canada similarly mean heavy importation from the U.S. of consumers' durable goods and many luxuries or semi-luxuries. When this happens at a time when we are financing a substantial portion of our exports to Europe on credit, the inevitable result is a drain on our exchange reserves. We still have, I should emphasize, an over-all surplus in our current account with all countries, a very large one in 1946 and one not so large in 1947, but in both cases this current account surplus was not as large as the volume of our exports financed on credit or given away. We have, as you know, put into operation a comprehensive program to correct the drain on, and to replenish, our reserves, and that program, I am glad to be able to report,-is working -- much better indeed than we had expected. However, it is pertinent for our present purpose to note that the effect of the import restrictions which form an important part of the program is to exert still further pressure upon prices.

In the face of the developing postwar boom, we have tried to adapt and develop our fiscal and monetary policies in such a way as to restrain excesses without endangering full employment and maximum production. Never before has there been so great a world need for the maximum output of this Western Hemisphere and our problem, it has seemed to us, is to keep the productive car rolling along at optimum speed, avoiding both the reckless speed that would soon lead to disaster and the too sudden or too drastic braking that would skid the car into the ditch. This type of consideration was primarily responsible for the gradualness and orderliness with which we dismantled our wartime price controls, which I have already described. It has had an equally important influence on our policies in the field of credit and finance.

In so far as fiscal policy is concerned, we have consciously followed a policy of maintaining taxes at such a level as would produce substantial surpluses in our Government accounts. True, our rates of tax on personal incomes have been cut substantially from the very high levels of wartime because they were threatening to impair output and undermine enterprise. But they are still very high as compared with pre-war levels. The excess profits tax was gradually reduced and finally eliminated only as from the first of this year. Corporations now pay to the Dominion Government a tax of 30% on net profits. The rest of the wartime tax structure stands very nearly intact. As a result of these high tax rates and of high incomes and business activity, total Government revenues have been maintained at abnormally high levels. Last year I was able to report a substantial surplus and for our latest fiscal year which ended yesterday, I shall be reporting to Parliament in a budget speech a few weeks hence another surplus of such a magnitude as to bring a glow to the heart of any Canadian Minister of Finance. Under our accounting system, these surpluses are calculated before taking account of investments and loans, including those to governments abroad, so that in fact we have invested a considerable portion of them in such so-called active assets. However, a substantial part of these surpluses has been available and has been used to retire public indebtedness.

While we have been using surpluses in part to pay off public debt, we have deliberately continued into the postwar period the wartime practice of carrying on nation-wide campaigns to sell government securities of the savings type to industrial workers and to persons of small or moderate incomes. Since October, 1946, the total sales of these National Savings Bonds, less redemptions, have amounted to $663 million. At first, as the inflationary pressure was not so strong, the dominant motive was to provide an opportunity for the small investor to continue the salutary habit of saving he had acquired in wartime. Increasingly as time has gone on, more recognition has been given to the value of these campaigns in mopping up purchasing power and easing the inflationary pressure.

I wish now to say a word about the effects of the Government's fiscal and financial policy upon the banking system. Direct financial assistance by the banking system to the Government reached its peak in October, 1945, when holdings by the Bank of Canada and the chartered banks of deposit certificates and other Dominion securities designed specially for the banking system reached $2¼ billion. From that date to the end of December last, out of our surpluses of cash receipts over expenditures and out of the proceeds of public borrowings, the Government was able to reduce the total of such banking securities by $1.4 billion. This reduction in the banking system's holdings of such securities represents about half the amount of the wartime increase in money supply resulting from Government financing. Of this reduction, $782 million had occurred by December, 1946, and the balance of $665 million took place in the calendar year 1947. These figures, it seems to be, demonstrate pretty clearly the extent to which the Government's postwar fiscal policies have attacked the problem created by wartime credit expansion.

During the latter part of the war, a substantial part of the increase in money supply took place because the general public on balance were net sellers of Government bonds during the months between bond selling campaigns;and most of these bonds of necessity ended up in the portfolios of the banking system. It is true that there was at the same time a very considerable expansion in idle savings deposits, but not to the full extent of the banking system's increased holdings of bonds. However, contrary to some prevailing opinion, sales by the general public of its accumulated holdings of Government bonds has not been a factor increasing credit expansion during the past year or so. In 1946 the banking system's holdings of Government bonds and of temporary loans made to assist Victory Loan purchases increased by only $93 million, while in 1947 Government bonds held by the Bank of Canada and the chartered banks actually declined by $27 million.

I should state at once that in spite of the large reduction in money supply which the Government's fiscal policy has effected, our <u>total</u> money supply has not declined during the past two years. On the contrary, according to the Bank of Canada's calculations, the supply of money in Canada increased from $3.5 billion at the end of 1945 to $3.9 billion at the end of 1947. The reason for this was the large increase in loans made by the chartered banks and in their holdings of securities other than those issued by the Canadian Government. At the end of December last, the total of these two types of assets in their portfolios was not far from double what it had been on December 31, 1945. Important as factors accounting for this large increase were increases in loans to and securities of provincial and municipal governments, increases in loans to manufacturers and merchandisers probably due in large part to higher inventories, increases in loans for consumer credit purposes, and increases in loans to and securities of business firms made or issued for capital development purposes.

The monetary policy which has been followed in the last two years has been of a type designed to supplement the restraining effect of the Government's policy of paying off debt out of current surpluses. As a result of central bank action, for instance, the average cash reserve of the chartered banks has been maintained at a slightly lower level in 1946 and 1947 than at the end of 1945, although the effectiveness of this action was weakened to some extent by the willingness of the banks to let their cash ratios run down a bit.

I might mention another development of some interest in the field of monetary policy, though it was instituted for other reasons as well. This was a voluntary agreement negotiated with the chartered banks in the opening months of 1946. To understand this arrangement, it should be remembered that we have practically no specialized savings institutions in Canada and that our chartered banks perform this public function as well as those of ordinary commercial banks. Under this arrangement, the banks agreed that their holdings of Dominion Government domestic bonds would not average more than 90% of their Canadian savings deposits and that by appropriate selection of an average term their earnings on such bonds held for investment account would not exceed their operating costs on Canadian savings deposits by more than a moderate profit margin for this type of banking business. This profit margin was to be subject to review from time to time. If the banks should wish to invest in Dominion bonds beyond the amount recognized as appropriate in connection with their Canadian savings deposits, they were to avail themselves of Treasury Bills or other short term securities bearing an appropriately low rate of interest. If perhaps the primary purpose of this agreement was to restrict to reasonable proportions the earnings of banks from holding Government bonds, a second purpose was to prevent banks from being unduly aggressive buyers of Government bonds in the market, which might have the effect of dislodging general public holdings of such securities and perhaps lead to some increase in the supply of credit.

It used to be the orthodox view, and it is a view still held in some quarters, that the solution to the type of situation which exists today is to allow interest rates to rise to increase the supply of savings and to choke off the demand for them. During 1947, especially in the latter part of the year, interest rates did stiffen in the United Kingdom and the United States, and since the first of this year in Canada the yield on long-term Government bonds has risen in two steps to the level on which the Victory Loans were raised during the war -- that is to say, 3%. However, I do not think this should be interpreted to mean any conviction on the part of our monetary authorities as to the efficacy of interest rate changes as an instrument for controlling credit expansion under current conditions. In commenting on the reduction in its bid prices for Government bonds on February 27th last, the Bank of Canada used the following words:

> "The degree of the change in interest rates does not appear inappropriate in the circumstances. On the other hand the Bank of Canada does not regard the increase in rates which has taken place as one of the most important factors in combatting a general rise in price levels. The bank is not in favor of a drastic increase in interest rates which would be likely to create a situation that might hamper, and might even prevent, essential forms of capital investment which Canada needs and which it is desirable should be proceeded with."

Perhaps I might amplify this statement a little. On the supply side, it is difficult to believe that any reasonable increase in interest rates would persuade the general public to save more and increase on balance its holdings of Government bonds, thus making possible effective open market operations by the central bank. During the war the public in all democratic countries was persuaded to increase its holdings of Government bonds on a scale far beyond anything previously dreamed of. A rise in interest rates likely to be sufficient to induce the public to increase its savings materially under present conditions would cause so drastic a fall in the prices of such bonds and so chaotic a condition in the money market and amongst institutional as well as individual investors that I doubt whether any responsible person would recommend it as deliberate policy. Even if the public should increase its purchases of Government bonds, this would not be anti-inflationary unless they were doing so by increasing their current savings. A switch from idle savings deposits to bonds would not be enough and it is difficult to believe that the mass of small savers are likely to reduce their living expenditures under current conditions merely because they can obtain a slightly higher interest rate on the money they save.

Analysis of the demand side of the market leads to a similar conclusion. From the point of view of the industrial borrower, demand is so intense that it would take a really substantial change in interest rates to dampen his enthusiasm and make him defer his capital project. Difficulty in obtaining loans or in floating securities would be a much more effective deterrent than higher rates. It would, of course, be comparatively easy for the central bank to produce such chaotic conditions in the money market that even the largest and strongest corporations would have difficulty in raising money. But as I have already indicated, what we need is a slowing down, not a sudden cessation, of capital development.

In general I would expect this to be substantially the philosophy which animates the monetary authorities in your country and in the United Kingdom.

In conclusion, I might merely mention that the remaining type of remedial influence on which we have placed some reliance is that of information and moral suasion. Those of us who have some responsibility in these matters have tried to disseminate information and understanding as to the nature and significance of prevailing economic trends. Probably of greatest importance in this connection is the influence of our central banking authorities. The annual reports of the Bank of Canada are models of penetrating economic analysis and replete with fruitful suggestion, express or implied. I know also that officials of the Bank are in frequent consultation with the management of the chartered banks and I am sure there is a continuing exchange of views as to changing developments and the actions and policies appropriate to each new development. Such exchange of information and opinion between central bank and commercial bank officials and between bank officials and business men is, it seems to me, exceedingly valuable.

It may not be wholly effective at a time when the prevailing psychology of business men and the public is expansive. But it is most in accordance with our democratic way of doing things, it is flexible and it may indeed be effective if all the relevant facts are made available and their meaning discussed by a sufficient number of the leaders of business and of public opinion. The Academy of Political Science is helping to do that by devoting this semi-annual meeting to a discussion of what is probably the most important of our current economic problems.