BANK OF CANADA

Future directions for the Bank of Canada and monetary policy

Notes for remarks by
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Governor of the Bank of Canada

to the
Canadian Club
Toronto, Ontario
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This is my first public speech since being appointed Governor, and I believe that it is particularly important for me to set out clearly the course that has been established for Canadian monetary policy for the period ahead. I would also like to comment on the economic situation as we at the Bank of Canada see it. This is as well an appropriate occasion to talk about the importance of the Bank providing a public account of what it does and why, particularly in the monetary policy area.

Goals and targets for monetary policy

I am certain we can all agree that the appropriate goal of macroeconomic policy is a strong economy, one characterized by a rising standard of living for Canadians. The best contribution that monetary policy can make to achieving this goal is to seek to protect the value of the money we use in Canada from being eroded by inflation. In other words, our objective is price stability, but as a means to the end of good economic performance rather than as an end in itself.

This objective for monetary policy was reaffirmed in the joint statement issued by the government and the Bank of Canada at the time of my appointment in December. The Bank attaches great importance to this statement. Not only does it set out the agreed objective of policy, but it also indicates target ranges for controlling inflation in the period ahead.

Let me be more specific about the targets. The statement takes as a starting point the target ranges established in 1991 and extends them out to 1998. The target of holding inflation inside a range of 1 to 3 per cent, which is the objective as of the end of 1995, will be maintained for 3 more years. The target was extended to provide sufficient time for the economy to adapt to an environment of low inflation, and for the Bank to have more experience in operating under these conditions, before we define more precisely what price stability means. By 1998 a decision will be made as to the movement in the consumer price index (CPI) that would be consistent with price stability.

The targets continue to be expressed as a range or band rather than a specific inflation rate because it is impossible to control inflation precisely. Inflation is a process in which price and cost increases acquire an ongoing momentum. That momentum, or trend, is what monetary policy must react to in a timely way, for it takes time to turn inflation around once the momentum builds up.

Suppose, for example, that strong demand pressures were accumulating and were threatening to exceed the production capacity of the Canadian economy and push the trend rate of inflation through the top of the target band. The Bank would have to take actions to contain the pressures even though inflation had not yet gone through the top of the band. Similarly the Bank would respond if it appeared that momentum was developing to push the underlying rate of inflation through the bottom of the band.

However, not every movement in the consumer price index represents a change in underlying inflation. There can be developments that have transitory, or one-time, effects on the level of consumer prices. For example, tax changes can affect the level of prices, without having ongoing effects on the process of inflation. Provided such developments do not result in a shift in the momentum of inflation, the Bank does not need to respond to them, either on the upside or on the downside.

You will have seen that the headline rate of consumer inflation has dropped in response to the recent reductions in tobacco taxes. However, this headline rate will not be a good indicator of underlying inflation over the coming period because of the temporary effects of these tax cuts on the rate of increase in the CPI. Therefore, in assessing what is happening to the underlying rate of inflation over this period, the Bank will be monitoring changes in the measured rate of inflation excluding the estimated effect of indirect taxes.

The Canadian economy

It appears to me that the Bank of Canada's commitment to price stability has been increasingly recognized, and this has been changing the way Canadians are making economic decisions. With the success in bringing the trend of inflation down -- from an average over the 1970s and 1980s of 7 per cent annually for consumer prices to about 1½ to 2 per cent now -- savers, investors, businesses and households are increasingly acting on the expectation of a non-inflationary future, and less on the fear of an inflationary one.

Indeed, in looking ahead, I believe the prospects are excellent that inflation will remain in the lower part of our target band. I also believe that the economy will continue to expand and pick up steam. For those who worry that economic expansion cannot proceed very far without generating inflation, let me remind you that our economy is capable of expanding for some time before it reaches capacity constraints. Hence, there is no immediate risk of pushing up inflation because of continued economic recovery.

I am also optimistic about our longer term capacity for sustained (that is to say, non-inflationary) growth in the Canadian economy. Why? It is because the decline in inflation and inflationary expectations has brought about a change in the fundamental situation of the Canadian economy.

Let me be more concrete. The gradual diminishing of concerns among Canadians about protecting themselves against future inflation should help monetary policy keep actual inflation under control even after the present unused capacity in the economy has been absorbed.

The shift in inflation and inflation expectations is also what has been behind the major downtrend in Canadian interest rates. Despite the recent backup, current short-term and long-term rates are close to their lowest levels in over 20 years.

The lower interest rates and associated higher equity prices have allowed businesses to strengthen their balance sheets. The fall in the cost of capital has also helped to encourage a high level of investment in machinery and equipment. With costs under control, businesses have been able to take full advantage of the depreciation of the Canadian dollar to improve their competitiveness. In all, business is now much better placed to compete in world markets and to take advantage of a pickup in world demand.

For households, lower rates of interest have meant a significant decline in their debt service payments. And lower interest rates have made housing much more affordable than it has been in years.

Thus in terms of what monetary policy can realistically contribute in a lasting way, considerable progress has been made towards strengthening the fundamentals of Canada's economic situation. And the economy is therefore in a position to do considerably better in the years ahead. Indeed, the expansion of the Canadian economy has gained momentum and become more broadly based over the past year.

But we cannot assume that these gains will somehow automatically get locked in. I liken inflation control to steering a car. Just because you are pleased with your progress and the direction you are heading does not mean you can stop steering the car and divert your attention elsewhere. In other words, we must continue to build confidence by keeping inflation inside our inflation-control targets and remaining constant in our commitment to the achievement of price stability. In doing so we will be providing strong support to economic growth and employment gains over the longer term.

The issue of government deficits and debt is of course also important for Canada's longer-term prospects. The point the Bank has made before, and I would like to repeat it here, is that fiscal positions need to be on a sustainable path. Deficits that continually add to debt so that the ratio of debt to the size of the economy continues to rise are not sustainable over time. There is also no doubt that interest rates, particularly medium- to long-term rates, can be importantly affected by budgetary performance at all levels of government. The more determination Canada displays in tackling its deficit/debt challenges, the better are the chances of sustaining a low interest rate environment for all types of loans and investments and at all maturities.

The economy can of course encounter some bumps and other driving hazards along the road. And if there are uncertainties about economic policies, it can be more difficult to cope with those bumps and hazards when they come along. Recently, we have had to deal with the effects on Canada of volatile international financial markets. Increases in short-term interest rates in the United States seem to have triggered a rise in bond yields around the world. However in Canada, uncertainties about our situation appear to have been a contributing factor to the larger rise in both short-term and longer-term rates than in most other major countries, as well as to a weaker Canadian dollar.

In these circumstances, the Bank of Canada has tried, in its public statements and actions, to focus the attention of markets on the fundamentals of the monetary outlook in Canada, for that will be a major influence on the value of Canadian investments over time. Those fundamentals are good -- low inflation and a monetary policy committed to price stability -- and they should provide a firm base of support for investor confidence.

Public communication

The Bank of Canada has sought over past years to increase public awareness of what monetary policy can accomplish, how it operates and what its very real limitations are. Why do we attach so much importance to this?

The first reason has to do with the special nature of monetary policy. Even though it is an important component of public economic policy, the responsibility for monetary policy has in most countries been assigned to a central bank -- an institution separate from the rest of government. Traditionally, the reason for this assignment has been the desire to separate the responsibility for printing money from the pressures of day-to-day government spending and taxation. More recently, the case for a separate central bank has emphasized the need to take a medium-term view in implementing monetary policy, given that its effects are spread over a considerable period of time.

But the success of assigning responsibility for monetary policy to a separate central bank involves broad public support for such an institution. And that requires an informed public with an ongoing interest in monetary policy issues.

The second reason also derives from the medium-term nature of monetary policy's effects on the economy. If consumers, savers, investors, businesses and governments are going to make informed economic decisions that take into account these medium-term effects, the objective of policy must be clear and the Bank's commitment to the objective over time must be understood. The greater the knowledge of our objective and the greater the credibility of the Bank's commitment to the objective, the quicker and easier it will be to achieve.

Thirdly, the Bank is a public institution and should present an account to Canadians of what it is seeking to do, why, and how well it has achieved its objectives.

The December agreement between the Bank and the government on the objectives of monetary policy provides information that is crucial for all three of these reasons. It sets out again the basic nature of monetary policy and why that leads you to price stability as the fundamental objective. It also establishes clear targets for inflation control for the period to 1998, which should provide Canadians with a firmer basis on which to make their economic decisions. At the same time the targets are a standard against which monetary policy actions can be judged and the Bank held accountable.

However, for the actions of the Bank to be understood and judged, the Bank must provide information, not only on the objectives of monetary policy, but also on its operations and on the factors it takes into account in making decisions. In addition to the Bank's Annual Report, we release the economic and monetary policy commentary from the minutes of the meetings of the Bank's Board of Directors. And, with increasing frequency, senior officials of the Bank make public presentations explaining monetary policy and the Bank's view on the current economic situation, whether before parliamentary committees or on occasions like this. The Bank also puts out a wide range of publications explaining its views and its operations.

Communication, however, is not a one-way street. The Bank needs to understand what is happening in markets and in the economy. The facts and interpretations we gather feed directly into our decision-making process. The Bank also recognizes the importance of listening to other views. Not everyone is always going to agree on monetary policy, but there is no reason why we cannot have reasoned discussions of the issues. We are keenly interested in pursuing additional ways and means where we can discuss and explain monetary policy.

One message I want to leave with you today is that we will be seeking to expand our communications efforts still further. Thus, you will be seeing a lot more of me and the other senior officials of the Bank, as well as still more information coming out of the Bank on how we have managed our responsibilities.