Towards a more transparent and more credible monetary policy

Notes for remarks by

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Governor of the Bank of Canada

at the

École des Hautes Études Commerciales (HEC)
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I am pleased to have the opportunity today to speak at the École des Hautes Études Commerciales, the alma mater of my colleague Bernard Bonin. We are keen at the Bank of Canada to use every occasion offered to us to explain monetary policy and to enter into a dialogue with Canadians. Certainly, we have an obligation as a public institution to give an account of our actions. But more than that, we understand that the economy will perform better if people are well informed about the orientation of monetary policy, and if we ourselves are well informed.

The conduct of monetary policy has changed a good deal since the start of this decade. This transformation stems from a decision by the Canadian government and the Bank of Canada in February 1991 to set specific targets for inflation control. The adoption of measurable targets serves to clarify the aim of monetary policy, making the Bank more accountable for its actions and helping to enhance the credibility of monetary policy.

In his 1982 Per Jacobsson lecture,[1] Governor Bouey described the approach to monetary policy in Canada to that point as a long learning process, one whose main lesson for monetary authorities was never to lose sight of the goal of preserving the value of money. By taking care not to give inflation a place to

1. "Monetary policy — Finding a place to stand." The text of this lecture appears in the September 1982 issue of the *Bank of Canada Review*.

start, he said, the monetary authorities can help promote better economic performance over time.

What I propose to talk about today is the continuation of this learning process. But before turning to the advantages of specific inflation-control targets, I would like to review the benefits of price stability.

1. The benefits of price stability

Keeping inflation low is an objective that is shared by most central banks. However, it is not one that the Bank of Canada has chosen in order to be fashionable. We chose it because it is the best way for monetary policy to contribute to good economic performance over time. We do not regard price stability as an end in itself, nor as a cure-all: rather it is the means by which the Bank of Canada can promote a more dynamic economy, one that is better able to raise the prosperity of Canadians. Why is that so? In part, because in the final analysis, monetary policy has a lasting impact only on inflation; also, because inflation imposes significant costs on the economy by distorting the decision-making of economic agents. Inflation brings about an arbitrary redistribution of income and wealth, and so causes people to focus their efforts on how to exploit the situation. It increases labour market rigidity and diminishes the economy's capacity to adjust. It discourages efforts to control costs and to seek more effective production methods, instead encouraging speculative investment. Furthermore, because of its interaction with the tax structure, inflation introduces major distortions in investment decisions.

Some people fear that, by focussing monetary policy tightly on inflation control, the monetary authorities may be neglecting economic activity and employment. Nothing could be further from the truth. By keeping inflation within a target range, monetary policy acts as a stabilizer for the economy. When weakening demand threatens to pull inflation below the target range, it will be countered by monetary easing; on the other hand, an expansion of demand that could push the inflation rate above the range will be contained by monetary tightening. Hence the influence exerted by monetary policy on demand growth serves to align demand with potential output.

The monetary authorities must remain constantly vigilant with regard to inflation; inaction or insufficiently firm measures on their part could lead to a drift in inflation and the entrenchment of inflationary expectations. Sooner or later they will have to come to grips with inflation, but the task will be all the more arduous in that it will involve countering inflation expectations. This will exacerbate economic fluctuations, as periods of overheating lead to recessions.

A distinction should be made here between ***reducing*** inflation and ***maintaining*** it at a low level. Reducing inflation requires a downward adjustment in inflation expectations and may entail transition costs, which is not the case with simply maintaining low inflation.

It is generally agreed that the gains achieved by reducing inflation exceed transition costs when inflation is high. Where opinions are more divided is on the question of how far inflation should be reduced.

Some fear that if inflation falls below a certain threshold, the economy will be deprived of a lubricant. They argue that it is easier to achieve wage adjustment among workers when rollbacks can be avoided. And inflation makes this possible. I must say that this argument assumes a degree of money illusion that I find difficult to reconcile with the observed behaviour of wages in inflationary periods. It is an argument that could not be supported by the empirical research presented at a conference on price stability held at the Bank of Canada in 1993. It is true that this research was not conclusive, since it did not cover a period of slow growth in average wages. Recent experience will provide us with more useful information in this regard. We have therefore undertaken new research on this question, to be presented at a second conference on price stability hosted by the Bank next spring. Since this research is just getting under way, I will confine myself here to reporting that our preliminary examination of the major wage agreements concluded between 1992 and 1994 in the private sector does not lend evident support to the thesis of inflation as lubricant. I would add that the behaviour of economic agents is not immutable, but tends to adapt to circumstances. It is to be expected that, under a regime of stable prices, people will gradually lose the inflationary reflexes they acquired in the uncertain environment of high inflation.

In any case, I would remind you that the current objective of the Bank of Canada is not ***to reduce*** inflation, but rather ***to maintain*** it within a range of 1 to 3 per cent.

2. The advantages of specific inflation-control targets

In February 1991, in conjunction with the Canadian government, the Bank of Canada established a series of targets consistent with the desired course of inflation until the end of 1995. The objective was to bring the annual rate of increase in the consumer price index within a range of 1 to 3 per cent by the end of 1995. In December 1993, the government and the Bank announced that the range of 1 to 3 per cent would be ***maintained*** until the end of 1998, since it seemed appropriate to give Canadians time to adapt to a low inflation rate. It also enabled us to acquire more experience with the functioning of the economy in a low-inflation environment before settling on a more precise definition of price stability.

In its monitoring of the trend of inflation, the Bank pays particular attention to the consumer price index, excluding the highly volatile components of food, energy, and the first-round effects of changes in indirect taxes. But it is important to stress that the objective continues to be the control of inflation as defined by the total consumer price index.

Not all central banks pursuing the objective of price stability have elected to adopt specific inflation targets. The Bank of Canada is somewhat of a pioneer in this regard, being the second central bank, after the Reserve Bank of New Zealand, to opt for specific targets. Other countries, including the United Kingdom, Australia, Finland and Sweden, have since followed suit.

The decision to adopt specific inflation targets was motivated by a need for clarity. In the early 1990s, Canada had just experienced rising inflation. The Bank's announcement of its intention to achieve price stability was not enough to convince people to make their decisions on that basis – especially since that statement of intent was open to various interpretations. The

Bank's adoption of concrete targets, in concert with the government, made the orientation of monetary policy much more explicit.

2.1 Inflation targets and the conduct of monetary policy

The conduct of monetary policy is not an exact science. The actions taken to achieve targets are based on necessarily imperfect forecasts of inflation six to eight quarters down the road. By keeping to a specific objective, however, the Bank can prevent errors from accumulating.

Furthermore, by explaining the measures it is taking to achieve its inflation-control targets, the Bank can help make its policy more comprehensible and more predictable. And I can say to you today that the conduct of monetary policy is a much more transparent process than it was in the past.

In this connection, the Bank of Canada has been publishing a semi-annual report on monetary policy since the spring of 1995. In this report, we inform people about the general performance of the Canadian economy and about the prospects for inflation. The explanations provided in this report are intended to help readers understand our monetary policy actions.

To give an even clearer indication of the stance of monetary policy, we made some changes in policy implementation. In mid-1994, we established an operating band of 50 basis points for the overnight interest rate. Since January of this year, we have kept the public informed of changes in this band through press releases. In addition, since February 1996, the Bank has set the Bank rate at the upper limit of this operating band, rather than on the basis of 3-month treasury bill rates, as had been the case since 1980. This new way of setting the Bank rate helps to avoid confusion on the stance of monetary policy, since it focusses attention on the rate that is most directly influenced by monetary policy actions.

2.2 The existence of targets changes the behaviour of economic agents

The adoption of inflation-control targets has not only encouraged more transparency in the conduct of monetary policy, it has also led to changes in the behaviour of economic agents. In recent years, we have seen inflation expectations converging on the announced targets. We also see businesses now more concerned with cost control and more focussed on productivity improvement.

Since these changes are gradual, it is difficult to say whether they are occurring because of the publication of targets or simply because of recent inflation developments. Obviously, outcomes do play a key role, but you will agree that it can be difficult for the public to guess the intentions of the central bank on this basis alone. Because the monetary authorities have only an indirect influence on inflation, it is not always easy to gauge their intentions. By providing specific targets for inflation, the monetary authorities give a clear, objective indication of the course they intend to pursue. What's more, the results obtained can be measured against these targets and, in the event of a discrepancy, the central bank will need to provide good explanations if it wishes to maintain the credibility of monetary policy.

3. Recent Canadian experience

The evolution of inflation in Canada has been quite satisfactory in recent years. After dropping much faster than expected in 1991 and 1992, the inflation rate (adjusted for the effect of indirect taxes) has remained within the target range. In August 1996, the 12-month rate of increase in the total consumer price index was 1.4 per cent (1.3 per cent in the index excluding food, energy and indirect taxes).

During this period, Canada has had to face some major challenges: corporate restructuring, market globalization, the need to restore fiscal health, and the correction of imbalances created by the speculative excesses of the 1980s. I am referring here to spiralling costs, oversupply (especially in the real estate sector), and the rising debt burden of households. As a result, the recovery from economic contraction that Canada experienced at the beginning of the decade has been much slower than expected. And just as expansion seemed to be gathering momentum, it was stalled by disturbances on international markets in 1994 and early 1995 and by investors' nervousness about the country's fiscal and political situation. The result was an increase in risk premiums, which translated into higher interest rates. The latter have thus remained relatively high after allowance for the rate of inflation. In such a context, the benefits of low inflation were slow to be felt.

However, we are now beginning to see signs of significant progress. In recent months, the Bank has been able to ease monetary conditions appreciably. Thanks to improvements in the fiscal positions of Canadian governments and in the current account balance, there has been a significant decline in interest rates – to the point where today, for the first time in many years, short- and medium-term interest rates are lower in Canada than in the United States. This is what we would expect, with inflation much lower here than in the United States. It shows that keeping inflation down is a low-interest-rate policy and not, as some critics have often claimed, a high-interest-rate policy. We have also seen better cost control and a dramatic improvement in Canada's competitiveness.

But would progress have been stronger had the Bank of Canada shown greater tolerance towards inflation? I doubt it very much. The 1970s and 1980s taught us that inflation does not promote adjustment: on the contrary, it masks the urgent need for adjustment. Many of the difficulties Canada has experienced in recent years have been exacerbated by a reluctance to confront them head-on. At present, the Canadian economy is on the right track. It has made most of the necessary adjustments, and the conditions are right for strong expansion of demand. This tends to confirm that the monetary policy of the Bank of Canada is fostering a climate conducive to sustained economic growth. Consequently, it seems to me inappropriate to regard the difficulties Canada has undergone as evidence that inflation has been kept too low to facilitate the adjustment of relative wages. Such an interpretation underestimates the profound changes that have occurred in Canada in recent years.

Concluding remarks

The original intent of the Canadian monetary authorities in adopting specific inflation-control targets was to clarify the Bank of Canada's commitment to price stability.

The adoption of concrete targets has promoted greater transparency in the conduct of monetary policy. This transparency simplifies the task of market participants and is helpful to all those who are interested in monetary policy.

Furthermore, declining inflation has improved the economy's ability to adjust by focussing the attention of businesses on cost control and productivity gains. It has also made possible a significant drop in short- and medium-term interest rates.

It remains for us to define more precisely the objective of price stability. As I mentioned earlier, research is presently under way at the Bank of Canada to shed more light on this question. But, already, the evidence on the behaviour of our economy in a low-inflation environment is quite encouraging. The Canadian economy has weathered some major transformations, and I think the prospects for the future are bright.