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THE BANK OF CANADA AND ITS OBJECTIVES

Notes for remarks by
John W. Crow
Governor
of the
Bank of Canada
to The Canadian Club
Toronto, Ontario
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The opportunity to talk about monetary policy and the Bank of Canada before the diverse and interested audience that Canadian Clubs provide is one that I greatly welcome. Let me add that I am certainly struck by the pace of economic expansion and increasing prosperity here in Toronto and in the surrounding regions. I wish such vibrant economic conditions were more evident elsewhere in Canada where economic activity is currently quite slow. But while there are continuing problems in our economy, there are also grounds for optimism. The world economy continues to grow; the prices of some of the basic commodities produced in Canada have improved from earlier very low levels; a better alignment of exchange rates now exists among the major industrial countries; and inflation and interest rates have come down a long way. These factors should contribute towards sustained and more balanced growth in the Canadian economy.

However, today I am not going to spend a lot of time discussing the current economic situation. Rather, as this is my first public speech since being appointed Governor, I think it is particularly appropriate to begin at the beginning. I want to focus on two questions that are basic in any consideration of monetary policy in Canada.

My first question is this; what should be the primary objective of Canada's monetary policy? This is a very general question. It focusses on what monetary policy should be aimed at, not the details of how it should be conducted. I can save that interesting, though somewhat technical, material for some later occasion. Second, I want to address the closely related question of how the Bank communicates its policies to the public, and thereby interacts with Canadians, as it must. The raft of recent public comment on the Bank of Canada, sparked by the publication in March of the Bank's Annual Report for 1986, as well as the appointment of a new Governor, leads me to a simple conclusion. There is a great deal of interest in the Bank of Canada, how it operates, and the role it plays in the economic policy process in Canada. I will try to explain what we are about as carefully and as clearly as I can.

Returning to my first question, it is clear that the goal of monetary policy should be to make the best contribution it can to a healthy Canadian economy. The Bank should seek to promote an economy that is capable of producing gains in output, employment and living standards, holding on to those gains and building on them further, year after year. I would be surprised if anyone here failed to endorse that goal.

Now let me go a little further. Monetary policy is only one of a range of economic policies we apply in Canada that have broad objectives similar to those I have just sketched. So, since no single one of them can achieve everything, the next question is what particular aspect of these broad goals is each kind of policy best suited to achieving?

In regard to monetary policy the answer may be unfashionable but it must in my view be unequivocal. The objective to which monetary policy should give central attention is maintaining confidence in the value of the money we use in Canada -- in other words, the goal of price stability. This is not because the Bank sees the reduction of inflation as an end in itself. That has never been my view -- nor has it been the view of any of my predecessors. Rather, the goal is founded on the fact that persistent erosion of the value of money, far from providing any lasting benefits, is bound to mean an economic performance for Canada that falls short of the best Canada can achieve.

But of course matters are not quite that simple. To recognize that getting rid of inflation has crucial benefits, benefits that cumulate over time, is not to deny that fighting inflation can have short-run costs. Financial policies directed at lowering inflation may for a while slow the expansion of demand in the economy. This aspect is, for example, reflected in comments one sometimes sees to the effect that if it were not for "tight" monetary policy, economic activity in such and such a quarter would have increased more than it did. Since we all want increases in economic activity, the clear inference is that monetary policy should have been looser -- for that quarter.

But let me reflect a moment on this kind of economic analysis. The immediate benefits of any action have to be measured against the benefits and costs stretching into the future. This is an awkward fact of life which responsible policymakers must recognize. The Bank of Canada has to address this fact all the time. I want to address it now as regards the goal of price stability.

It is sometimes suggested that the Bank should replace the underlying goal of price stability with the more immediate objective of simply seeking through monetary policy to stabilize the current inflation rate; in effect that the Bank should declare victory at whatever inflation rate happens to exist and certainly not try to reduce it. I wish that we could say yes to this easy alternative to hard choices, but unfortunately the lessons of history teach us otherwise.

Why does this alternative not work? The basic reason is because a willingness on the part of the monetary authorities to stop short of price stability tends to encourage the belief that they are willing instead to try to live with an inflationary economy. The "living with inflation" prescription that I have just outlined is bound to be seen as putting a floor under inflation but it will not be seen as restraining inflation. The result is the promotion of inflationary expectations and inflationary behaviour. The evidence from both home and abroad indicates that in such circumstances inflation has a built-in upward tendency. At some point this tendency has to be resisted. At some point the authorities have to show that they do have a ceiling rather than a floor for the rate of inflation.

The evidence also indicates that the longer this resistance is delayed, the greater the economic and social costs that will have to be borne. Persistent generalized inflation will not take us to some promised land. On the contrary, it encourages the spread of economic and financial distortions that sap the strength of the economy and are painful to unwind. That is the lesson I take from our experience of the 1970s, and the lesson that is reviewed in the Bank of Canada's Annual Report released last month.

Let me pause here a moment to elaborate on what I mean by "generalized inflation". What I mean is a movement generally in the level or average of prices in Canada, not changes in the prices of individual goods and services. Individual prices and costs vary in response to market conditions. I can certainly agree that the prices of some of the basic commodities we produce are now too low in relation to basic costs of production, and that it would be better for the balance of the Canadian economy if those prices were higher relative to other prices. That is not what I mean by "inflation". What must be the central concern for monetary policy is the trend of the rate of change of costs and prices more broadly. That is what I shall be referring to in my remarks on these matters.

I should think that our experience with inflation in the 1970s is still vividly impressed on the minds of many people here today. It is a history and a legacy of bad investments, economic recession and a burden of indebtedness which will hamper the world economy for many years to come. Is it any wonder, after this worldwide experience with inflation, that every major industrial country -- including Canada -- now gives priority to achieving a more stable price level?

I know there are many people who will agree completely with what I have just said -- in principle! But they will nevertheless still ask why, at the present time, the Bank is not more willing to ease monetary policy in order to expand demand and, hopefully, growth. They argue that even if inflation has been very costly to the Canadian economy, we have after all made great progress in bringing it down, and inflation today is surely not as serious a problem as unemployment. In their view the Bank of Canada should, at least for the time being, be taking some risks on the side of an easier policy in order to get our unemployment rate down faster.

My response to that proposition is sympathetic. Unemployment is too high. It must be reduced further. That is not an issue. But the real question is how to make our economy work better from the point of view of encouraging employment, and that is not done by increasing inflation. It did not do it in the 1970s and it will not do it now. Taking risks on the side of an inflationary policy is exactly what got us into so much trouble in the 1970s -- and indeed contributed fundamentally to the 1981-82 recession and the high level of unemployment that has troubled us ever since.

I can add that encouraging inflation is not the way to get interest rates down either.

We believe that the careful monetary policies we have been pursuing are making the surest contribution we can to getting interest rates and unemployment down -- and keeping them down. The task is not finished, but the record shows that the policy is working. The Canadian economy has expanded by close to a fifth in the past four years. In those four years the rate of domestic inflation has been cut by more than half. This record has increased confidence in Canada's currency, allowing interest rates to decline more than inflation. That is, real interest rates, interest rates adjusted for inflation, have declined, thereby improving the prospects for investment.

My remarks have concentrated on monetary policy, but I would not want to leave the impression that other economic policies are unimportant in encouraging a climate of price stability and more generally in enhancing Canada's economic performance. For example, the credibility of any commitment to price stability, or indeed to good economic management in general, would evidently be undermined by a government budgetary deficit that was not under control. At the very least, people would tend to wonder whether inflationary financing would be sought at some point to cope with rising government debt service costs. Fiscal deficit reduction and debt containment is both practical and important. I applaud the substantial fiscal progress already made in Canada, and the commitment to make still further progress.

Let me in the rest of my remarks turn from the monetary policy message to the monetary policy institution, the Bank of Canada.

The Bank has the responsibility to explain its policies publicly -- to tell Canadians as clearly as it can what it is doing and why. For more than fifty years we have been making speeches, issuing Annual Reports, and appearing before House and Senate Committees to explain both the objectives of monetary policy and the means chosen to achieve them. We are going to carry on doing this, and I don't think we need to worry about oversaturating the market. I hope that our recent decision to publish regularly that part of the Minutes of the Bank's Board of Directors that deals with economic and financial developments and monetary policy will be seen as a constructive additional contribution in this regard.

But there are some limits to what we can say, even if the public's appetite is very great.

The Bank of Canada has sufficient independence to take direct responsibility for the monetary policy pursued in Canada. But the Bank is of course also a part of government; it operates in a well-defined manner within the framework of government and not separately from it. Moreover, the Bank not only formulates monetary policy but also implements that policy in financial markets. Both these considerations are worth elaborating on.

Let me begin with the latter consideration. Because the Bank implements monetary policy, what we say can have very marked and immediate effects on the Canadian money and foreign exchange markets. Indeed, I can attest to this from quite recent personal experience. Therefore, as a matter of principle, you are never going to get colourful, oversimplified and under qualified commentary from the Bank. Such commentary may make for better copy and bigger headlines, but it risks causing exaggerated responses in financial markets. We should not promote that risk. No one except pure speculators would want the uncertain and volatile markets that would result.

The second consideration, our position within government, needs somewhat lengthier treatment.

The first observation I shall make is that while the Bank is, as I have just noted, directly responsible for the formulation and conduct of monetary policy, the Bank of Canada Act also requires the Governor and the Minister of Finance to consult regularly on monetary policy and its relation to general economic policy. This provision underlines the fact that the Bank of Canada is part of the broad public policy structure. Moreover, in the spirit of this provision, and for many other good reasons as well, there is very frequent contact between officials of the Bank and the Department of Finance.

And since the Bank can be expected to counsel the Minister of Finance on a whole series of economic and financial matters, it cannot be effective in that role if it is at the same time engaged in wide-ranging free public debate on those matters. In other words, if I am to be an influential and an ongoing source of advice to the Minister of Finance then that advice will have to be given in private.

But I should also stress that being part of the public policy structure does not mean that the Bank has no scope to make any public comment on fiscal, or indeed any other, economic policies. We have in the past and we will in the future. What it does mean is that our commentary will continue to be directed at the economic fundamentals of issues rather than at specific policy proposals. Furthermore, I underline what I have already touched upon earlier in these remarks, that the Bank is very conscious of the fact that other policies can have major effects on the results that can be achieved by monetary policy. We have the responsibility to assess those effects and explain them, in public if necessary.

Having spoken about the flow of information and ideas from the Bank to the general public, let me finish with a few words about the information that flows in the opposite direction.

We have always worked very hard at the Bank to obtain a full range of views from the outside. In particular, because of the great variation in economic circumstances in different parts of the country, we have made a special effort in recent years to develop an in-depth understanding of regional developments and regional concerns. In this regard I should bring to your attention the important role played by the twelve outside members of the Bank of Canada's board of directors. They bring to our discussions a wide range of backgrounds and a good balance of regional representation.

Let me conclude these remarks on a more general note. Canada has made great progress in extracting itself from the inflationary quagmire of the 1970s and early 1980s, yet I cannot tell you that all our economic problems are now about to be solved. The operation of the world economy, while much improved from five to six years ago, is still not well-balanced, and these imbalances have affected our domestic situation. But the better we run our affairs domestically, with sound policies and a good public understanding of the implications of those policies, the better we will be able to cope with the external events which are bound to buffet us from time to time. We are indeed part of the world economy but we are not its captive. The results we achieve in Canada depend ultimately on the quality of the economic policies we pursue in Canada. That applies of course to monetary policy, and I plan to continue to take that responsibility very seriously and conscientiously in going about the business of central banking.