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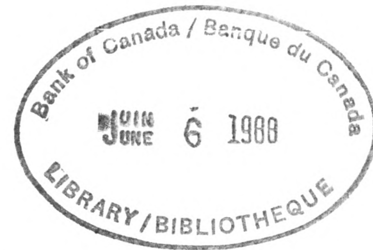

SOME RESPONSIBILITIES AND CONCERNS OF THE BANK OF CANADA

Notes for a luncheon address
by John W. Crow
Governor of the Bank of Canada
at the annual meeting of
the Canadian Economics Association
University of Windsor
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Introduction

I very much welcome the opportunity of addressing the annual meeting of the Canadian Economics Association. You may also welcome the chance to listen to a paper containing not a single equation, footnote or list of references.

My remarks today will deal with a number of issues touching on the responsibilities of the Bank of Canada. These issues are not only of concern to the Bank but are also likely to be ones in which the economics profession generally has an interest. The first part of my remarks will be a commentary on the objectives of monetary policy. This will have a mainly domestic orientation, but I also think that it is useful to look at some of the potential implications stemming from international economic coordination. Following this, I will touch more briefly on what the prospective disappearance of banks' cash reserve requirements means, or perhaps does not mean, for monetary policy, and then on the evolution of the relationship between monetary policy and public debt management. Finally, I will

have something to say about the relationship between the Bank of Canada and the economics profession in Canada.

Objectives of Monetary Policy

This is the second time this year that I have addressed an academic audience. The first was when I gave the Eric Hanson Memorial Lecture at the University of Alberta, and my theme was the objectives and techniques of monetary policy in Canada. I do not propose to repeat that lecture here -- after all it was fairly lengthy, and in any event was published in the February issue of the Bank of Canada Review. But I will make some comments about it.

What was the message? Regarding the objectives of monetary policy, I made the case that in order to promote the sustained good performance of the Canadian economy, the best thing the Bank of Canada could do would be to aim for a pace of monetary expansion that promotes stability in the value of money -- in other words, stability in the general level of prices. This view reflects the fundamental fact that we live in a monetary economy, and without a trustworthy monetary standard that economy will not perform as effectively over time as it otherwise could. The bottom line is sustained good economic performance, and an inflationary monetary policy is not helpful in achieving that kind of performance.

Monetary policy actions can of course have effects on economic activity in the short run. But as I indicated in the Hanson Lecture, the size and rapidity of the effects at each stage of the transmission of monetary policy actions to the economy are subject to considerable uncertainty. This substantially reduces the likelihood that a monetary policy

that is geared to "fine-tuning" the economy will produce satisfactory results.

These considerations suggest strongly that the Bank should have at hand some kind of policy guide to ensure that long-term objectives are kept front and centre as we go about our business in financial markets from day to day, week to week, month to month.

In particular, given the pressures to open up the monetary throttle in the short term that are always prominent, the absence of some such guide or anchor makes monetary policy more susceptible to the kind of inadvertent but cumulative missteps that are the stuff of which endemic, and even spiralling, inflation is made. Identifying a nominal anchor is not easy, particularly if it is to be used in the demanding role of a formal target variable. The Bank of Canada's experience with the use of the M1 monetary aggregate over the 1975-82 period provides a good illustration of some of the problems that can arise. But, as I indicated in the lecture, despite the difficulties of finding suitable guides or targets, this question continues to be the focus of considerable policy and research interest at the Bank because we think it is very important. To date, the aggregates M2 (made up of personal non-transactions deposits at chartered banks as well as the currency and transactions balances that comprise M1) and M2+ (which adds to M2 deposits at trust and mortgage loan companies and at credit unions and caisses populaires) appear to be the most promising candidates as guides to policy.

What has been the general reaction so far to the Hanson Lecture? The main body of the lecture dealt with the means by which monetary policy can be managed, and the

difficulties that unstable expectations about inflation or the exchange rate can pose for policy in the short run. This part of the lecture appears to have elicited little reaction to date. Given the complexities and technical nature of the issues involved, we do not expect much reaction outside the academic community. And in that community, it seems to me, disagreement gives rise to a livelier, quicker, response than does assent. Perhaps our views in that area command broad agreement.

What has attracted more attention is the notion that general price stability could be a proper central objective for monetary policy to work towards and to maintain. A number of press commentators and some academic economists seem to find this a radical, perhaps even dangerous notion. It drives them to strong, colourful language.

But does tolerating inflation contribute to sustained good economic performance? Can it really be argued that a monetary policy that is in effect designed to accept a higher rather than lower rate of inflation will lead over time to a higher level of output and employment or, conversely, that working towards price stability will damage rather than enhance Canada's economic fortunes? I believe that the answer to these questions has to be "no". I think that by now everyone recognizes that persistently inflationary policies cause cumulative economic damage. But perhaps not everyone recognizes yet the insidious way in which inflation can ratchet up, and the need for monetary policy to be directed at a clear and well-founded goal in this regard.

Of course, in expressing a measure of surprise that price stability as a sensible target for monetary policy should be considered radical by some, I am not suggesting that getting there from here will not require careful thought, time, and steadiness of purpose. And that is why the framework and techniques of monetary policy and, I might add, such connected notions as the credibility and the time consistency of policies, are important and worth discussing. There is plenty of room for serious analysis and debate of these and other related matters, and we very much welcome participants and considered views.

International Policy Coordination

These initial remarks have stressed the importance of the goal of domestic monetary stability. At the same time, much of the focus nowadays is on the international dimension and in particular on the progress of, and prospects for, international economic coordination. How the two strands, domestic and international monetary considerations, can be harmonized is something that will merit a lot further exploration. For one thing, the existing procedures for international economic coordination can reasonably be expected to undergo further testing, and while important progress has been made we cannot be sure that we are very far along the learning curve, since what is being done has not been tried before. Furthermore, deciding exactly how a country's monetary policy can help out internationally while remaining aimed at domestic monetary stability will always, in my view, involve difficult judgements. Still, there are some features that are worth commenting on at this stage.

First, let me back away a bit from monetary policy by emphasizing that the main relevant international problem has been the very large fiscal and current account imbalances that emerged among the major industrial countries in the early to middle 1980s. These imbalances are being eased but are still very large. Associated with them have been wide swings in exchange rates.

There is little dispute that to improve the situation it is crucial to have greater compatibility among the major external surplus and deficit countries in the performance of domestic demand relative to output. Thus, a good basic case can be made that countries with unwanted external deficits should tighten fiscal policy, while those with large surpluses can help by undertaking some fiscal expansion. This is being done, although it must be conceded that it is easier to say than to do. By and large, countries with external deficits have found it difficult to effect tax increases or expenditure cuts. This is so even when relatively buoyant domestic demand conditions or the importance of pressing ahead with public debt containment point to the appropriateness of fiscal tightening. On the other hand, countries with external surpluses have been understandably reluctant to run the risk through a more expansionary fiscal policy of unleashing a progression of budgetary deficits and debt accumulation that they might later find difficult to contain.

The analytics of coordination demonstrate that in an interdependent world there are, in principle, payoffs in better economic performance from an explicitly coordinated approach. Nevertheless, these gains are not necessarily easy to come by. However, the seriousness of the international imbalances that have needed to be addressed and

their potential for economic trouble, not least in encouraging the cancer of protectionism, yield ample testimony to the value to the world economy of the effort and progress that is being made. Furthermore, in sorting out the issues related to the procedures of coordination, the major industrial nations have been able to count on the truly valuable expertise and balanced judgement of the international economic agencies.

From what I have already said, it will be evident that the place of national monetary policies in the area of coordination is not sharply defined. This no doubt reflects in part the fact that monetary policies are not at the root of the problems that international economic coordination is aiming to solve. Still, some analysis has been done on the monetary aspects, particularly in regard to exchange rate regimes.

The wide swings in real exchange rates to which the world economy has been subjected have brought into focus the question of commonly agreed target zones for exchange rates. But even advocates of target zones recognize that they are desirable, or feasible, only to the extent that the discipline they can bring will result in a systematic improvement in domestic policies. Indeed, some proponents appear to see such zones as the world's best chance of securing that improvement, with emphasis on improvements on the fiscal side. This would be, then, working from the outside in. However, it would also be necessary to make very sure that any contribution such zones might make to exchange rate stability is not used to underwrite domestic and international inflation.

In this regard, I might note that from the viewpoint of forestalling world inflation there has been evident interest in seeing whether indicators of commodity price movements can be a useful tool, although not necessarily as part of a target zone package. Work underway under the auspices of the G-7 and other bodies may turn out to demonstrate that such indicators provide helpful early warnings of global, or even national inflation. But it already seems clear that such indicators would in any event be appropriately used as supplements to existing national indicators of inflation and policy guides, not as alternatives.

Having looked at some very broad issues relating to Canadian monetary policy, I want now to turn to a couple of questions more related to the day-to-day implementation of policy.

Reserve Requirements and Monetary Policy

A number of you will be aware that the December 1986 "Blue Paper", New Directions for the Financial Sector, released by the Government of Canada announced that minimum reserve requirements -- that is, the non-interest-bearing reserves that chartered banks are required to hold -- would be phased out.

In some quarters a concern has surfaced that eliminating reserve requirements would result in the Bank of Canada losing control over the monetary base and, therefore, over monetary policy.

Now, it is true that what fundamentally gives us leverage in monetary policy are operations on the monetary base, in other words operations that affect the size of our balance sheet. But it is not the case that we rely on any direct, multiplier link from the monetary base to broader monetary aggregates to achieve our monetary objectives. The important link is from the monetary base to short-term interest rates. And there is no reason to believe that the elimination of reserve requirements will undermine our ability to exercise that influence over short-term interest rates through which we can influence the demand for money and hence, the pace of monetary expansion. Indeed, monetary policy will work in much the same way in the new framework as it does now because the key elements giving the Bank of Canada an influence over yields in financial markets will remain essentially unchanged:

(1) the settlement of the daily clearing of payment items by major deposit-taking institutions will continue to be undertaken of necessity on the books of the Bank of Canada;

(2) so even in the absence of statutory reserve requirements, these direct clearers will still need balances at the Bank of Canada in order to settle;

and (3) the Bank of Canada will continue to be able to determine the availability of such balances, and thereby influence very short-term interest rates directly. In this way it will maintain its leverage over monetary conditions in general.

The removal of statutory reserve requirements does have various secondary implications for the way the Bank of

Canada operates monetary policy from day to day, and we have been discussing them with the institutions involved. But the far more important consequence, indeed the motivation for making the change, is that removal of non-interest-bearing statutory reserve requirements will result in a more equitable treatment of banks and non-bank institutions. In the changing Canadian financial system, the distinction between bank and non-bank financial institutions is becoming increasingly blurred. And in these changed circumstances a failure to remove the obligation on banks to carry non-interest-bearing reserves would be patently unfair.

Public Debt Management and Monetary Policy

I want now to move on to another area in which the Bank is importantly involved -- public debt management. What I want to emphasize is that while the Bank in its capacity as fiscal agent and adviser to the Government of Canada remains actively involved in the management of the public debt, debt management and monetary policy management are now quite separate areas of operation. This stands in contrast to the situation a number of years ago -- for example, see the description in the Bank of Canada's submission to the Royal Commission on Banking and Finance in 1962 -- when debt management operations were held to interact in an important way with monetary policy actions.

In the world of 1962, the Bank of Canada focussed on "credit conditions", encompassing both price and non-price terms affecting the availability of funds, in setting the stance and gauging the impact of monetary policy.

Within such a structure, Government debt management operations were judged to exert an impact on credit conditions. This was partly because changes in the term to maturity of Government debt affected broad liquidity in the economy (to the extent that short-term securities were more ready substitutes for money than long-term securities), and partly because it seemed that even relatively moderate changes in the supply of government securities at different terms could affect the term structure of interest rates. Accordingly, such operations were regarded as an adjunct of monetary policy.

The world has changed a good deal since then. Institutional changes such as the elimination of interest rate ceilings, much greater substitutability among various kinds of financial instruments, and a general deepening of Canadian financial markets have all worked to undermine the operational relevance of "credit conditions" as a guide for monetary policy and therefore to diminish greatly the link between debt management and monetary policy.

Just a note of caution. To take an extreme example, if the average term of the debt were greatly shortened, the massive and frequent turnover of debt could pose some operational complications for monetary policy. Also, notwithstanding the fact that our financial markets clearly now have a great deal of absorptive depth, there is no reason to assume that a major shift in maturities in order, say, to take advantage of the shape of the yield curve, would have no disruptive effects at all on securities markets.

Before leaving this area, let me emphasize that my references to debt management have been only in the context

of techniques of monetary policy. On a much broader and more fundamental plane, there of course remains the problem for the economy and financial markets of absorbing the growth of government debt, and the corresponding need to ensure by sustained fiscal action that this growth is contained within reasonable bounds.

The Bank and the Economics Profession

In my remarks today I have tried to convey a flavour of some of the issues for which the Bank of Canada has a responsibility and which are surely of considerable interest, both professionally and otherwise, to this audience. And the Bank's relationship with the members of this audience, the economics profession, is a matter of great interest and importance to us. I will, therefore, end my remarks today by commenting on that relationship.

It seems to me that the links are by and large in good repair. Exchanges between the economics profession and the Bank are steady and constructive. They come through a variety of channels. The Bank, for example, drew intensively on the services of academic consultants in developing the RDX1 and RDX2 econometric models a number of years back, and we have continued to bring in academic economists to give seminars or as consultants on particular projects from time to time. As well, the Bank has publicized its own research efforts through submissions to various royal commissions as well as through direct publication of staff studies and technical reports. Indeed, in an effort to get more of our work into the public domain sooner, we have recently instituted a new working paper series and will of

course value comments from the profession on the pieces that will be issued as part of that series.

In addition, the Bank's economists publish in professional journals and they participate actively in various professional forums such as the annual meetings of this association, those of La Société canadienne de science économique and others.

Thus, my overall impression is that the Bank has not been remiss in its contributions to the practice of economics in Canada. But, of course, there are bound to be areas where we could conceivably do more. For our part we would certainly welcome more input from the profession. Naturally we already rely heavily in our economic analysis on general research done in academia, but we would particularly appreciate more contributions in our own area, monetary policy, and especially in applied monetary policy. I might note in this regard that only a handful of economists, most notably those associated with the C.D. Howe Institute, have provided detailed commentary on current Canadian monetary policy in the past decade, and even their output has been of an occasional nature.

It is not immediately clear why there should be a relative dearth of output on monetary policy issues. Is it difficult for economists to stay sufficiently abreast of developments to provide up-to-date commentary rather than more retrospective analysis? Or has it simply become unfashionable to be concerned about monetary policy?

The point I want to emphasize is that the matters in which the Bank is involved are important and merit serious

commentary. To this end we are willing to provide comments, formal and informal, on other people's work. But could we be doing more to promote this exchange, such as giving fellowships to academics to spend time at the Bank working on projects of common interest or by organizing panel discussions? I and my colleagues would appreciate any constructive suggestions that you may have to enhance further the quality and frequency of dialogue between the Bank and the economics profession at large. We do pay attention to what is said, and if we can do anything more to promote good work in our area and to increase the understanding of monetary policy, we will.