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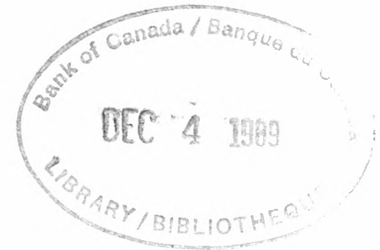

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Notes for remarks by
John W. Crow
Governor of the Bank of Canada

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TARGETING MONETARY POLICY

The appropriate goals of monetary policy elicit much discussion these days in all our countries.

Naturally, the Bank of Canada reflects on this question a lot. Our considered view -- one that recent experience only serves to confirm -- is that monetary policy has one essential goal if it is to make the best contribution it can to overall economic performance. Monetary policy should aim at achieving and maintaining broad stability in domestic prices.

This is a particularly useful time to discuss again the objective of price stability. Recent economic developments represent an important challenge to its achievement. This is true not only in Canada but also elsewhere, including both of the other countries represented on this Committee.

Why does price stability matter?

Why is price stability so important that the monetary authorities should focus on it? Some find this proposition virtually self-evident, but there are certainly others who seem to find the idea disturbingly radical -- who

question the fundamental importance of ensuring that a nation's money retain its value. So let me outline the case for price stability and why it needs more than lip service.

All modern economies have a monetary foundation. We use money so that transactions may be carried out in the most efficient and least costly way possible. To secure fully the economic benefits this provides, our economies need a monetary standard that people can trust. This means a monetary standard that keeps its value over time.

Let me expand on this.

Consumers make daily decisions based on the prices of the goods and services they want. Businesses make decisions about investment and production based on selling prices and the prices of their inputs. It is a good system, and it defies reason to believe that inflation will make this system work better. Inflation does not just cause difficulties in understanding the meaning of current changes in prices. It compounds the problem by introducing needless uncertainty regarding future price movements. The result is that people make needless errors in their economic decisions. People have to work to shield themselves against inflation -- effort that could be used for productive activities. Thus our economies cannot perform as well as we should expect them to.

Inflation carries with it social as well as economic costs. Since some individuals and businesses can protect themselves better than others, inflation reshuffles income and wealth arbitrarily. As an economist, I can say that economic science has difficulty assigning general economic costs to arbitrary transfers. But this perhaps

tells us more about the limitations of economics than about the impact on our society.

What about the other side of the argument? It is often contended that inflation is acceptable if maintained at a "moderate" or "low" rate -- perhaps something between price stability and 10 per cent. Why do some people find this acceptable? It cannot be because our economy is going to perform better this way. The idea that we could, for example, really lower the unemployment rate just by allowing some more inflation has been completely discredited by the events of the past twenty years. More likely, it is being argued that reducing inflation involves costs that may not be worth incurring. Better to live with inflation.

But what does "living with inflation" mean? Does it mean a chosen target for inflation? In my experience, if a target is suggested it is almost invariably whatever the rate of inflation happens to be at the time. Some target!

One can pose further questions. If all policy needs to do is to settle for the going rate of inflation, what is to stop that "going rate" from moving up further? In other words, if bringing inflation down is seen as, well, simply too difficult, in what direction are the risks going to be systematically taken in setting policy? Towards higher inflation of course. And monetary policymakers will receive considerable encouragement to take those risks. Monetary policy in Canada has been invited to declare "victory" over inflation on a number of occasions in the past year. This was so even as the rate of inflation rose above 5 per cent and threatened to go higher. Is the Bank of Canada supposed to expand money to accommodate whatever inflation pressures exist until inflation comes close to, say, 10 per cent, and

then get serious about combatting the consequences? Will this make inflation easier to live with or improve economic performance? Hardly.

In other words, a policy of living with inflation not only entrenches the burden of chronic inflation but severely lacks believability. It is inevitable that people will become increasingly pessimistic in their expectations of future inflation and let that pessimism colour their actions in the marketplace. Furthermore, any increase in inflation beyond an indicated target would require considerably more effort, and cost, to pull back. In fact, a policy aiming at a given and truly stable target rate of overall inflation would require a lot of policy commitment. And for what purpose? This commitment would surely be greater than that required for genuine price stability because it would not have the benefit of the inherent consistency and credibility -- that is, the common sense -- of a policy of price stability.

Reaching price stability

What is required to reach price stability? Certainly it will not be achieved unless monetary policy is oriented towards this goal. It requires a commitment from monetary policy that is sustained. Practically speaking, achieving price stability has to be a long-run proposition. But as lower inflation is achieved, as people are less conditioned by fears of inflation, reducing inflation and preventing its resurgence becomes less difficult.

Let me draw on an example that a number of you will be familiar with. Sustained commitment was critical to the eventual success of negotiations in Europe for a more

integrated market, or "Europe 1992" as it is popularly called. Five years ago, the prospects for a vastly expanded common market within the EEC was considered vastly improbable by many. Today, after much hard work and periods where there seemed to be little progress, it is suddenly looking to be a reality. The key was getting people to think differently -- in this case to think in terms of a single cross-country market and the benefits that come with it.

How smooth will the path to price stability be? Difficult to say. Many things can happen that are outside the influence of monetary policy.

Still, what should remain consistently and unmistakably clear is for monetary policy to be set in a way that gives price stability strategic importance. Monetary policy has to keep very clearly in sight the necessary longer-run objective. It should attune monetary expansion and therefore its influence on the path of total spending in the economy to a pace consistent with the ability of the economy to expand its supply of goods and services. Monetary and credit aggregates, as intermediate targets or information variables, have a useful role.

The belief that demand management policies can coax more and more economic activity in the short term, whatever the prevailing circumstances, is persistent but erroneous. Short memories and short horizons make for shortsighted policies. Monetary policy has to be a policy that looks ahead years, not simply weeks or months. To do otherwise, to try to run monetary policy in a way that aims to ward off every shift in the business cycle, will only degrade economic performance. We know this from experience.

Finally, let me also emphasize that price stability makes the economy more productive. Thus it represents an investment in a good economic future. This investment will not be realized if the focus of policy is dominated by short-run considerations.

The international dimension

Before turning to the current situation, let me make some comments on the exchange rate and the international dimension.

Where does the exchange rate fit in? We can certainly agree that it is a key price in our economies. A quarter of Canada's total production of goods and services is exported. The United Kingdom exports a similar share, and the trend is upwards for the United States.

Clearly economic policy, including monetary policy, has to pay attention to the exchange rate and to be mindful of its effects on the economy and on inflation. We would all like to see as much stability in the external value of our currency as we can get. Indeed, part of the mandate of the Bank of Canada as set forth in the preamble to the Bank of Canada Act is "to control and protect the external value of the national currency unit."

But what I should also reiterate is that national monetary policy has to have the central objective of stability in the general level of domestic costs and prices -- for us, the stability of the Canadian dollar in Canada. Let me put it another way. Canada, not the rest of the

world, is responsible for what happens to Canadian monetary expansion and therefore to the path of inflation in Canada.

In fact, domestic monetary stability is the best general guarantee a central bank can give for exchange rate stability. By no means an absolute guarantee, but from a monetary angle the best guarantee.

I should perhaps add that I am aware that there are other angles from which one might view the exchange rate -- for example, such perspectives as the optimum size and configuration of markets as well as political considerations. These are getting a lot of exposure in Europe in the context of '1992' and beyond. However, from a monetary perspective, the point of attaching one's currency to that of some other country would be essentially because the other country has, somehow, been able to establish a better domestic inflation record. One imports anti-inflationary credibility. It is an interesting question of course why, in a given instance, it is not possible to manufacture enough credibility of the homegrown variety, but I shall not pursue that question here.

Before concluding on the international side, let me broaden further the argument why monetary responsibility begins at home.

Recently, the importance of co-ordination of policies across major industrialized countries to promote exchange rate stability has been much emphasized. Nevertheless, barring radically altered international institutional arrangements, ones that radically constrain sovereign national economic policy choices, national monetary

stability remains the keystone of international monetary stability.

Even if exchange rate stability could be achieved with all the partners living with about the same rate of inflation, this would not be a bargain. And in any event, is exchange rate stability realistically achievable in such a globally inflationary situation? Inflation uncertainties disorient expectations of all participants in financial markets. This is so whether those participants are within one's borders or outside. A market consensus on underlying financial values becomes increasingly tenuous. In this situation financial values become very shaky, as do of course exchange rates, which, after all, serve to relate those values across countries. This would generate the very opposite of exchange rate stability.

Where are we now?

How are we doing in regard to inflation? Let me begin with the broad international scene and then focus on Canada. The major industrialized countries have been undergoing an extended period of strong demand expansion. After slowing somewhat in 1986, demand rose with renewed vigour in 1987 and 1988. The resulting high level of economic activity contributed to a general intensification of inflationary pressure, and the response of policymakers was to tighten monetary conditions. Short-term interest rates moved up throughout the major industrial countries, including Canada, the United Kingdom and the United States.

Monetary policy has had to carry a major burden in resisting inflationary pressures. This has meant relatively

large increases in interest rates to contain the expansion of inflationary demand.

Let me note parenthetically that the United Kingdom's situation is different, in a very interesting way, inasmuch as its budgetary position is in surplus. But notwithstanding this surplus, with the tremendous buoyancy of private spending, U.K. interest rates have had to be pushed up very sharply -- to levels higher than in the United States or Canada. One thing that the U.K. experience illustrates is the difficulty of making flat commitments that short-term interest rates could be reduced if fiscal policy were tighter.

Canada faces a situation similar to the rest of the industrialized community. Our economy has been one of the top performers during the current recovery, with rapid expansion in incomes, robust business investment, and strong increases in employment.

But demand pressures have accumulated. Total dollar spending in Canada has been growing unsustainably, rising at an average annual rate of 10 per cent from the beginning of 1987 through the first months of 1989. This has been well beyond the ability of our economy to increase the volume of goods and services supplied. We are now seeing the results of this earlier demand pressure show up in Canadian costs and prices.

These developments challenge progress towards price stability and economic progress in Canada. The response of the Bank of Canada, beginning in 1987, has been to tighten monetary conditions progressively. We wanted to ward off the destructive inflationary momentum that we could

see building up. Of course, in an environment of strong spending this has induced upward movements in short-term interest rates. However unpopular this may be in some quarters, ignoring the inflationary build-up, printing money still faster, would not be a recipe for sustaining the economic expansion. Our recent history, in which every economic contraction has been preceded by an outburst of cost and price pressures, indicates that this would only invite a severe downturn.

More recently, there has been a moderation in the pace at which spending is advancing, both in Canada and for some, but not all by any means, other major industrialized countries. Still, for Canada, the pressure on available resources remains very strong.

Conclusion

The invitation I received to address you today placed special emphasis on the difficulties for monetary policy -- "the dilemma of a central banker", was the way it was put.

I certainly do not think that my remarks have skipped over the problems that central banks face.

At the same time, what I have aimed to do is not so much worry out loud about our problems as to emphasize what monetary policy can achieve, and therefore what it should be about. There is much to be said for monetary policymakers being clear about the scope and limits of their policies, and therefore what they can reasonably accomplish. This is certainly the case if they wish to avoid needless dilemmas or impossible choices. What is far more serious is that by

trying to do too many things they can damage the economies they serve -- in the end making matters worse on every front.

I made the case earlier in these remarks for valuing and pursuing domestic price stability. In concluding let me emphasize that the Bank of Canada very much welcomes further discussion and analysis of the issue of price stability. Some of this has gotten underway. What I will underline is that arguments regarding price stability that do not consider seriously what monetary policy can and should credibly achieve in the national economic interest are hardly likely to withstand scrutiny.