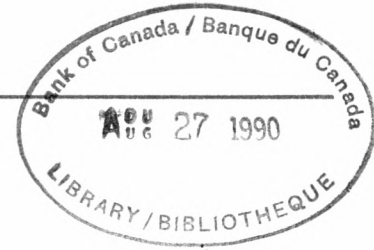




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Notes for remarks
by John W. Crow
Governor of the Bank of Canada
at a symposium on central banking issues
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**ISSUES AND OPTIONS IN MONETARY POLICY AND THE CONTROL OF
INFLATION IN EMERGING MARKET-ORIENTED ECONOMIES**

As "presenter" for this session of the Symposium I see my task as more to indicate than to prescribe. There are other reasons as well for a cautious approach. Even if one could claim to have a good understanding of the common features of the economies in question, the differences among them are also very important. It is therefore unlikely that any single prescription could satisfy all cases. And while I can claim a background in central banking, I can only claim a very great interest in the financial and economic transformations taking place across Central and Eastern Europe and the conditions under which central banks have to operate and establish a place for monetary policy.

Some overlap with other parts of the Symposium is unavoidable. For example, we need to assume that in this morning's first session, on the role of central banks, it was accepted that central banks will be provided with the tools necessary to conduct monetary policy in a way that (of course) gives central attention to monetary stability. Monetary stability can also be described as price stability or, in the possibly less demanding terms chosen for this session, as inflation control.

It is also worth highlighting at the outset the particular relevance of the fact that we are discussing monetary policy against the backdrop of "emerging market-oriented economies" -- that is, economies emerging from the system of "material balancing", under which quantities of inputs are made available administratively on the basis of estimated needs for fulfilling the production targets stemming from a central plan, and moving towards one where the price mechanism and competition in private markets play a major role in resource allocation.

In a market economy, monetary policy is transmitted above all through changing yields in financial markets. Until the transmission linkages -- from the instruments of monetary policy to financial markets, and from financial markets to the rest of the economy -- have developed, monetary policy as it is generally perceived is unlikely to be very effective. Conversely, while the general range of market reforms or creations under way are hardly being undertaken in order to improve the playing field for monetary policy, the better financial markets function, and the better they become linked to the market decisions of consumers and investors, the more effective monetary policy will be in getting macroeconomic results.

Another reason for emphasizing the shift towards market economies is that while inflation is bad news under any economic system, it is particularly bad for a decentralized, that is market, system. For this system, with its reliance on the price mechanism and monetary exchange, monetary stability is essential if market signals are going to be interpreted efficiently. In other words, to function well, a market economy depends on confidence in the money that is being used.

Broad approaches to establishing monetary confidence

This section reviews the main ways in which monetary policy might be anchored so as to secure the credible performance necessary for monetary confidence.

Bearing in mind perhaps the debates in Western Europe over the exchange rate system, consideration needs be given in this session to the merits of a fixed exchange rate as the anchor for monetary stability. Such an approach would also entail an early decision to make the currency convertible in the foreign exchange market (at least for current if not right away for capital account transactions). Currency convertibility will also get a discussion all to itself later at this Symposium.

For monetary policy, the crucial value of relying on a fixed exchange rate anchor is that it promises to deliver early credibility. It does this through explicitly locking onto a currency that already enjoys a good reputation for preserving its purchasing power. Credibility would be enhanced if it is likely that strong trading links will develop with the economy using the currency in question. In this context, the European Monetary System could be an obvious pole of attraction -- either in the collective currency bundle, the ECU, or, conceivably, through its strongest constituent currency.

Still, arguments for not betting monetary policy on the exchange rate have considerable weight.

Reliance on the exchange rate (in effect on someone else's monetary policy) for monetary discipline, and therefore for confidence, means commitment to a fixed exchange rate that must be seen as unwavering if it is to be credible enough to shape price and cost decisions. Simply pegging the exchange rate

may not by itself provide the necessary demonstration of commitment. Indeed, can anything less than some sort of monetary union be seen as "unwavering"? And practically speaking, monetary unions or EMS-type arrangements for monetary policy convergence look a fair way off at this point.

Fixing the exchange rate means that the discipline on domestic costs that is imposed by an unyielding exchange rate dominates other considerations regarding the role of the exchange rate -- particularly the role of shifts in the nominal exchange rate in facilitating shifts in the real exchange rate (the exchange rate adjusted for relative rates of inflation) as a way of getting the economy to adjust efficiently to real economic changes.

As an illustration of the above point, it may be presumed that the terms of trade will shift as CMEA trade declines and new trading patterns emerge. More generally, relative prices will move, probably a great deal, under the impact of market transformation. It follows that the real exchange rate will likely have to move as part of the general process of relative price adjustment. Without some flexibility in the nominal exchange rate, it may well not be possible to get anything approximating the necessary exchange rate shifts in real terms except at great economic cost in terms of foregone output and increased unemployment.

What about domestic indicators, guides and anchors?

In this area it does not seem likely that any clear-cut option would be available. One common approach from the domestic angle is to use monetary or credit aggregates as a way of plotting a path for monetary policy. However, in view of the economic and institutional transformations taking place, it seems

unlikely that stable relationships to either spending or interest rates will be forthcoming any time soon.

Accordingly, the authorities might be well-advised to adopt an eclectic approach to the use of domestic guides. An initial focus on an IMF-styled measure of maximum domestic credit expansion, grounded in the central bank's balance sheet, may well be called for. Whatever other monetary management decisions are implemented, in the prevailing economic and institutional flux the central bank will want to keep a close eye on the pace at which its own assets are expanding (more on this below).

The authorities will in any event want to monitor movements in any relatively broad indicators of prices that are available, as a gauge by which to adjust the thrust of monetary expansion. At the same time, in this period of structural change relative prices will be changing a great deal in all markets, and it may be difficult indeed in the shorter run to separate out the impact on the price level of changes in relative prices, from the impact originating in a process of general domestic cost and/or price inflation. How well relative cost or price changes can be distinguished from general movements in costs or prices will of course depend in part upon the quality of the cost and price measures. Developing satisfactory measures will therefore be a priority.

Even if monetary policy is not fully geared to the exchange rate, the balance of payments outturn in general, and exchange rate pressures in particular, can obviously also play a role in gauging the degree of demand and inflation pressure, and therefore in indicating a need to adjust the thrust of monetary policy. However, as in the case of price movements, in this area also it will be important to make distinctions -- between on the one hand the effects of demand on the balance of payments and the

exchange rate, and on the other the effects of influences of a structural nature.

The pace of increase of the general level of money incomes (conventionally called the money wage rate) is clearly of great relevance in terms of the possibilities for inflation control. However, it may be relevant not so much because of its sensitivity to demand pressures, but more especially because of its cost and price push features in a particular institutional context. These features could call for other forms of restraint as a complement to monetary restraint -- not as a way of life in a market-based economy but in the initial stages of economic stabilization. In this way the money wage rate could act as a temporary nominal anchor alongside any available guides that are more directly linked to the monetary process. In this context, the Polish experience to date will be of interest. There, wages (on the basis of a tax-based incomes policy) apparently serve as the nominal anchor, reinforced to some degree by a fixed exchange rate.

Building the foundations

Evidently, a great deal of institution building (beyond the questions relating to central bank structure and powers that were presumably covered earlier this morning) will have to occur before the economies in question can use monetary policy in the market-based way that is available elsewhere.

No doubt a major priority at the start is to establish a market-oriented system of deposit gathering and commercial credit extensions -- the traditional field of commercial banking. But also, more generally, the authorities will wish to encourage greater competition in the financial markets, to channel savings to their most productive uses. Within the OECD this objective

has been met both by systems in which banks play a dominant role (the continental European model), and by systems in which marketable securities are also very important (the North American-U.K. model). Markets for short-term funds are, in either case, of particular interest to central banks, given the fact that their policy actions are transmitted through such markets into the rest of the financial sector and into the non-financial sector.

Sometimes appropriate market structures have developed only after central banks and governments have taken the lead. For example, the Bank of Canada realized quite early in its existence that a well functioning money market -- dealing in treasury bills, commercial paper, overnight funds, and the like -- would assist the implementation of monetary policy as well as the overall efficiency of the economy. But although the banking system as such had been well developed for many decades, an active money market emerged only after a series of Bank of Canada initiatives in 1953-54. (These are documented in the Appendix.)

From the viewpoint of monetary control, and therefore inflation control, the development of the Canadian money market had two particularly desirable features.

In the first place, the Canadian money market's development provided an avenue for increased reliance on price-related methods of monetary management -- broadly speaking, open market operations. And in this process, reliance on jawboning and on bank liquidity ratios to influence commercial banks' extension of credit became less and less -- to the point that these features now have no role in Canada.

Secondly, the broadening of outlets for the placement of government debt -- to include the money market as well as the

bond market -- helped to provide a first line of assurance that government deficit financing would not impinge upon monetary control. In general, in the absence of broad and resilient financial markets through which to absorb financing demands, the central bank would find it very difficult to deflect direct pressure from government deficits on its balance sheet and therefore on inflation of the monetary base.

To deflect the pressure by, for example, imposing higher bank reserve requirements in cash, or in government securities, is not an adequate solution. At the very least it causes problems for the efficiency and competitiveness of the deposit-taking part of the financial system. A better solution would be for the government to pay an interest rate sufficiently high that it attracts willing lenders, and without pumping up the money supply. In general, if credit of various kinds really has to be subsidized or channelled preferentially, the subsidy should be out in the open and not financed through what is in effect a tax (and therefore fiscal, not monetary, policy) on the intermediation of savings through the banking system.

A related issue with implications for controlling inflation is the importance of developing at an early stage a workable system of prudential oversight for financial institutions, including determining which institutions will have access to the lender-of-last-resort facility for liquidity purposes. This, too, is a separate topic of discussion in a later session. Its importance for inflation control is to remove a potential constraint on the conduct of monetary policy. The presence of distressed institutions may inhibit monetary discipline, for fear of precipitating a crisis in the financial system or of disrupting the flow of investment finance to the non-financial sector.

The immediate challenges

Building institutions and building confidence takes time, and meanwhile monetary policy has to do what it can with what is available, keeping its eye fixed firmly on inflation control.

It cannot be emphasized too strongly that central to any prospect of overall monetary control is the absence of pressure on the central bank to inflate its balance sheet (simply put, to print money) because of budget deficit financing needs. Depending of course on each country's circumstances, some fiscal reining in, even fiscal reform, is therefore probably implied. This does not necessarily mean that deficit financing would not be available at all from the central bank. But such financing would have to be budgeted for in the framework of an overall monetary financing plan that reflected the needs of monetary control and not whatever size the deficit happened to be.

There may be a large monetary "overhang" -- a form of forced savings -- as a legacy from the previous system of passive credit creation and price control. The consequence may be an extreme burst of spending and inflation when prices are decontrolled. This carries the threat of derailing the process of building monetary confidence before it even gets started.

Here, the challenge clearly is to eliminate this burden as quickly as possible. One way of absorbing the overhang is the privatization of existing government assets. This is a delicate problem, given the natural concerns about selling at (possibly) fire sale prices, especially to foreigners. Nevertheless, asset sales will be a useful safety valve. The housing stock in particular is a prime candidate for privatization, and one that in the hands of individuals would greatly increase their stake in

the market economy. At the same time the disposition of state assets, for which the true market value of many is far from clear, will raise important prudential questions. If such sales are made on credit to domestic residents or firms it is critical that this not lead to an extension of the safety net of lender of last resort to insolvent financial or non-financial firms. It is also possible that an upward price level shift (for example through an increase in the relative price of food to stimulate production) could absorb some or all of any overhang of real balances. Currency reform, to eliminate excess balances, clearly has a place on the list of potential measures, but if it does not give every appearance of being definitive and final it will surely have serious after-effects on confidence in the monetary system. Therefore, currency reform looks more like a constituent measure of a broader stabilization package, most likely in the context of associated deficit-reducing fiscal measures to remove a systemic cause of inflation, rather than a self-contained step.

Another crucial challenge will be to ensure that "real" interest rates on both loans and deposits are positive. This will help to ensure a proper incentive for voluntary savings, and that there is room to differentiate credits on the basis of risk. It will also help to diminish any monetary overhang to the extent that real yields on these "overhang" balances were formerly negative.

* * * * *

In a period when rapid structural, and therefore relative price, changes are occurring, and barring a fixed exchange rate solution that can be seen as definitive, the monetary authorities will have even greater difficulties than

usual in determining what rate of monetary expansion is consistent with inflation control. Control over the central bank's assets (the ultimate lever of monetary policy) would likely need to be closely managed -- so as to limit the pace of central bank credit expansion to one consistent with the authorities' best estimates of the flow of resources accruing to the central bank through the growth of the liability side of its balance sheet (e.g. from bank notes issued, increases in commercial banks' reserves) in a non-inflationary environment. There will be distinct merit in conservative estimates because confidence, once lost, is not easily regained. Such a "domestic credit expansion" approach has the virtue of safety first, being both a potentially useful brake on excessive monetary expansion and protective of the overall balance of payments.¹

¹ See for example "Credit Versus Money as an Instrument of Control": Manuel Guitian, IMF Staff Papers, November 1973.

APPENDIX

ESTABLISHING THE CANADIAN MONEY MARKET

Before 1953 there was no organized short-term money market in Canada. Business had few options other than the chartered banks for short-term financing or money placement, at sticky interest rates set by the banks. "Call loans" of the banks to money market dealers were then quite illiquid and priced on the basis of the prime loan rate. Treasury bills and commercial paper were typically held to maturity. The banking system relied heavily on New York for short-term liquidity adjustments.

The lack of flexibility and competition in the domestic market for short-term funds was clearly detrimental to the efficient provision of financial services and the allocation of savings. Moreover, from its establishment in the mid-1930s, the Bank of Canada had been aware that its operations were hampered by the lack of a money market. In the absence of active markets for bills and overnight funds, the banks would allow their excess cash reserves to fluctuate over a fairly wide range. This meant that the central bank did not have reliable leverage over short-term monetary conditions, even though it could set the supply of cash to the banking system with some precision (through open-market operations).² The banks tended to react sluggishly to reserve tightening or easing. The Bank thought that the establishment of an active money market would induce the banks to manage their cash more finely and so provide a more effective channel for the transmission of monetary policy. However, any plans that the Bank may have wished to pursue in this respect had to be put off because of World War II and its economic aftermath.

² "Cash" in this context refers to the deposit claims of banks on the Bank of Canada. These claims serve as reserves, for which there have been legal minimum requirements in Canada as elsewhere, and as settlement balances in the payments system.

By the early 1950s conditions in Canada were in principle favourable for the formation of a money market: official controls imposed during the war had been dismantled, and the central bank no longer attempted to hold down market interest rates; savings and investment had expanded strongly; the banks, trust companies and insurance companies formed a core of large and sophisticated intermediaries; and since bond and equity markets were thriving, there were plenty of securities firms with the resources to be money market dealers. Yet the overt encouragement of such a development by the Bank of Canada met with little success until various concrete initiatives were taken:

- 1953
- The Bank of Canada offered a line for short-term financing -- purchase and resale agreements (PRA) -- to a group of 13 investment dealers, known as "jobbers". Under this facility, inventories of treasury bills and short-term Government of Canada bonds could be temporarily financed at the central bank. Each jobber was given a specific limit on its access to PRA; the total value of the available lines was initially about as large as the eligible inventory held by the jobber group.
 - Auctions of treasury bills were changed from a fortnightly to a weekly cycle, and amounts auctioned were increased.
 - Since the charge for PRA was substantially less than the prime rate, the jobbers quickly switched to central bank financing for most of their needs, going to the limit of their PRA lines. The Bank urged the chartered banks to provide day loans to the dealers at

rates in line with money market yields, but the banks initially showed no interest in such an innovation.

1954

- The Bank Act Revision introduced reserve averaging. Since statutory cash requirements would now apply to average reserve positions over a calendar month, the banks could make sizable economies on excess cash. This led to a more stable demand for bank reserves, and to prompt system responses to changes in policy settings.

- It was decided that credits to chartered bank reserve accounts for Bank of Canada security purchases would be subject to a settlement delay of at least two days. In contrast, settlement at the Bank for the proceeds of day loans that chartered banks had called from investment dealers would be booked next day. This difference in the speed of settlement greatly enhanced the relative position of day loans for liquidity adjustments by the banking system.

- The chartered banks now agreed to provide day loans, at rates near those on treasury bills, up to the limit of unused PRA lines. This allowed the central bank to confine itself once again to last resort lending.

- The banks also agreed to reduce charges for intra-day ("daylight") overdrafts of the investment dealers.³

³ The fee of a bank for a daylight overdraft is called "over-certification." Such overdrafts are necessary to dealers in securities because of technical lags in delivery and settlement.

- The Bank provided wire facilities across the country for the transfer of government securities.

These measures achieved their objectives. By 1958 an active money market provided the channel for the transmission of monetary policy that the Bank had sought. In 1962 the central bank allowed bankers' acceptances to be eligible for PRA to assist their introduction in Canada, phasing out this support, later when the BA became well established. By this point the money market was going ahead under its own steam; and the rapid expansion of recent decades has been propelled by profit opportunities, competition and new technology rather than by policy measures. Indeed, the contribution of the authorities in the latter period has been more to liberate market forces than to undertake new measures of support.

This experience would suggest that the central bank can make a useful contribution to structural change in the financial sector. In the right environment, such as Canada's money market in the 1950s, a few key policy actions can propel rapid modernization. In turn, a well-functioning money market has proved of great value in improving the competitive efficiency of the financial market and in the implementation and transmission of monetary policy.