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Monetary policy: A Canadian perspective

Notes for remarks by
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to the
Chamber of Commerce France-Canada
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I am enormously pleased to have this opportunity to address you -- especially since it is a première for the Bank of Canada that is long overdue.

How best to use the occasion? It seems an excellent one for commenting on the international economic scene more broadly than I would normally, before concluding with some particularly Canadian content.

A Canadian needs little excuse for taking an international perspective. We trade directly across two oceans, look immediately south to the largest economy in the world (Canada indeed is easily the United States' largest national trading partner, accounting for almost one-fifth of all U.S. merchandise trade), and Canada also reaches beyond to the Americas as a whole. In fulfilling its central responsibility, the design and conduct of monetary policy, the Bank of Canada is constantly made aware of the force of international economic and financial influences.

And indeed the present situation is very "international".

We are all affected by the Mid-East crisis and the fallout it is having in so many markets, besides of course its impact in the market for oil. Headlines are also being made by the miracles, transformations and strains in Central and Eastern Europe. The rapid progress of the European Community captures the attention and enthusiasm of more than just Europeans. And it is every country's business and responsibility to assure in the short time left, to the end of this year, that there will be a positive outcome to the Uruguay Round of world trade liberalization. Given the absolutely fundamental importance of open trade for world economic prosperity, this issue merits more headlines than it seems to receive.

All this being said, it is not my intention to focus so much on particular developments as on the contribution that monetary policy can make to ensuring that the particular outcomes are constructive.

Let me begin with a general observation about how monetary policy is viewed that is also somewhat of a criticism. Because the nature of monetary policy is not always well understood, it is often seen as a kind of residual policy that is capable of coping with many different problems -- a handyman. Perhaps monetary policymakers should be flattered by this, but I believe they would be wise to resist the temptation. Better that they stick to the task to which monetary policy is best suited -- that of seeking to provide a policy framework that provides monetary confidence. Let me give some examples of what I mean.

In Canada, admittedly in the face of differences in regional economic circumstances that sometimes can be rather wide, there has persisted a current of opinion that it would be desirable for Canadian monetary policy to be set regionally.

However, the question as to whether this is indeed desirable is hardly relevant since it is not in fact possible. A country with a common currency and well developed financial markets cannot have in any way levels of interest rates, or rates of monetary expansion, that would be systematically different in different regions or provinces. Neither of course will such differences be possible in a Europe that is truly unified in a monetary sense.

The same encouragement to have monetary policy reach in various directions shows up on the international scene. There, for example, one can witness a constant debate between those who view monetary policy as essentially concerned with monetary control and monetary stability, and those who reckon that it should be directed first and foremost at securing particular exchange rates or particular changes in exchange rates. This debate gives rise to lots of interesting, subtle and, I must add, important, issues. But it is vital to retain one central point. That point is that focussing monetary policy on exchange rates and hoping that inflation will take care of itself is not, at the most general level, the place to start -- not even for exchange rate stability.

Indeed, for stability in exchange markets for different currencies, experience indicates that the monetary authorities cannot provide a better basis than to ensure that various national monetary policies are directed at limiting monetary expansion to a non-inflationary pace. This promotes domestic price stability for each currency and thereby provides a consistent monetary basis for exchange rate stability. This would be the kind of stability underlying the phrase "stability-oriented monetary policies" in the communiqué of the G-7 group of major industrial countries, of which Canada and France are both members, that was issued in Washington at the end of September. The same basic idea was expressed by the Managing Director of the

International Monetary Fund, Michel Camdessus, in his recent address to the Annual Meetings of the International Monetary Fund and the World Bank. He noted the importance for the international monetary system of a "low inflation club" among major industrial countries. We would all be well-advised to be members of that club at least, and the key to entry is an anti-inflationary monetary policy.

What I have just said is testimony to the strength and credentials of the conviction that monetary policy really had better be anchored on preserving the value of money if it is going to make a lasting contribution to both national and international economic progress.

There are excellent reasons of principle why monetary policies should pursue price stability. We do after all have economies that depend crucially on money and monetary exchange, and monetary policy, as well as other economic policies, should strive to provide confidence in the future. But what has probably been more compelling than arguments from basic principles in generating support for stability-oriented monetary policies has been practical experience. We have learned, often painfully, that other ways of applying monetary policy manifestly contribute to economic and social disappointment.

The Latin American experience with inflation demonstrates, perhaps in an extreme way, that inflationary policies are a dead end. Indeed they are worse than a dead end, they are economically destructive. That experience also demonstrates that the inflation slope is a very slippery one. That is to say, once an economy is caught up in an inflation spiral it finds it very difficult indeed to extricate itself. Even when it does extricate itself de facto, the monetary authorities have to convince those still holding its money that they will show sufficient determination not to subject the economy to inflationary policies again, and this will take even longer. And all this time, the lingering risk in people's minds of a repeat bout of inflation will push interest rates higher than they need to be. This is further reason why it is better not to get caught in the inflation trap in the first place. I should perhaps add that I am of course aware that fiscal policy can often have a great responsibility in this matter.

Coming closer to home, the experience of the industrial nations in the 1970s also made it very clear that monetary policies that were not addressed promptly to fighting inflation only made matters worse for their economies. The first oil shock, which hit in late 1973, came on top of a demand situation in industrial countries that was already inflationary. And even then, monetary policies were slow to react and give a clear anti-inflationary message. However, some countries, notably Germany and Japan, learned the lesson faster than others and demonstrated that firm anti-inflationary policies, spearheaded by monetary policy, paid major dividends in terms of economic performance in subsequent years.

This lesson provided by the 1970s goes part way in explaining why the economic expansion that the world has enjoyed since the early 1980s has been so well sustained. Throughout this period, monetary policies of the main industrial countries have above all given weight to the need to resist inflation and thus provide this vital underpinning of confidence to planning and decisions.

And bringing the narrative up to the present, the bad experience of the 1970s also explains why the economic response to the recent oil price outbreak has generally been so different from what happened after 1973.

Unlike then, it is now broadly accepted that by far the wiser course, because it is ultimately more effective, is to let increases in world oil prices flow through directly to the domestic price of oil and the costs of the final products. This means that countries will generally avoid attempts to control, or otherwise suppress, for example through subsidies, the ultimate pass-through of oil price increases, as was often the case in the 1970s. Such suppression is confusing and counterproductive. It is costly to the taxpayer, and impedes conservation and the efficient use of energy generally.

But at the same time, the monetary authorities need to demonstrate with clarity and determination that they are also going to resist any upward push to general inflation because of the disturbances coming through oil prices. It is not possible to avoid blips in domestic prices. But these could easily turn into an inflationary spiral if, in response to the oil-induced increase in consumer prices, there were increases in income demands, which in turn fed back into consumer prices, and so on. In this way, the hot potato of higher oil prices would be passed around the domestic cost-price system indefinitely, with the inflationary impact becoming more widespread with each pass. Monetary policy should not allow that to happen. Such an inflationary spiral would only nourish monetary instability, with bad results for economic performance.

As a final observation on the international side, let me note that the extent to which interest rates might come under upward pressure in the current environment depends on a whole series of factors. Besides the initial upward effects stemming from the inflation and uncertainty generated by the disturbances to oil prices, important pressures are being placed on available savings by the strong domestic spending in Japan and by the economic reform and restructuring that is taking place in Europe from Germany eastward. Those forces have already exerted upward pressure on long-term interest rates in Japan and Germany and, of course, this has spilled over into world capital markets. In contrast, there is in North America and the United Kingdom evidence of slowing in domestic spending. This can be an important offset, as of course can actions to hold down or to reduce fiscal deficits in all the industrialized countries.

Monetary policy cannot increase national savings or change the supply of oil. What can be done through monetary policy to limit upward pressure on interest rates or bring them down in a durable way is to provide confidence in the future value of money by limiting the rate at which the supply of money expands.

Let me continue with some words on the Canadian scene, as viewed from the Bank of Canada's perspective.

In recent years, the Canadian economy has undergone a remarkably strong expansion in demand. Total spending in Canada in the three years 1987-89 rose appreciably faster than in the United States, for example, and in fact more rapidly than for the G-7 group of countries as a whole. Strong commodity prices, vigorous growth in investment (in fact, real fixed investment spending took up a record share of total demand in Canada in this period) and buoyant consumption based on rapid job creation, all contributed to this surge. But with the inevitable squeeze on productive capacity, inflation began to pick up.

The Bank of Canada consistently provided strong resistance to these pressures and was relatively prompt in doing so. In this environment of strong demand, short-term interest rates rose from around 7 per cent at the beginning of 1987 to over 13 per cent in the spring of 1990, with a temporary easing for a few months after the 1987 stock market crash. Furthermore, the spread of Canadian short-term interest rates over those in the United States tended to widen from the spring of 1989 as U.S. rates eased.

While Canadian monetary policy has no exchange rate objective as such, this widening of spreads at the short end of the market did provide as a by-product a measure of support for the Canadian dollar against the U.S. dollar. But it is also worth noting that the bulk of the recent appreciation of the Canadian dollar took place between 1987 and the spring of 1989. That is, it occurred before the widening of interest rate differentials vis-à-vis the United States. This earlier appreciation cannot therefore be directly attributed to monetary policy, but must rather have stemmed from such non-monetary factors as the extraordinary boom in our commodity exports.

In 1990 the advance of money and credit, and of dollar spending, in Canada has, finally, slowed to a less inflationary pace. Furthermore, capacity pressures in the Canadian economy have slackened. The extent to which they slacken will obviously depend in part on how responsive domestic inflationary forces are to the changed economic conditions. At this stage the evidence is that the response, while not rapid or clear cut, may at least be beginning.

It is of course very important for this response from the side of domestic costs to occur, particularly in view of the adverse inflation pressure from oil prices, and particularly, I must add, if interest rates are to ease in a lasting way. Canada, as an energy-rich country, is in one way better off because of the oil demand-supply situation. But this windfall is only relative to the situation of other major industrial countries. The world as a whole is undergoing an adverse supply shock, and while Canadians may be better off than others it does not at all follow that Canadians are better off in absolute terms. In any event, energy prices for Canadian consumers are, as elsewhere, moving up. Those increases will have to be absorbed without unleashing an inflationary spiral. This presents an obvious challenge for Canadian monetary policy, as it does for policies elsewhere.

In moving to a conclusion, I must recognize that this review of the economic scene has, unavoidably, brought into relief uncertainties and complications. And it hardly needs emphasizing that they face us on whichever side of the Atlantic (or the Pacific for that matter) we happen to be.

Public policy has to rise to the challenge. Because of these uncertainties it is all the more vital that monetary policy should stick to the kind of path that provides assurance of monetary stability. As I indicated earlier, the other ways of conducting monetary policy -- essentially, being tolerant of inflation -- end up creating more problems than they can hope to solve. There are indeed many economic problems that monetary policy cannot solve, but it must avoid compounding those problems and creating new ones. Monetary policy, as well as other public policies, must provide confidence in a sound economic future.