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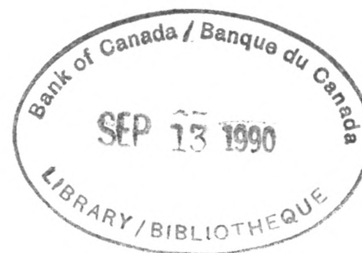
Current Monetary Policy



Notes for remarks by
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Governor of the Bank of Canada

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to the
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Ottawa, Ontario
13 September 1990

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It is a pleasure to be with you this morning. In the insurance field you have to take an appropriately long view, making sure that in interpreting and managing shorter-term developments you keep the fundamentals clearly in sight. So should monetary policy if it is to do its job properly.

Your Chairman's suggestion was that I talk about current monetary policy, and I am delighted to give an update on how we at the Bank of Canada see the present situation.

However, to understand current monetary policy it is crucial to distinguish between the principles behind monetary policy and the economic environment in which that policy operates. Too often the actions that the Bank takes in financial markets are viewed as a change in the basic thrust of monetary policy, when in fact they only reflect a change in the economic and financial environment within the framework of an underlying monetary policy which is unchanged. In these remarks I shall focus on both the principle underlying monetary policy and recent changes in the economic environment.

The principle that underpins monetary policy -- providing Canadians with a money that can be trusted, one that

can be counted on to retain its value -- remains a permanent fixture, and in that sense is not "current." This principle is the foundation of monetary policy because it is the essential contribution that monetary policy can make to sustained economic progress. What monetary policy contributes will not be everything that can be done through public policy for sustained economic progress. But what monetary policy can bring to the table is monetary, that is price, stability.

In recent years, developments in the Canadian economy have in fact pushed us further away from price stability. It has been crucial that we reverse this trend. The Bank has never suggested that we should aim to reach price stability virtually immediately, without any regard for short-run consequences. What we are seeking are gradual but progressive reductions in inflation that will ensure there is no doubt about the commitment of monetary policy to contribute price stability to Canada's economic well-being.

One striking example of how the economic and financial environment in which monetary policy is conducted can change is what has been happening to the world price of oil recently, together with its impact in all kinds of markets, including bond and foreign exchange markets. A more fundamental change in the environment is the shift in the forces of supply and demand at work in the Canadian economy. Whereas for quite some time the Canadian economy overall was operating in strained market conditions with a pronounced inflationary bias, there are now signs that those inflationary forces, at least from the side of demand, have begun to give some ground.

These kinds of developments do not call into question the strategic objective of price stability on which monetary policy must rest, but they do change the economic and financial

climate in which this goal is pursued. And such shifts in the climate affect the kinds of actions the Bank takes in financial markets that have an influence on short-term interest rates.

The need to distinguish between the principles behind monetary policy and the environment in which that policy operates is highlighted by much of the recent public commentary on monetary policy. This commentary sees the policy as a "high interest rate" policy, but it is a profoundly incorrect view. As the Bank has noted on many occasions, the surest way to build high interest rates into the economy would be through policies that nourished inflation.

Why, then, is the Bank of Canada so often seen as having a high interest rate policy? The problem seems to be one of perspective.

Let me expand on this by underlining two reasons particularly relevant to monetary policy why interest rates in Canada have risen in recent years. First, in an economic climate of inflationary demand, such as Canada has evidently been experiencing, a monetary policy that does not print additional money at an inflationary pace will for a while put upward pressure on short-term interest rates. This is part of the mechanism by which anti-inflationary resistance from the Bank of Canada is transmitted to the economy, and this, presumably, is what the commentary focusses on. However, there is another, more deep-seated reason for upward pressure on interest rates. To the extent that a higher rate of inflation takes hold, confidence in the value of money is undermined and people demand a higher return -- an inflation premium in the rate of interest -- for saving money and lending it. The experiences of other countries with inflation -- the more inflationary the policies over time,

the higher the interest rates that prevail -- readily confirm this point.

What the Bank of Canada's monetary policy is designed to provide is a climate where the inflation premium can narrow as inflation pressures and expectations are subdued. We would like to see this happening progressively, and not just for short-term rates but across the whole range of interest rates. At the same time, as the pressures on inflation in our economy recede this eases the demands for money and credit and provides room for policy actions to ease conditions in financial markets.

With that review of the fundamentals of monetary policy and the effect of changing economic and financial developments on monetary policy actions, I want to turn to the current situation and then to some of the challenges that lie ahead for the Canadian economy.

Short-term market interest rates in Canada have come down by slightly more than one percentage point from their peaks this spring. But I trust that what I have just said about interest rates does help to explain why it is inadequate to describe the underlying path of monetary policy simply through interest rates. The lesson of experience is that there is no single sure guide for monetary policy actions, and the Bank of Canada relies on a wide range of indicators of economic and financial developments in making its decisions. However, the thrust of monetary policy over an extended period of time is probably best seen in terms of its influence over the pace of monetary expansion in the economy. To lend concreteness to this key idea, we calculate, publish, and analyze various measures of money and credit on a very regular basis.

Although the Bank has undertaken considerable research on the monetary and credit aggregates, we have not found the behaviour of any one of them sufficiently reliable to shoulder the burden of acting as a formal target for monetary policy. Nonetheless, encouraging a moderate expansion of money and credit in the economy, as opposed to a pace of expansion that is very rapid, does provide some reasonable assurance that monetary policy is on the right track. By "the right track" I mean one conducive to a pace of advance in total dollar spending in the Canadian economy that is consistent with a return to price stability. This is a basic principle that those responsible for monetary policy cannot afford to ignore, and its validity has once again been borne out in Canada's recent experience.

Thus, in the three years 1987 through 1989, the monetary aggregates were expanding exceptionally rapidly. Over that period, the more narrowly based aggregate, M1 -- which has for quite a few years been shrinking as a share of money-like claims -- rose on average by 6 per cent a year. The more broadly defined aggregates, M2 and M2+, which include the currency and demand deposits in M1 as well as personal savings and non-personal notice deposits and which have had a relatively stable relationship with total spending in the economy, went up on average at a double-digit pace. Credit also expanded very rapidly. Credit to businesses went up steadily by 10 per cent a year, while lending to households went up still faster, by 16 per cent a year.

Numbers like these taken together, and when sustained over such an extended time period, offer persuasive evidence from a monetary perspective of the buildup of inflation pressure. They were, of course, not the only evidence on this threat to the economy that the Bank of Canada had available. But they provided important signals that the Bank bore very much in mind in its

monetary policy actions. We wanted to see a less inflationary pace of monetary expansion, and that is why we progressively tightened the rein on the supply of central bank liquidity to the financial system.

Since the beginning of 1990 the growth of the monetary aggregates has slowed, thereby permitting some easing of the rein on central bank liquidity and of conditions in money markets. Has monetary growth slowed too much? In some recent months the aggregates were declining. Credit is also growing much slower than before. However, it is important not to leap to strong conclusions -- in particular that monetary policy is way off track -- on the basis of monetary aggregate data over a relatively short time period.

In this regard, two points are worth bearing in mind. The first is that the recent slowdown in the aggregates needs to be viewed in the context of the earlier strong and very prolonged surge. For example, in August of this year, M2 was more than 20 per cent higher than two years earlier and about 10 per cent higher than a year ago. The second is that the recent slowing in M1 and M2 is greater than can be explained by the performance of the economy -- in particular the growth of total national income and the level of interest rates -- even with the rebound in these aggregates in August. There is a good deal of short-term volatility in the aggregates, and it is important to look at averages over longer periods of time.

However, if weakness in the monetary aggregates were to persist, for reasons that seemed to be reasonably well grounded in the behaviour of the economy, the need for a better sustained expansion in the aggregates would clearly be a major consideration propelling Bank of Canada actions towards further easing in money markets.

Considerable attention has recently been focussed on the Canadian dollar, so let me now turn to the question of where the exchange rate fits into our policy thinking.

The exchange rate is an important price in the Canadian economy, with effects on demand, inflation, and incentives to export, as well as on the value of investments in Canada. Therefore, it is very understandable for headlines to be generated by movements in the exchange value of the Canadian dollar. And while the exchange rate is affected by many different forces, it is certainly also affected, even if imprecisely, by Bank of Canada actions in money markets. Indeed, insofar as movements in the exchange rate can be attributed to short-term interest rates, they are one channel through which monetary policy will have effects on the economy.

But this does not mean that the exchange rate should be a target of monetary policy -- a particular number to be sought as a basic goal of monetary actions. The issues surrounding exchange rate targeting are in fact both complicated and far-reaching. The Bank has discussed various aspects of these questions on a number of recent occasions, and the only point I will make here is that the basic reason for not having the exchange rate as a target of monetary policy is that only under some very particular assumptions is such a target consistent with domestic monetary stability. However, we pay a good deal of attention to the Canadian dollar in terms of its effect on overall demand conditions in Canada, alongside interest rates and other influences on demand, and the Bank reacts accordingly. Let me emphasize as well that we are also keen to see to it that the exchange market itself does not become a source of domestic financial and economic instability.

As regards recent exchange rate developments, let me make two observations that illustrate the complexity of exchange-rate considerations. First, the recent movement of the Canadian dollar has evidently resulted in part from world oil price developments. This aspect of exchange rate change, relating to an independent economic shock, is not really a monetary policy phenomenon. Second, interpretation of exchange-rate change also has to bear in mind that while the Canadian dollar has fluctuated against the U.S. dollar, the U.S. dollar has also fluctuated against overseas currencies. Thus, looking at the Canadian-U.S. dollar relationship in isolation is only seeing part of the picture.

Let me now turn more directly to economic developments.

For some time the Canadian economy was operating at levels of activity well above the actual capacity of the economy to produce on any sustained basis. As a result there were mounting pressures on inflation, and the trend of inflation was upward. Because the pressures persisted for so long, a momentum developed in the inflation process that has been slow to reverse. Concerns about continuing inflation have accumulated, and businesses and individuals have been seeking to protect their incomes from future erosion by inflation.

Monetary policy has sought to resist and reverse these inflation pressures, and in recent months evidence has been accumulating that the situation is changing considerably. Demand in the economy has eased from the unsustainably high levels of last year. As the demand pressures on inflation have become less intense, there has been scope for easier monetary conditions. This is evident in the reduction in short-term interest rates that has taken place. Longer-term interest rates have also declined in recent months as confidence has grown.

Progress is being made. After a long delay, the economy is adjusting to a balance of demand and supply that can provide a solid basis for sustained non-inflationary growth. If businesses and individuals now begin to base their economic decisions on the prospect of easing inflation, the path ahead should go more smoothly.

Still, there will be some potentially difficult passages to navigate. For example, the recent surge in oil prices can complicate progress of the Canadian economy towards a non-inflationary environment. While the overall balance of inflationary and disinflationary forces to which monetary policy needs to pay attention depends on far more than what happens to the price of any one commodity -- even such an important commodity as oil -- a rise in the price of oil that persists has important consequences that cannot be avoided for real incomes in Canada and among our main trading partners. As well, the proposed Goods and Services Tax is due to come into effect at the beginning of 1991.

While the initial direct effects of the GST on the price level (estimated to be about 1 1/4 per cent) plus any oil price effects will lead to a jump in the consumer price index in the period ahead, it will be important for us to look through those effects and ensure that we continue to make progress in bringing down the underlying rate of inflation. In particular, monetary policy must guard against the risk that the expected jump in consumer prices will trigger an inflationary round of compensating increases in incomes and prices.

Keeping to such a course will be a challenge, as the experience of recent years with the buildup of inflation pressures all too clearly indicates. It will require an adjustment to less inflationary rates of increase in domestic

spending and less rapid expansion in money and credit than we have managed in the last few years.

As I noted earlier, our monetary aggregates are not sufficiently reliable for us to use them as formal intermediate targets; however, they are valuable indicators in a period such as this. Continued progress on inflation will imply, for example, rates of expansion of the broad monetary aggregates, M2 and M2+, that are down from the 10 to 15 per cent growth rates of recent years. Indeed, making allowance for the tendency of such broader aggregates to grow rapidly in relation to the economy, we would expect annual rates of increase that are consistently below 10 per cent, and ultimately going down to well below 10 per cent. Confidence in an improved inflation performance should permit us to achieve this outcome with interest rates that are lower than at present.

By way of conclusion I would like to make four observations to summarize these remarks.

* Monetary policy must, because of its very nature, be dedicated to fighting inflation and promoting price stability. This process takes time, but it is the vital contribution, or anchor, that monetary policy can provide to confidence and economic growth for an economy based on money and monetary exchange.

* The intensity of inflation pressures will, however, vary over time, largely because of fluctuations in demand relative to the capacity available in the economy. Around the basic trend provided by a monetary policy framework consistently aimed at promoting price stability, changing demand conditions will be reflected in movements of short-term

interest rates. When inflation pressures are intensifying, as they were earlier in Canada, short-term interest rates will rise. When the pressures on inflation begin to ease, this provides room for lower rates.

* But in order to maintain low interest rates, monetary policy must encourage Canadians to base their actions on declining rather than on rising inflation. Such a policy is the only way to build confidence that the dollars Canadians save will retain their value. People who have confidence that the value of their savings will not be dissipated by inflation will save without requiring high rates of interest.

* Finally, it needs to be stressed that these lasting benefits from monetary confidence flow through to the economy as a whole.