BANK OF CANADA

Some monetary policy basics

Notes for remarks by
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at the
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SOME MONETARY POLICY BASICS

I want to take advantage of this morning's occasion to get back to some monetary policy basics.

I will begin by highlighting key themes of the Bank's annual report, that was published last month. Then I will look at the targets for reducing inflation and how they fit within monetary policy.

The Bank of Canada's annual reports traditionally go well beyond a recounting of monetary events. They have also been occasions for explaining monetary policy -- for adding some perspective. This is particularly important because an adequate appreciation of the Bank's work, and its results, certainly needs a perspective beyond a single year.

I realize that in many circumstances a year, even a day, may seem a long time. Since the Bank of Canada operates in financial markets, we appreciate very well how fast moving developments can be. There, decisive events can occur in minutes, or seconds even. Nonetheless, in relation to what monetary policy can accomplish on a lasting basis a year is in fact a rather short time.

It is for this kind of reason that the Bank seeks every occasion to explain what monetary policy is, and therefore what it should be about.

We did it again in the annual report for 1990 that was just released.

For example, I noted that the fact that we live in a monetary economy is so readily taken for granted that the central importance of this can easily be overlooked. Therefore, we underlined again that money has an absolutely essential function in our economy. It is the medium that links buyers and sellers, savers and investors, lenders and borrowers in all markets in all parts of the country. If our economy is to work well, the money we use needs to be one that retains our confidence. Only a money that holds its value will retain confidence. It follows that the underlying basis of monetary policy should be to preserve the value of money and to avoid actions damaging it.

This understanding of what monetary policy can deliver is not a matter of opinion. The only policy lever the Bank of

Canada has to influence financial and economic developments is its ability to control the supply of ultimate liquidity, the final means of payment. This is why monetary policy is by its very nature about the supply of money and the management of monetary expansion. This is also why protecting the value of the nation's money is at the heart of what the central bank can do. And this is what it must do if money is to play fully its essential role in economic society.

Now, those of us who undertake monetary policy are well aware that this understanding stands in sharp contrast to a popular view of what monetary policy is really about. In this popular view, the defining purpose of monetary policy is to manipulate the level of interest rates or the level of the exchange rate, or even both.

However, those of us who undertake monetary policy do not share these illusions. We know very well that the lasting impact that we can have on these rates comes not through our day-to-day operations in the money market or the exchange market -- significant as these operations are in the short run -- but from whether we can provide fundamental monetary confidence.

Let me elaborate.

Confidence is the essential element that the Bank of Canada can provide to lenders and borrowers when they make judgments on interest rates and on the exchange rate. Confidence determines more than anything else what they think money lent or borrowed now is likely to be worth in the future. And confidence determines what value they can see in the Canadian dollar as opposed to some other currency.

Evidently, it is these broad market judgments that are central to determining the levels of interest rates and the exchange rate. But equally evidently, the Bank of Canada cannot tell lenders and borrowers what judgments to make and when to make them, any more than it can answer for any of the other, non-monetary considerations that may go into making such judgments. That is why the popular view as to the Bank's rate-setting powers, focussing as it does on the Bank's techniques for influencing short-run quotes in financial markets rather than on consistency and confidence, is off-track. The foundation that the Bank can and should put under those market judgments is the assurance that Canadian monetary policy will not be inflationary.

There has been a lot of comment on the exchange rate, so let me indicate more fully how it fits in.

The exchange rate is very important, since its movement and its level are elements that matter a lot to the economy.

Therefore, the exchange rate matters a lot for monetary policy. But it is important to appreciate in what way it matters.

So let me underline that the confidence the Bank of Canada seeks to foster is that the Canadian dollar will retain its value in Canada. That is what is meant by price stability. Obviously, this is not the same as having the exchange rate at any particular level. It should also be evident that while monetary policy must of course guard against financial disturbances affecting the Canadian dollar, the most basic contribution that monetary policy can make to protecting our currency's external value (as, by the way, the Bank is specifically called upon to do under the Bank of Canada Act) is to have a care for its internal value.

As a final point in reviewing our annual report, let me add that I observed that if spending had not surged to such an unsustainable level during the late 1980s, and if inflation and expectations of continuing inflation had not become so entrenched in Canada, this would have helped to avoid the slowing in the past year.

Now, it is certainly open to debate how much of that surge in spending could or should have been foreseen. It can also be debated how policies, federal or provincial for that matter, could ideally have been deployed to moderate the surge, thus avoiding the inflationary fall-out and making the expansion more sustainable. However, what I believe is hardly open to debate is that, given the way events did develop, it was monetary policy's duty to provide firm resistance to those spending pressures.

Let me go further. Failure to have provided this resistance would have made the situation we face today much more difficult. To have accommodated an unsustainable expansion with easier money would have worsened the inflation. It would have added to the economic distortions associated with inflation. And it would have intensified the economic slowdown that inevitably follows an inflationary boom.

Indeed, a more appropriate question is whether monetary policy during that period of surging national demand should have been still more restrained in supplying liquidity, not less. It is arguable that if monetary policy had been still more restrictive then, with higher short-term interest rates probably, interest rates would be lower now -- and lower across the whole spectrum of rates.

Let me now turn to the targets for reducing inflation and reaching price stability that were announced on February 26.

The targets that the Bank of Canada announced, at the same time as the federal budget, were for year-over-year increases in the Consumer Price Index of 3 per cent by the end of 1992, 2 1/2 per cent by the middle of 1994 and 2 per cent by the end of 1995. Thereafter the objective is to achieve further reductions in inflation until price stability is achieved.

A good deal of work has already been done in Canada on what stability in the broad level of prices might mean as an operational matter. This work suggests a rate of increase in consumer prices that is clearly below 2 per cent. However, a more precise definition than "clearly below 2 per cent" is not being specified now, in the event that further relevant evidence and analysis becomes available in the next few years. A target path after 1995 also remains to be fixed, but again pending new evidence, our aim would be to continue to make steady progress.

It is worth reiterating that monetary policy works with a considerable lag in exerting its full effect on spending, and then on inflation. It therefore has to be very forward-looking. So a post-1995 path will need to be established sooner rather than later. I can also add that it is because of the lags in the impact of monetary policy on inflation that no explicit target (only an interim guidepost of less than 4 per cent, excluding the impact of the GST) was set for the end of 1991.

Because policy cannot be calibrated so precisely as to achieve an exact pace of deceleration in inflation, we included bands, of plus or minus one per cent, around the target path for reducing inflation. There will undoubtedly be temporary divergences from the indicated path. But the Bank would not have announced these targets if it did not have the means and the intent to achieve the downward trend in inflation they describe. We will respond to unexpected developments that cause unacceptable changes in the rate of inflation and clearly re-establish inflation reduction on the indicated path.

A lot of detail on the targets was contained in the background document that the Bank released in February. I will focus here on the implications for monetary policy.

Clearly, the targets will only be useful if they are able to improve progress in the direction of price stability -- which is the same as monetary stability.

The Bank believes that targets do this for two related reasons.

Firstly, they can encourage Canadians to base their expectations and economic decisions on a clearly indicated downward path for inflation. This in turn means that lower inflation is more readily achieved.

Secondly, the targets also provide information on the specific objectives to which the Bank's monetary policy actions will be directed. In other words, the Bank of Canada will be carefully monitoring the trend rates of money, credit and total spending as regards their consistency with the targets, and will be adjusting its monetary policy actions accordingly. The Bank will also be reporting on progress in reaching the targets, in its annual report and elsewhere.

The way the Bank of Canada will conduct policy with targets is basically no different from the way it conducted policy in the past. The targets have the helpful feature of making the milestones in reducing inflation and achieving price stability more explicit. But the essential objective -- that of seeking to ensure that the confidence of Canadians in the value of money is not subject to chronic erosion by inflation -- is the same.

Let me add here a point that was stressed and elaborated on in our annual report. Confidence among Canadians that the money that they earn and the money that they save will keep its value is the essential contribution that monetary policy can make to sustained low interest rates and a well-functioning economy.

But of course that confidence has to be earned. And a disciplined monetary policy -- that is, a consistently antiinflationary monetary policy -- has an essential role in earning it.

This is exactly what the Bank of Canada has been aiming to provide. The lower interest rates that have developed over the past year, both short-term and long-term I might emphasize, may be viewed in that light.

In the early part of the year, unusual circumstances pushed up the rate of inflation, to about 7 per cent here in British Columbia for example. However, there now appears to be considerable momentum in the Canadian economy for lower inflation. Markets today are much less likely to support actions that push up costs or prices.

Making a reality of this momentum through declining inflation will provide the ideal and necessary context for further progress towards lower interest rates across the maturity spectrum. There could not be a more solid and more lasting basis than this.

I began these remarks with references to the Bank's latest annual report, and I will conclude in the same way. As I noted then, sound money is an investment in the economic well-being of the nation. The efforts to bring down inflation in the early 1980s after the disastrous experience of the previous decade were a cornerstone of the sustained expansion that our economy enjoyed in the years that followed. For the 1990s we need to extend, and improve upon, that success of inflation reduction leading to economic expansion. This is the monetary policy objective to which the Bank of Canada is committed.