Method and myth in monetary policy

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

to the
Saint John Board of Trade
Saint John, New Brunswick
24 June 1991

Not for publication before 24 June 1991 at
1:00 p.m. Atlantic daylight saving time
12:00 p.m. eastern daylight saving time

Notes for remarks by
John W. Crow
Governor of the Bank of Canada
to the Saint John Board of Trade
Saint John, New Brunswick
24 June 1991

METHOD AND MYTH IN MONETARY POLICY

In conducting policy, it is always useful to understand with what kind of policy instrument you are working and therefore what you might be able to do. In this light, I would like to begin my remarks today with some comments on the nature of monetary policy and what it can therefore hope to accomplish, and on some of the challenges to the Bank of Canada's view of these matters. Then I'll share with you some thoughts on the current situation.

The basic messages about monetary policy that the Bank seeks to convey are the following.

First, Canadians like others live in an economy in which money is essential. Money links markets, and for our market economy to work as well as it can we need to use a money that we can trust. Obviously we will only trust our money if it can hold its value, its purchasing power.

Second, the systematic way to assure that our money is one we can trust is to work at limiting monetary expansion to a pace in line with sustainable economic growth. The Bank of Canada exerts its influence by its control over the supply of base money (which represents the ultimate means of payment in the economy) to the financial system. Therefore, the Bank's role is absolutely central in providing this trust.

So, monetary policy has the clear responsibility to work towards and maintain monetary stability -- that is, price stability.

At the risk of understatement, I will say that there are voices in Canada that challenge strongly this view of how monetary policy can best serve the economy. However, let me also observe that these challenges do not profess to represent a blatantly contradictory position -- for example, that monetary policy should <u>promote</u> inflation rather than fight it. Whereas the Bank of Canada emphasizes that its responsibility for monetary stability has rather clear implications for what monetary policy should actually do, our critics attempt to minimize or sidestep those implications.

Let me give you a flavour of some of the arguments.

Living with inflation isn't so bad. Much Canadian commentary along these lines apparently depends on a view that inflation is necessary to reconcile competing claims on the economic system. Somehow, it is implied, chronic inflation turns inconsistent claims into more consistent ones. Somehow, inflation helps the economic players to believe that they got what they wanted, even if in reality they didn't.

For example, a large increase in money income, even if offset by a large increase in prices, might on this score be seen as a better situation than a small increase in money income in conditions of price stability. In this view, loss of confidence in the value of money and the adverse consequences of this for the way our economy works would be of little importance.

This opinion about human credulity tends also to get generalized to the belief that because there are at work in our society powerful associations and interest groups, various kinds of monopolies, and regulated prices -- commentators often add in tax increases as well nowadays -- our economic system will not work decently unless there is chronic inflation. So, in order to make the system go, monetary policy should underwrite inflation -- presumably at the rate required to have the economy work properly.

These arguments suffer from serious difficulties.

It is worth noting for example that in this line of argument, the rate of inflation that achieves a reconciliation of all the different claims on the economic pie is never spelled out. But it also seems to be assumed that inflation, left untended while monetary policy devotes itself to something else, will most likely stay "reasonably" down. And even if inflation doesn't stay down, interest rates can be kept down by printing more money. These assumptions, popular though they are, are a triumph of hope over experience, as I shall explain shortly.

Furthermore, it strains imagination to hold that inflation will in point of fact do anything to make problems of disputes over economic power, monopolies, taxes, etc., easier to live with. Does built-in inflation generate greater social harmony? Does resort to inflationary finance create jobs? History certainly doesn't point in that direction. Quite the contrary. The additional stresses and uncertainties brought about by inflation will worsen such problems. For example, why would anyone surrender economic power because of inflation, or try to exercise it less? Indeed, inflationary policies increase the opportunities for widening such power, as the effectiveness of our market economy deteriorates.

I conclude then that these kinds of arguments do not in any way justify using monetary policy to tolerate or encourage an inflationary process rather than to resist it. Using monetary policy in an inflationary way would only be justified if it made the overall situation better.

The mirage of a steady, gentle, inflation that acts as a kind of general lubricant to the economic system should have been exploded by the experience of the 1970s and early 1980s. That experience greatly sharpened our understanding of the way fears of inflation develop. And it cannot be emphasized too much that the extreme difficulties of the 1970s and early 1980s were set up by the inflationary policies and the resulting accumulation of inflationary expectations that were the hallmark of the late 1960s.

We now better understand that if inflation <u>does</u> seemingly at any point reconcile competing claims on the system, it does so by fooling society. This, as Abraham Lincoln noted, can hardly be expected to last forever. Then, exit the beneficent effects of inflation -- a popular view in the 1960s -- and enter the inflation-ridden 1970s and early 1980s.

I should not think that anyone recalls that period with particular fondness.

Admittedly, the economic benefits of monetary stability do not accrue quickly. Indeed, the story that the monetary authorities can believably tell is not one of quick fixes. Rather, it has to be one of broad gauged, general benefits to economic performance in a monetary economy. These benefits cumulate, they are lasting, but they do accrue gradually. So monetary stability does have to be seen as an investment in the future.

It is awkward of course that a monetary policy aimed at preserving the value of money cannot promise quick payoffs, even if this is the fact of the matter. But let me also warn against the suggestion that an inflationary monetary policy does offer quick payoffs, indeed any payoff in terms of good economic performance. Whatever its highly debatable short-run effects, which depend on the extent to which citizens can be fooled as to what is really taking place, such an inflationary policy would certainly cast a dark shadow over the future. And it wouldn't sustain low interest rates.

It is no doubt helpful if Canadians bear in mind the past results of inflationary episodes, for example the experience of the late 1960s leading into the 1970s that I just noted. This can bring into relief what happens when confidence in money begins to fade.

Memories fade as well. Still, it would be a great shame if memory decay resulted in chronic reversions to inflationary policies, and therefore inflation (punctuated by intervals of recessionary squeeze in an attempt to retard the cumulative erosion of confidence), a build-up of inflation pessimism, and a consequential march upward in interest rates. This looks suspiciously like stagflation. And this is something against which monetary policy must stand guard by insisting on providing a money that people trust.

Let me add here that it should not of course be inferred that because monetary policy matters, other policies do not. Other policies, even if they are not quick fixes either, matter a lot in improving growth conditions, the functioning of markets, and in getting a better balance in demand.

In other words, monetary policy does not work in isolation. However, Canadians should expect monetary policy to do properly what it can do. And that, as I indicated at the beginning of these remarks, is to provide Canadians with confidence in the value of money. Furthermore, as I also indicated, it would not improve the situation if the Bank of Canada gave up trying to fulfil its proper role.

Let me turn now to the current situation.

The recession in economic activity that dates back a year now is showing signs of approaching an end. External factors, always very important for Canada, are on balance more favourable. The U.S. market, which absorbs over three quarters of our exports, has steadied.

On the Canadian domestic side, signs of improving market conditions are beginning to appear.

Interest rates have eased substantially. Not only have they eased at the short end of the maturity spectrum -- by some 5 percentage points since the spring of 1990 -- but there has been a substantial drop at the longer end as well. It is at the longer end that views of the future are particularly crucial, and this improvement in expectations, that is, confidence regarding low interest rates in the future, is well worth underlining. Canadians would not want to lose that confidence.

This brings me to inflation. Inflation is still high in Canada. For example, consumer prices have increased recently by over 6 per cent year-over-year. Important here are the one-shot effects of the introduction of the GST and the additional taxes on tobacco and on other items. But these effects do not, in themselves, constitute underlying developments in Canadian costs of production. It is these underlying developments that have determined and will continue to determine the basic course of inflation in Canada. And it is on these developments that monetary policy needs to keep its main focus as regards inflation and the prospects for inflation reduction.

The targets for reducing inflation announced earlier this year are intended to make clear the rate of progress towards price stability that monetary policy is aiming to achieve. This initiative does not signal a shift in monetary policy. But if Canadians begin to base their economic decisions on this path, the adjustment to lower inflation and to price stability will be attained more easily.

In that regard, there is no doubt that Canadian markets are not at all supportive of inflationary actions nowadays. But it does take time for such reality to have an impact on market behaviour, and on the costs and prices that flow from this behaviour. We would expect the impact to become greater in the months ahead.

I can also note that decisions in that part of the economy that is less directly exposed to market forces, mainly the public sector, are also becoming less inflationary.

Finally, a comment on Bank of Canada actions.

The Bank of Canada does generally have some room for manoeuvre in regard to short-term interest rates. However, how much downward room it has at any given time depends crucially on the degree of confidence savers and investors have in its policies, including whether those policies will be sustained. The Bank of Canada's monetary policy has been an investment in monetary and economic confidence -- also necessary for sustained low interest rates.

For some time now, the Bank has been exercising this room for manoeuvre so as to accommodate an easing in short-term interest rates -- a process broadly ratified by market developments. Our view has been that there is in train a corresponding easing of cost and price pressures that is consistent with the inflation-reduction targets set out in February. At the same time, there are still important uncertainties in the outlook. Therefore, we do need to move carefully -- making sure that the ground is firm under each step, and in particular that developments remain fully and clearly consistent with the goal of bringing down inflation and preserving monetary confidence.

In concluding, let me reemphasize that monetary policy is an investment for a healthy economy. Perhaps monetary policy is a bit like the designated driver -- not the life and soul of the party, but quite likely the most solid element to come out of it. If the Bank of Canada joined the festivities, no one would get to where they wanted.