BANK OF CANADA

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

to the
Chamber of Commerce of Metropolitan Montreal
Montréal, Quebec
1 October 1991

Not for publication before 1 October 1991 at 8:00 a.m. eastern daylight saving time

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Today I want to share with you some thoughts on two topics. Both of them have already gathered a lot of coverage, and both of them are timely.

For most of my remarks, I will be dealing with issues and progress in bringing down inflation, particularly in light of the targets for reducing inflation that were announced last February. Towards the end, I want to stand back a bit from current developments, but not from issues at hand. In recent months the question of the institutional framework within which the Bank of Canada ought to operate has drawn much comment, both in Quebec and elsewhere. And last week the federal government presented its plans for constitutional change, which include proposals for monetary policy and the Bank of Canada. I do not intend to comment at this stage in any detail, but I do want to make some points on the broad issues.

Underpinning the targets for reducing inflation is the objective of bringing about a slowing in the rate of inflation of Canadian costs and prices over the next few years, thereby moving towards monetary, that is price, stability. To provide as concrete an indication as possible as to the path, thus helping to guide expectations and actions, the specific numbers that were announced were year-over-year increases in the consumer price index (CPI) of:

- 3 per cent by the end of 1992;
- 2 1/2 per cent by the middle of 1994;
- 2 per cent by the end of 1995.

Thereafter, the objective is further reductions in inflation until price stability is secured. Quite a bit of work has been done at the Bank of Canada and elsewhere on what price stability might mean in terms of the indexes that are used to measure changes in the general level of prices. For the CPI, and taking into account its particular measurement complications, this work indicates that price stability implies increases of clearly less than 2 per cent a year. Therefore, further targets for the period beyond 1995 will need to reflect this.

Before reviewing progress thus far, let me make two points by way of background.

My first point has to do with the way monetary policy exerts its impact on inflation.

The targets are, for obvious reasons, spelled out in terms that are as specific as they could realistically be. No useful purpose is served by ambiguity, because the targets are intended to help guide economic decisions. At the same time, it is important to bear in mind that monetary policy does not directly manage the consumer price index -- far from it. Monetary policy works principally through the demand side of the economy, and through its cumulative influence on demand it affects the myriad decisions on costs and prices in our economy. You can appreciate that this is quite a chain of influences.

Furthermore, there are other influences unrelated to overall demand conditions in the economy that in the shorter run can push up or down the individual prices of the various kinds of goods and services that consumers buy. Such influences will not have the fundamental impact on inflation over time that is exercised from the side of demand. However, in a particular period they can shift the price level by a sizeable amount. And, given that monetary policy works with lags stretching out over quite a few months, it cannot offset immediately the effects of large, unexpected price changes.

The Bank has aimed to cope with these considerations in two specific ways.

First, it has taken specific account of three components of consumer prices where abrupt change is particularly apparent: food prices; energy prices; and indirect taxes. Consumers are aware that the prices of food and energy can be very volatile. This volatility can in the short run mask the underlying tendency of consumer prices generally. Therefore, as a practical matter, the Bank will focus more on the behaviour of the consumer price index excluding food and energy in its reading of what is happening to domestic inflation and what this implies for the thrust of monetary policy. In addition, the Bank will take into consideration the sharp short-run effect that indirect tax changes can have on consumer prices.

Let me also emphasize that there can be a great deal of interaction between the three items that we have singled out and other, slower moving, cost and price elements in the economy. Therefore, making these short-run, operational distinctions does not imply any lessening of the focus on inflation overall in terms of achieving the inflation-reduction targets.

The second specific way in which we aim to cope with volatility is by underlining that the particular inflation reduction target numbers may be considered as the midpoints of a range -- a notional band of one per cent on either side.

Let me also draw to your attention that these technical questions, in particular further detail on the way any indirect tax changes affecting the CPI will be dealt with, are analyzed in an article just published in our September monthly Review.

My second point by way of background is more basic than questions of measurement and control. Inflation-reduction targets are not goals in themselves so much as means to an end. They do serve as guides for economic agents in general; they do help to guide the Bank of Canada in the conduct of monetary policy; and they do provide a yardstick for measuring progress. However, I regard their primary contribution as helping to reinforce the basic principle that monetary policy should provide and maintain a trustworthy monetary standard. This emphasis on the importance of a monetary policy anchored in price stability is not to suggest that monetary policy can be a cure-all or that other policies are not important. What the emphasis is meant to convey is that, since money has an absolutely essential function in our economy, the contribution that monetary policy can make to good economic performance, year in and year out, stems from its capacity to sustain confidence in the nation's money.

The process of securing monetary confidence encompasses more than the inflation-reduction targets themselves. But it certainly is encouraging to be able to report a good start.

In terms of year-to-year increases in consumer prices overall, the rate has been coming down and it is now under 6 per cent. And given the large increases in indirect taxes that occurred in the first half of this year -- with an estimated direct effect of slightly less than 2 1/2 percentage points on the year-over-year increase of the CPI -- the prospects are that consumer prices will rise distinctly less rapidly next year as these effects on the CPI drop out of the calculation.

However, further progress is required if the initial 3 per cent target for the end of 1992 is to be attained. And in this regard the costs of Canadian production are particularly important, because in the end these costs are the key element in the prices paid for Canadian goods and services.

In this area, developments to date also appear to be heading in the right direction. At this stage in the economic cycle, costs could well be eased by a rebound in productivity in quite a few sectors as output resumes expansion. On the other side of the ledger, money wage increases have begun to slow, even though this has reflected thus far developments in the public sector, and there only partially, more than developments in the private sector. Still, these processes take time and market conditions are conducive to further slowing in inflation. In the longer run, a stable cost structure means that average money incomes should be basically rising at the pace warranted by the expansion of national productivity. As I just indicated, the growth of productivity does vary over an economic cycle, but in any event in recent years productivity seems to have trended up at about one and a half per cent a year.

In summary, my progress report is that experience over the first six months of the inflation-reduction targets has been generally encouraging. I have underlined that there is further progress to be made, both to reach the first, end-1992, target and the targets stretching beyond, but this should not of course be any surprise. The targets have been designed for a path of steady progress.

To the extent the targets help to shape decisions leading to price stability, they make an important contribution. Even more crucial is the commitment of monetary policy. And monetary policy's commitment is to manage monetary expansion so as to secure a trustworthy money. This is what the Bank of Canada has been doing and obviously has to continue to do in the months and years ahead. In this context, let me point out that money and credit aggregates are no longer rising at the double digit pace of two years ago. In particular, the monetary aggregate M2 has been rising this year at an annual rate of 6-7 per cent, compared with an average rate in the previous three years of over 11 per cent.

On this note, let me turn to the institutional side for a few concluding comments.

As I noted earlier, in recent months Canada's central bank has been the object of quite a lot of commentary in connection with the debates taking place on constitutional change, and last week the federal government's proposals were released. My purpose today is not to make any detailed commentary on these matters. Rather, at this stage I want to underline a few basic principles regarding the position and purpose of a central bank responsible for monetary policy.

Let me begin by noting that what was striking about much of the earlier discussion was the focus on how the Bank of Canada should be governed -- particularly, what kinds and balance of interests should be included. The accountability of the central bank is an important question that must be weighed very carefully. At the same time, judging by the thrust of some of the prescriptions, it is certainly worth underlining a very basic truth, namely, that monetary policy by its very character is <u>indivisible</u>. That is to say, because monetary policy is what it is, operating in a single currency in an efficient financial market, it cannot be split up. Certainly, demand and supply conditions may very well differ across regions and industries. But monetary policy cannot be metered out on either a regional or an industrial basis -- either for money creation or for interest rates. As the federal government's proposals make clear, there can only be a single monetary policy for Canada, based on the economic picture overall -- that is to say, based on the sum of the regional situations.

Besides the question that has attracted the lion's share of earlier commentary -- how monetary policy decisions should be arrived at -- there is the important, and I believe logically prior, issue of what monetary policy decisions should be aimed at. That is to say, if we are to begin at the beginning the focus should be on the question of the actual scope and objective of monetary policy. The federal government's proposals focus on the objective of achieving and preserving price stability -- and rightly so. Indeed, the Bank of Canada has consistently made very clear that since monetary policy is by its very nature about the supply of money and the management of monetary expansion, the best contribution that monetary policy can make to good economic performance over time is to see to it that Canadian money will maintain its purchasing value. The clearer this is, the better.

In my remarks today I have covered a lot of territory -- but all having to do with the responsibilities and role of the Bank of Canada. As regards the targets for reducing inflation, the results to date indicate a promising start, even if only a start. I have emphasized that these targets are a means to an end -- the achievement of price stability. I have also emphasized that this is what monetary policy can be expected to deliver, and therefore should be expected to deliver. Indeed, any discussion of matters relating to the way a central bank should carry out its monetary policy responsibilities is much better informed if it focusses very fully on what monetary policy should try to do before aiming to settle the question of how the central banking institution can be best set up to do it. To do otherwise would be to put the cart before the horse.