What to do about the Bank of Canada

Luncheon remarks by

John W. Crow
Governor of the Bank of Canada

to the

Canadian Economics Association Annual Meeting
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When I last spoke to you, four years ago, much of what I said was on the question of the underlying objectives of monetary policy. Then, I noted that price stability was an appropriate target for monetary policy and that getting there would require careful thought, time, and steadiness of purpose.

Let me today return to the question of an appropriate monetary policy framework from a different angle -- the institutional angle.

In the past year there has been quite a lot of debate concerning the mandate and governance of your central bank, the Bank of Canada.

This debate was brought into sharp focus last fall by the proposals that the Government of Canada made in the context of constitutional renewal. Specifically, the Government suggested revisions to the Bank of Canada Act to spell out that the achievement and maintenance of price stability was indeed the basic objective of monetary policy. At the same time, the Government made suggestions regarding more formal regional representation on the Bank's board, regional channels of consultation, how the Bank might interact on a regular basis with Parliament, and how the Bank might participate in the federal-provincial economic consultation-coordination process. It also proposed that the Governor's appointment, presently made by the Bank's board of directors with the approval of the Government, have the additional step of being ratified by the Senate -- something close to a triple veto.

In response to these proposals, the House of Commons Finance Committee established a sub-committee to hold hearings and prepare a report. The sub-committee focussed particularly on the Bank's mandate and its structure of governance.

It is worth mentioning, especially in this forum, that the sub-committee noted that it would have taken up those matters anyway. Its interest had been stimulated by Professor Laidler's critique of the governance of the Bank which was published in the spring of 1991 by the C.D. Howe Institute as its first monograph on the economics of constitutional renewal.

Today, I plan to review these matters -- summarizing the points the Bank of Canada has emphasized and commenting on the range of views provided by the witnesses before the sub-committee -- mainly economists. Since the potential subject matter is broad and quite complex, and my time today is limited, it may also be helpful to note that the Bank's extensive memorandum to the sub-committee was published in our Review of last November.

The monetary policy mandate

Before addressing the question of desirable objectives for monetary policy, let me suggest that it is a good presumption that clear objectives are better than cloudy ones. Certainly, those of us who are responsible for Bank of Canada actions have underlined that from the important viewpoint of public accountability, the clearer the acknowledged purposes of this institution, the better.

Of course, obscure language can sometimes serve a useful purpose. It can allow differing interests to agree to differ. However, such obscurity does nothing for accountability, and the matter of accountability is a vital issue for a public agency with public policy responsibilities.

Having made this general point, let me turn to the particular. To what basic, clear, set of objectives could and should monetary policy be directed?

The Bank has of course supported the proposals to make explicit in the Bank of Canada Act that the appropriate underlying objective of monetary policy is the achievement and maintenance of price stability. This is not so clear from the Act as it is presently worded.

The main criticism of those proposals has been that they are too narrow -- in particular, that they somehow let the Bank of Canada off the hook as regards the performance of the economy.

Let me address this criticism.

In the first place, the Bank has emphasized consistently that price stability, in other words monetary stability, is a means to an end. The end is good economic performance, generally seen as high employment and rising living standards. Confidence in money contributes to good performance in a monetary economy and lack of confidence detracts from it.

Furthermore, the way to sustain confidence in money is to ensure that it maintains its value. We have the tools to do that.

The Bank has also underlined that monetary policy matters for the economy, but is not a cure-all for whatever problems the economy faces either in the short or the longer run. In other words monetary policy, by providing a trustworthy money, can contribute in a fundamental way to good economic performance, but it cannot guarantee it whatever else happens.

At the same time, and indeed as I pointed out the last time I spoke to you, the Bank has always considered price stability as a goal that is medium-term to long-term in nature, and that it does of course matter how you get there. This is evident, for example, in the specification of the inflation-reduction targets jointly announced by the Government and the Bank in February of last year. We have issued a number of studies on this range of matters. In those studies, full recognition has been given to the fact that expectations adjust gradually and that shocks of various kinds that could push the economy away from price stability have to be coped with as efficiently as we can. It is also worth noting that the government proposals of last fall addressed this issue. It was suggested that the Bank of Canada Act provide a specific continuing mechanism for explicit and public agreement by the Bank and the Government on a path leading to price stability.

To synthesize, we agree that the Bank has to be very mindful of all elements of the economic environment as it makes decisions implementing monetary policy. At the same time, we believe that the Bank should have a clear underlying goal in terms of monetary policy, and that this goal naturally should be something that monetary policy can hope to deliver over time. Price stability should be that goal, and it would be gross irresponsibility on the part of the Bank to seek to duck this basic issue.

In the parliamentary hearings there were those who supported changing the monetary policy mandate of the Bank so that it emphasized price stability, those who said, effectively, "yes, but not just now," and those who opposed the proposed change.

Those arguing for delay contended in part that consideration of the Bank's mandate should not be tied to the constitutional discussions. However, it is worth noting that while the government proposals were put forward explicitly in a framework of constitution rebuilding, they in fact focussed mainly on things that could be managed simply by amendments to the Bank of Canada Act. And in some respects they could conceivably be managed without any legislation at all.

My own view has been that the government proposals provided a valuable basis for discussion and debate, whether or not they were linked to constitutional change. It was not the Bank's ambition to link them to constitutional change. Indeed, the proposals were not crafted by the Bank, although we did of course have the chance to comment on them before they were published.

Witnesses opposing the changes to the Bank's mandate had views that came from a variety of directions. Some focussed on difficulties in the transition to price stability and, implicitly at least, saw the cumulative benefits of price stability in a monetary economy as something of relatively little value. Others continued to hold to the belief that there is a permanent trade-off between output and inflation in the way that conventional wisdom saw it in the 1950s and 1960s. We at the Bank believe that both theory and evidence are, to say the least, unkind to this view.

However, some came to the view that there may exist a long-run trade-off from a different, newer, direction. They speculated that the Canadian labour market might be characterized by strong persistence or momentum effects that go under the head of "hysteresis."

Since this has been an "in" topic, let me note that the Bank has done a lot of work on the issue of labour market hysteresis. This has involved extensive testing of plausible formulations of empirical equations "explaining" Canadian inflation. Technically speaking, what we have tested in particular has been whether the <u>level</u> of the pressure of aggregate demand contributes to the explanation of changes in inflation in place of, or in addition to, the <u>change</u> in such pressure. Our conclusion is that extensive testing does <u>not</u> favour the hypothesis of hysteresis, because levels do in fact play an important role.

What follows from this is that we do not see hysteresis in the Canadian labour market as a convincing argument for us not to fight inflation in Canada.

<u>Governance</u>

The other main issue that the sub-committee dealt with was the matter of governance -- in other words, how the Bank's monetary policy decision-making should be structured.

The issue that became most prominent in the hearings concerned the merits of the current system, where the policy responsibility in the Bank is very much focussed on the Governor, with the Senior Deputy Governor also having a special role, compared with a system where responsibility is more dispersed.

An alternative model never became completely defined. It could presumably be something like the Federal Reserve Board or the Bundesbank Council, or possibly something like the structure for the Swiss National Bank. See our memorandum.

It seemed that part of what support there was for a different model of governance was inspired by the view that the present system generated the wrong results. That is to say, monetary policy could well be improved by changing the system. This view is at least implicit in the argument that with some kind of monetary policy board, the Bank would become more open to new intellectual currents.

Let me just say in this regard that I believe that the Bank has to be very open to ideas. We should debate our policy views internally and present them clearly, debate them externally and listen carefully to what other people say. Furthermore I believe we do just that. Indeed, when this argument that the Bank is closed to new ideas was put forward at the sub-committee hearings, one could not fail to be struck by the extent to which the line was: "Well, I don't say this is true, but many people believe it." This way of putting the point has the advantage of not requiring any evidence. If this suggestion that we are a closed shop is to be taken at all seriously, it needs some evidence.

Perhaps the most difficult version of the issue for the Bank to handle is the one where the proponent agrees with the policy, but still thinks that the policy would get more ready support if it were seen to be formulated explicitly by a board. Then it becomes essentially a matter of public perception, and the invocation of what has been called "political legitimacy." This is akin to the notion that not only should justice <u>be</u> done, but that it should be <u>seen</u> to be done.

The "legitimacy" question is difficult for us at the Bank to handle because we are not political scientists. Indeed, if this is the heart of the issue, it is surprising that the sub-committee did not call on more political scientists and specialists in public administration to appear and thrash it out, rather than calling on so many economists.

Even if the mechanism of a full-time board is held to satisfy some notion of "political legitimacy", it has other implications that are not always appreciated.

One is the question of corporate oversight. Now, the Bank's board, composed mainly of part-time directors, has very much the role of overseeing the Bank's management across the whole range of the Bank's activities, in the way that corporate boards are generally supposed to do. In addition, as I already mentioned, the outside directors are responsible for the appointment of the Governor and Senior Deputy Governor, subject to approval by Governor-in-Council.

Why might this oversight role be important? It is important if the Bank is to have corporate responsibilities to answer for in a transparent manner. The outside board arrangement provides a mechanism for the necessary oversight of management. A full-time board would be a board of insiders, and in that case another legitimate oversight mechanism would presumably need to be found.

The implication of a full-time monetary policy board that the sub-committee did focus upon, although typically not addressed in specific proposals, is what it might mean for the relationship between the Government and the Bank of Canada.

There is no time today to go into all the subtleties and details of the existing public policy relationship. But it is worth underlining the two crucial aspects of that relationship as set out in the Bank of Canada Act. The Act, firstly, requires regular consultation on monetary policy between the Minister of Finance and the Governor. Secondly, it specifies that in the event of a fundamental disagreement, the Government can issue a directive on monetary policy to the Governor that the Bank has to follow. It has always been recognized that the most likely result of such a directive is that the Governor would resign.

The directive power is best analyzed as part of the accountability framework. In the event of profound disagreement, it provides a clear and simple mechanism for the Government to insist on the policy it keenly wants.

In any consideration of a full-time board, one has to ask whether the system of regular consultation and directive power would be maintained. If it were maintained, would the Minister of Finance consult regularly with the board as a whole, rather than with the Governor? Would any directive be issued to the board as a whole? Would only those supporting the policy at issue resign or would the entire board feel obliged to resign? Would the existence of such a board make it more or less difficult for the Government to exercise the directive power?

Let me just note at this point that I do not plan even to begin to discuss the matter of provincial involvement and how it might affect the consultation-directive process. Neither did the sub-committee.

Finally, before some concluding remarks, let me say a few words about the matter of central bank independence.

It is interesting that quite a few witnesses assigned particular importance to Bank of Canada independence. However, in this context independence, taken in isolation, does not seem to be such a useful notion. It really only becomes meaningful when one describes what in fact the scope for independent action that might be assigned to the Bank is to be used to accomplish. Indeed, at the Bank of Canada we tend to think in terms of the need for a clear sense of purpose and the associated accountability regime, rather than in terms of independence per se.

What then we found somewhat surprising in the testimony was the extent to which witnesses were both supportive of Bank of Canada independence, and at the same time content with a rather loose mandate.

I believe that the justification for an independent central bank, with the accountability that this entails, must stem from the view that there is a proven need for an institution that concerns itself with ensuring that the value of money is maintained. And if this is indeed why independence matters, one would think that it makes sense to say so in the mandate.

Concluding remarks

Current indications are that the Bank of Canada will not figure significantly at this time as part of the process of constitutional change. However, the examination of our affairs that it has prompted has certainly been absorbing for the Bank of Canada and, I believe, worthwhile generally.

The sub-committee report, released in February, examined a wide range of matters and had quite a few thoughtful things to say. In the end, it recommended no change in either the mandate or the basic governance structure. Perhaps this was a case where, after examination, it was decided that something that wasn't broken did not need to be fixed. This stands in some contrast to the view of Professor Laidler, that the Bank of Canada was not broken but that there still were reasons why it needed fixing anyway.

Many things about the Bank of Canada and about the nature of monetary policy should be generally clearer than they were before this exercise. The sub-committee report is testimony to the fact that the fundamental importance of having the national monetary institution answer for monetary, i.e. price, stability, is a good deal better appreciated than before. All this is certainly a step forward.