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WHAT CENTRAL BANKING IS ABOUT

Remarks by Gerald K. Bouey, Governor, Bank of Canada
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Some of you may recall that last autumn, after having accepted an invitation from your President to speak to members of your Club in the latter part of November, I subsequently asked for a postponement. A number of events of some note occurred between the date of my acceptance in August and the scheduled date in November, but the relevant one in this connection was Mr. Rasminsky's decision to retire as Governor of the Bank. The topic I had planned to use was "What can be expected of monetary policy", and suddenly I felt more like asking the question than trying to answer it. Your President was most understanding. After my appointment on February 1st he renewed the invitation and I promised to show up this time. Today I would like to say something about the way I look at central banking and in the course of doing so refer to some recent events.

Anyone taking on a job like mine is bound to notice something all too familiar about the list of major economic problems which, he is told, demand his urgent attention. The level of unemployment, the trend of prices, international monetary and trade uncertainties -- surely such a list must be an out-of-date one prepared several years ago for a predecessor.

Unfortunately, the truth is that the problems central bankers have to worry about these days, whether in Canada or in other countries, are still the same hardy perennials. It's not much easier than it ever was for public policy to keep the economy expanding steadily along a satisfactory growth track. There are risks of falling off on either side -- into inadequate growth and rising unemployment on the one hand, into worsening inflation on the other -- and those concerned with economic policy must try to weigh these risks as best they can, knowing that the problems are not of a kind that yield to once-and-for-all solutions.

This is not the only reason why a new governor is likely to feel some trepidation. While in some quarters central banks once appeared to enjoy a quite undeserved reputation for omniscience, the opposite view -- that both the motives and the competence of central banks should be regarded with suspicion -- seems to have gained ground in recent years.

Up to a point, of course, it is possible even for a central banker to regard this shift in public opinion as a welcome move in the direction of realism. After all, there is no reason why those of us whose jobs involve us in the management of the nation's monetary affairs should not be expected, like anyone else, to be able to offer reasonable explanations for our actions.

On the other hand, some of us do find it a little difficult to recognize ourselves in the more extreme caricatures

of central bankers that seem to be in vogue these days. Perhaps an illustration or two might help to make the point.

Some critics seem to believe that the typical central banker combines a pathological obsession for fighting inflation with a heartless disregard for the plight of the unemployed. This is alleged to be reflected in an habitual foot-dragging attitude toward monetary expansion together with continual harping on the evils of inflation.

Others suspect just the opposite -- that in spite of much sanctimonious preaching against inflation central banks are in fact prime culprits in fuelling the process. Their record over the years is cited as proof that central banks can be counted on to permit a rising tide of money to finance chronic inflation, whether in response to the insatiable financial demands of governments or because of their own anxiety to avoid unpopularity.

Still others, conceding that central banks probably mean well, judge them to be merely incompetent and vacillating. According to this view, at the slightest rise in the inflation rate they jam the money tap tightly shut, and are quite surprised when this has no immediate effect on prices; later on, when the unemployment rate begins to rise, they not only fail to recognize this as being a predictable lagged effect of their own actions, but try to correct it by going to the other extreme and flooding the country with money. In this view central bankers, like the Bourbons, are incapable of learning anything from experience.

Without going so far as to claim that these caricatures are totally inaccurate, I do think that they reflect a less than perfect understanding of the problems faced by a central bank in a modern society.

Let me begin with a word about what I take to be the ultimate objectives of monetary management. My view, which is in no way new, is that the objectives of monetary policy are the same as those of public policy generally. Not only would it be presumptuous of the central bank to try to impose different goals of its own on the community, but it would also be quite unacceptable in a democratic country.

Among the most important objectives of public economic policy are sustained economic growth, high employment -- that is to say, low unemployment -- and reasonably stable price behaviour. These are difficult goals to achieve all at the same time, but I don't believe there is any major quarrel about them in our society. The real arguments are about what is the best strategy for achieving these objectives, and about how long a time horizon one should have in mind in weighing the consequences of alternative policy approaches.

What contribution can monetary policy make towards the achievement of these goals? We can skip the technicalities -- open market operations, cash reserve management, changes in secondary reserves and in the Bank Rate. The important thing is that the central bank is a public agency with certain

technical powers at its disposal, and that these powers enable it to influence credit conditions by controlling the rate of growth of the nation's privately-owned banking system.

There are two main reasons why the operations of the chartered banks have an important bearing on the functioning of our economy. The first is that bank loans and bank purchases of securities are among the major sources of financing in Canada. The second is that as a by-product of these transactions, the public comes into possession of deposit balances in bank accounts, which serve as much the most important form of money in this country.

Over the years, the amount of credit extended by the chartered banks and the amount of money in the hands of the Canadian public have grown hand in hand. At times the growth of bank credit and money holdings has been allowed to proceed quite rapidly, and at other times much less rapidly, depending on discretionary judgments of the Bank of Canada as to how to exercise its technical powers in particular situations.

The effects of these policy choices show up in various ways. The most immediate effect of a rapid rate of monetary growth is that for a time it brings about easier credit conditions than would have prevailed with slower monetary growth. The cost and availability of credit throughout the financial system are, of course, also importantly affected by changes in the underlying economic situation and in the related strength

of credit demand in Canada, as well as by changes in credit conditions in other countries.

The ability of the central bank to influence credit conditions in Canada has further ramifications, since changes in the relationship between Canadian and foreign interest rate levels can affect flows of funds between Canada and other countries and can therefore affect the exchange rate for the Canadian dollar.

Of course it is not just conditions in financial markets that are influenced by Bank of Canada actions in permitting a faster or a slower rate of domestic monetary growth. The ultimate effects of the monetary policy followed -- and much the most important ones -- are felt in our markets for goods, services and labour. There is an important connection -- though by no means an immediate or very precise relationship -- between the growth of the banking system and the growth of money expenditure in the economy. It is this flow of money expenditure, of course, that enables production and employment in Canada to grow. But it is also this same flow of money expenditure that enables prices, wage rates and other money incomes to rise at the rates they do.

Monetary management is not, of course, the only influence affecting the over-all level of spending in the economy, nor is it necessarily the dominant influence. In addition to private decisions, the policy actions

of governments at all levels directly affect aggregate spending in Canada through decisions taken with respect to expenditure, taxation, lending and borrowing, and so do economic and financial conditions in other countries. Major ups and downs in economic activity in Canada have always been closely related to those in the United States. One does not have to believe, however, that monetary policy is all important for the functioning of our economy in order to believe that it is nevertheless important enough to try to get it right.

So much for the nature and broad effects of the powers the central bank has to work with. How are these powers to be used in practice? This takes me back to the beginning of my remarks, where I implied that the job of a central banker is essentially a balancing act. Bearing in mind the impact of other domestic policies and of economic conditions in other countries, he wants to ensure that the banking system keeps growing at a rate high enough to enable the economy to reach -- and to stay on -- a sustainable path of vigorous growth at high levels of employment. On the other hand, he wants to avoid a rate of growth of the banking system so rapid that at some stage it will become virtually impossible to contain inflation while at the same time maintaining satisfactory employment growth.

In an economy suffering from abnormally high unemployment and much idle plant capacity, the main response to a strong rise in spending usually takes the form of more jobs and

more output rather than a more rapid rise of costs and prices. If the growth of jobs and output is rapid enough and lasts long enough, however, in due course a stage will come where growing scarcities of the right kind of labour in the right places, together with spreading production bottlenecks, progressively alter the form of this response. In circumstances such as these; an overly rapid growth of money expenditure is increasingly likely to have as its main result a marked escalation of cost and price increases rather than further large gains in employment and output.

Indeed, if the process is allowed to continue, a point will eventually be reached where further postponement of policy measures to check the pace of spending growth in order to contain inflation will no longer be possible. Past experience in many countries shows that an unfortunate by-product of belated action to cope with a situation of this kind -- once it has been allowed to get out of hand -- can be a sharp slowing of economic growth and a substantial rise in unemployment. For this reason, I believe there is an important sense in which it can be said that a worsening of inflation often leads in time to a worsening of unemployment.

The operating decisions that have to be taken by the central bank necessarily involve difficult judgments about whether credit conditions are suitable, and about the degree to

which the rate of growth of the banking system should be speeded up, slowed down, or maintained approximately within its existing range. Such judgments have to be made on an assessment of probabilities rather than on certain knowledge. For this reason they are bound to be provisional and subject to modification as new information and unexpected developments alter the balance of future probabilities.

An essential ingredient of judgments of this kind is an informed view not only about how the economy has been moving in the recent past and where it stands now, but also about the possible paths it might follow over periods as long as two years or more into the future under alternative policy assumptions. The need for such a long forward view about where the economy seems to be heading is a consequence of the long time lags that exist between monetary management today and its eventual impact on the future course of economic events.

Perhaps I can best illustrate the way in which the Bank of Canada approaches the decisions it has to take by outlining very briefly the basic rationale of recent monetary policy.

During 1972 the Bank of Canada permitted a further large increase of 15 per cent in the over-all size of the domestic banking system, following a 19 per cent increase in the previous year. Thus over the past two years we have had

sustained monetary expansion at rates not only on the high side in relation to past Canadian experience but also distinctly higher than the recent growth rate of aggregate spending and income.

The dominant consideration underlying this expansionary policy was the obvious need for large increases in demand, output and employment for some time if the Canadian economy was to regain more satisfactory operating levels. In seeking to maintain relatively easy credit conditions, the Bank also had in mind the potential drag on economic expansion of an undue appreciation of the Canadian dollar in foreign exchange markets if too much foreign capital moved into Canada.

While giving priority to the immediate objective of reducing the margin of slack in the economy, the Bank has not been unaware of the time lags involved in the operation of monetary policy, and for some time now it has kept the liquidity of the chartered banks under close control. When the already high rate of growth in bank loans became even higher in the first three months of this year, reaching an annual rate in excess of 25 per cent, the Bank of Canada did not permit the whole of this loan expansion to be accommodated through a correspondingly faster rate of monetary growth. The resulting pressure on the liquidity of the domestic banking system, together with recent substantial increases in short-term interest rates in the United States and overseas, were the main factors that led to the recent

rise in short-term interest rates in Canada, including the increase in the Bank of Canada's own lending rate.

Since a change in our Bank Rate tends to focus attention on the stance of monetary policy, I want to spend a few moments in an effort to explain as clearly as I can what our current policy is intended to achieve.

As I emphasized at the time of the Bank Rate change, substantial rates of bank loan and monetary expansion continue to be needed in order to finance vigorous growth in output and employment. There is ample evidence that the pace of economic growth in Canada since the third quarter of last year has been unusually rapid, and that we are well on our way towards the restoration of high levels of employment. Prospects that the current vigorous expansion will continue are good. There are, for example, clear signs that the pace of capital spending by Canadian business will be accelerating in the period ahead, and strongly rising demand for our exports will be an additional source of stimulus.

Looking even further ahead, however, it must be recognized that the current rate of growth in aggregate spending is too high to be sustainable over the longer run. If the economy has too much momentum when it eventually begins to bump up against its capacity limits once again, we risk a period of temporary overshoot followed by another period of

slack. To guard against this danger, what will be needed at a later stage is some moderation of the rate of growth of spending.

The recent pace of bank credit extension has clearly been too rapid. Part of the increase in the demand for bank credit appears to have come from foreign corporations, which at present have an interest rate incentive to raise funds in Canada either for use abroad or to replace funds that would normally be obtained abroad. The effective interest rate paid for bank credit by large prime borrowers in the United States is currently about 8 per cent (after allowing for the widespread practice of requiring compensating deposit balances) as compared with 6½ per cent in Canada. In view of this situation, the Bank of Canada has asked the banks to give priority in the use of their total loan resources to the credit-worthy demands of their Canadian customers rather than respond to unusual requests of the kind I have mentioned from foreign corporations or foreign-owned subsidiaries in Canada. In addition, the banks have been asked to pay particular attention to the needs of small businesses, which do not have easy access to other credit sources, and to applications for credit in the slower growth regions of the country.

I want to stress again that we are not moving to a tight money situation and that the banking system will continue to be in a position to accommodate reasonable growth in the total amount of bank lending.

I hope you will bear with me if, in concluding, I reemphasize three main points.

The first is that there are long time lags in the response of the economy to monetary management. It is true that some effects may be felt relatively quickly, but on the average the time that elapses before output and prices are affected is relatively long. Why would the Bank of Canada raise the Bank Rate when the latest unemployment figure available at the time was still as high as 5.9 per cent? (It has since come down to 5.5 per cent.) The answer is that the Bank must not only keep in mind current developments but must also look ahead to the likely situation next year and the year after.

The second point is that the demand for credit, the growth of the banking system, and the level of interest rates are all interrelated. To insist that a central bank maintain any particular level of interest rates is to insist that it abandon control over the growth of money and credit. This may seem to be an elementary point, but I sometimes have the impression that the central bank is expected to avoid both a rapid increase in the money supply and higher interest rates regardless of the strength of the demand for credit.

Finally I want to reject totally any suggestion that the Bank of Canada is somehow more concerned with price indexes than with people. As I have already stated, the Bank

remains firmly committed to maintaining rates of monetary growth high enough to support a strong expansion of employment and output. But for monetary policy to go even further and promote excessive spending that will speed up the pace of inflation -- inflation which in turn must eventually be brought under control with serious risk of adverse effects on employment and growth -- is not my idea of the way to advance the cause of human welfare. We will do better over the longer run in terms of employment as well as in terms of our price and cost performance if we try to avoid such excesses.

Recent experience has shown how difficult it is to deal with the aftermath of periods of excessive spending through demand management policies, once inflationary expectations have become very strong. This is not, however, an argument for failing to take the necessary measures to avoid getting into such a situation in the first place.

The Bank of Canada is going to continue to pay close attention to the problem of unemployment. At the same time -- although I acknowledge that living as we do in a sea of world-wide inflation greatly limits the possibilities for achieving as good a price and cost performance as we would like to see -- the Bank is not going to forget about the problem of inflation.

There are many more settings on the dial of monetary policy than the extremes of very easy money and very tight money, although we seem to lack an adequate vocabulary for describing the intermediate points. The best chance of getting our policy setting right is to try to strike a reasonable balance between risks that lie ahead on either side -- the risks associated with too much monetary expansion or too little. But that, after all, is what central banking is about.

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