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Statement prepared for the appearance of

Gerald K. Bouey

Governor of the Bank of Canada

before the

Senate Standing Committee

on National Finance

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I welcome the attention this Committee is devoting to the issues that might face the Canadian economy over the medium-term because the Bank of Canada has a deep interest in the performance of the economy over such a period. Monetary policy has in the past often been regarded as primarily a short-term contra-cyclical type of policy but the Bank, like many others, is strongly of the view that monetary policy should have a longer time horizon in mind. Moreover, it is certainly the case that a major objective of monetary policy, the reduction of inflation, cannot be achieved without undue disruption except over a period of years.

The Bank of Canada became committed to what might be called a medium-term policy in 1975 when it announced its intention to bring about a gradual reduction over time in the rate of monetary expansion. This approach rests on two key propositions that are absolutely fundamental: first, that it is very much in the public interest that the earlier drift into inflation in Canada be halted and reversed; and, secondly, whatever else may be done to bring inflation under control, it is absolutely essential to keep the rate of monetary expansion within reasonable limits. I am not going to say much about these propositions in this statement because I think they are widely accepted, but if you have any doubts about them I hope that you will express them so that we can discuss them.

I discussed the experience with the Bank's policy since 1975 in some detail in my latest Annual Report, and I will not repeat that discussion here. The main thing that I want to do today is to say something about the problems that lie ahead and about some of the factors that will be important in determining the course of economic events. I shall begin by talking in fairly general terms about how monetary policy influences the economic process.

One way of describing the role of monetary policy is to say that it influences the trend of total current dollar spending in the economy, and that it will over time have a major effect on the rate at which Canada's Gross National Expenditure in current dollar terms will be increasing. The cutting edge in this process is interest rates, and these are determined by the interplay of economic developments and the rate at which the Bank of Canada permits monetary expansion in the country to proceed. The Bank of Canada's emphasis since 1975 on gradually reducing the rate of expansion of money should be seen as a way of bringing about a similar slowing in the growth of aggregate expenditures. The rate of increase of spending in the economy had reached 15-20 per cent a year in the period immediately preceding 1975, and since that rate was far above any possible increase in the physical volume of output of the economy a high rate of price and cost inflation was inevitable.

I want to emphasize that monetary policy is a financial instrument and it operates directly on financial flows in the economy. What effect it has in the short run on the so-called real economic variables -- employment, productivity and output -- is largely dependent not only on the state of inflationary expectations but also on other features of the economic system. I shall have a little more to say on this matter later, and all I want to register now is that the way in which the real economic variables in the economy respond to changes in financial flows is heavily dependent on other policies and practices throughout the economy about which the central bank can do very little.

Let me turn now to the future. As I have said, the Bank of Canada has for some time now been embarked on an effort to steer the Canadian economy on the path back to price stability. I want to say something about the uncertainties and the difficulties that we seem likely to encounter.

Our greatest problem lies in recent economic history. When one looks back over the past twenty-five years it is clear that the basic trend has been towards higher inflation. This tendency predates current popular explanations of inflation like oil price shocks or beef cycles. There is little doubt that the key reason for this slide towards ever more inflation was an effort by public policy in most countries to achieve and maintain more output and employment from their economies than was consistent with price stability. For a while it was fashionable to rationalize the inflation process as a kind of lubricant to the economic system. This view should have been discredited long ago by logic for it implies that people can be fooled indefinitely, and it has now been discredited by events. People have learned to expect inflation and they have learned to do what they can to protect themselves from it. They have also learned to be skeptical about public promises to reduce inflation for the fulfilment of such promises would require a radical break from a long-established inflationary bias in public policies. This is the history that we have to reckon with.

It would be a mistake to underestimate the potential difficulties involved in changing expectations of continued high inflation. It would of course be comforting to suppose that the rate of price and cost increase would slacken almost automatically along with the rate of monetary expansion and the growth of spending. This would allow the adjustment to less inflationary conditions to be made with very little cost in terms of output and employment because markets would remain buoyant enough under those conditions. There is little sign, however, that economic behaviour is so conveniently influenced by policy pronouncements. It is influenced more by experience of actual market conditions. If markets are not buoyant because aggregate money demand is limited by a declining rate of monetary expansion, prices and costs will thereby be encouraged to adjust. There is the danger that the adjustment may be slowed by resistance offered by stubbornly-held inflationary expectations with the unfortunate result that the cost in terms of lost output and employment will be greater than the transition to less inflationary conditions would otherwise require. The point here is that the success of monetary policy in lowering the rate of inflation requires the adjustment of price and cost behaviour to the lower rate of monetary expansion. To attempt to avoid that adjustment by accelerating monetary expansion would be to confirm inflationary expectations, and to make the future fight against inflation even tougher.

If the problem facing all of us is the nature of the response of the Canadian economy to a monetary policy designed to reduce gradually over time the rate of growth of nominal spending in the economy, the natural question is -- what can be done to improve that response and to maximize the prospects for employment and output in the period ahead?

The first thing to be said in that connection is obvious -- that everything that can be done that will help to convince Canadians that the period of high and rising inflation in this country is to be brought to an end will be helpful. If Canadians become convinced of that they will act in a way that will facilitate the process, but until they are so convinced the process cannot reasonably be expected to go easily. Who can convince them? and how? The Bank of Canada certainly has a central role to play and we are trying to play it. Governments at all levels have a major role to play, and the role of the Federal Government is clearly of crucial importance. But the need for leadership in this matter goes beyond the public sector.

It is important that those policies and practices throughout the economy which are inflationary should be modified, and all policies and practices should be reviewed in this light. While I do not intend to comment in this regard on particular policies and practices in either the public or private sectors, I certainly hope that they will be looked at searchingly by those directly involved.

It is not difficult to say something in general terms about the characteristics of policies and practices throughout the economy that will encourage good economic performance during the transition of the economy to price stability and thereafter. There are many things in economics to debate about but there is an agreed core of knowledge about the basic requirements for a decentralized market-type economy to work efficiently over time. Here are some of them.

1. The arrangements in the economy must offer effective incentives to its people to work conscientiously and efficiently. We all know

that the central dynamic of the productive process is private initiative: the energy, the skill, the imagination and the application of the working population. We also all know that people respond to many motivations but a principal motivation for most people is to enjoy the product of their work. Insofar then as a society wants to encourage production it must be concerned about the incentives to individuals that its economic practices offer.

2. The productivity of work is enormously affected by the amount and quality of machinery and equipment that people have to work with, and rising productivity in a society is heavily dependent on the scale of business-type investment. In our society such investment is undertaken for the most part at private initiative, and it will not be undertaken unless there is the prospect of a profit from it sufficient to warrant the effort and the risk. If our society wants good economic performance it must therefore follow practices that provide good incentives for business-type investment.

3. Another requirement for good performance of the economy is flexibility. By this I mean primarily the effective freedom of economic resources to move between different employments in response to changing economic circumstances and changing

profitability. It is this process that keeps economic systems competitive and dynamic, and that reinforces economic successes rather than economic failures. The process of economic change is of course uncomfortable to some of those involved and that is no doubt one of the reasons that one frequently observes initiatives to slow it down or to prevent it. Unless such initiatives are watched with care they can over time generate rigidities that sap the dynamism of the economy.

To summarize, the main point that I have been trying to bring to the attention of the Committee is that good monetary policy, though absolutely necessary, needs to be accompanied by many other adjustments if we are to achieve our economic objectives. A gradual reduction in the rate of monetary expansion will help to bring the rate of inflation down but it will not by itself ensure acceptable economic performance during the period of transition to a non-inflationary economy. Over the longer run monetary policy can help create a favourable financial climate for economic activity but economic progress depends mainly on more fundamental factors.