Statement prepared for the appearance of

Gerald K. Bouey

Governor of the Bank of Canada

before the

Standing Senate Committee on National Finance

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A statement that I made in a speech last week to the effect that the Bank of Canada no longer has a target for the M1 definition of the money supply has given rise to a variety of reactions. Some people seem to think that I was announcing a change in the thrust of monetary policy. Others, who have followed our actions and statements in recent months and years more closely, recognized that no departure from the path we had been following was being signalled. In the light of these different reactions I am pleased to have this opportunity to talk to you about monetary policy and to clear up any confusion that may exist.

In explaining monetary policy it often helps to begin with its basic objectives. The principal objective of the Bank is to achieve a pace of monetary expansion that best serves the needs of the Canadian people. Experience has proven, I believe, that the rate of monetary expansion required for this purpose is one that is consistent with reasonable price stability. Since an immediate return to price stability is not practical in a country where inflation and expectations of inflation have become as ingrained as they have in Canada, the principal objective for monetary policy in current conditions should be to help the economy move toward

reasonable price stability. This, in turn, will help us to achieve the lower levels of interest rates we need for economic recovery.

This brings me to interest rates. Monetary policy has its effect on the economy, on output and prices, through its effect on interest rates. It affects interest rates by altering the rate of monetary expansion. The determination of interest rates in our economy is a market process that reflects the borrowing and lending activities of all participants -- government entities, businesses and individuals, residents and foreigners. The Bank of Canada participates in that market process and it can influence the interest rates that the market produces by expanding or contracting central bank money. The extent of its influence is subject to important practical limitations that I will not go into here. The point I wish to make here is that the policy question for the Bank of Canada from day-to-day and over time is what use of the power to influence interest rates by monetary expansion best promotes the national economic interest.

That is not a simple question, and there is no easy way to find the answer. What one has to do is to examine the whole complex economic process sufficiently carefully to come to a balanced view about how the economy would respond over time to different rates of monetary expansion.

That is what the Bank of Canada has always tried to do, and that is what it continues to try to do. To that end it has a considerable staff of able and experienced economic analysts who are occupied constantly

in observing developments in the economy and the international environment, and who use all the information and all the analytic techniques that are available to throw what light they can on why the economy is performing as it is. In this process it is natural that central banks look for stable relationships between measures of the money supply and more general indications of economic performance to help them in their analyses. Such relationships encourage the central bank to assess monetary policy within a longer run framework.

For a number of years there was a relatively stable relationship between the narrowly-defined money supply -- currency and demand deposits (M1), essentially the transaction balances in the economy -- and interest rates and the trend of total spending in the economy. So long as that relationship existed it was helpful both to making and to explaining monetary policy, and the Bank of Canada used it as a basis for its monetary targets and gave a good deal of prominence to it. The Bank was, however, aware from the beginning that events might undermine the stability of that relationship. As I said in my Annual Report for 1975:

> "It should be borne in mind that M1 will provide useful information for policy purposes only so long as the public's behaviour with respect to its holdings of transactions balances per dollar of income continues to follow a reasonably predictable pattern. It is possible that the public's habits in this regard will change over time, perhaps in response to innovations in payments technology and in the characteristics of the various kinds of financial instruments offered by deposit-taking institutions and their close competitors. The Bank of Canada recognizes the need for careful monitoring of such developments and of their impact on the public's behaviour".

During the period that the Bank of Canada had a monetary target for M1 it continued to do the same kind of analysis of developments as it would have done without the target in order to check the signals that it was getting from M1. The M1 target system was never regarded by us as an automatic pilot. For more than a year now we have been aware that the M1 target system that existed was not giving good direction signals and we have not been guided by it.

The reasons why the M1 target system ceased to be a good guide are clear enough. As I pointed out in my speech on November 29th, a number of important recent innovations in banking services have caused major and continuing shifts of the money balances held by individuals and businesses for making payments out of the demand deposit accounts that are included in M1. These innovations include the much more widespread availability to businesses of the cash management facilities provided by banks. These facilities permit all the demand deposit balances that may be held by a business across the country to be consolidated at the end of the day and the surplus transferred into an overnight investment account. As for individuals, an increasing number of them are giving up their personal chequing accounts and are instead making use of recently introduced deposit accounts which provide chequing services and pay a competitive savings interest rate when a certain minimum balance is held in the account.

The difficulties we have encountered in making use of M1 are well known to those who follow monetary policy matters reasonably closely.

My Annual Report for 1981 contained a description of the problems. Our difficulties were serious enough at the time of writing that Report last winter that I said that for the time being we were "not inclined to draw inferences about monetary conditions from the recent pattern of M1 growth beyond those which can be confirmed by other economic and financial indicators". When giving my assessment of monetary targetting in the 1982 Per Jacobsson Lecture in September I summarized our problems with M1 once again and concluded with a great deal of regret that our M1 target had not been able to provide the clear-cut guidance for monetary policy that one had hoped for.

We delayed announcing that we were dropping our target for M1 because of the possibility that we might be able to adjust the target to take adequate account of the shifts and thus preserve the usefulness of M1 as a policy guide. We have done this before but the size and ongoing nature of the current shifts have made such an adjustment impossible. I wish to stress, however, that we have dropped the target solely for these technical reasons -- not because we have changed our minds about the desirability in principle of money supply targets. We are therefore continuing to explore that use of monetary aggregates.

Perhaps I can give you a more specific indication of how monetary policy has been determined for some time now without any help from a monetary target. Adequate relevant information needed for monetary policy decisions has certainly not been lacking. We know how weak the economy is. We know that we want to see interest rates as low

as would be consistent with continuing resistance to inflation. We believe that we will make the most progress in moving to lower interest rates if we do not use monetary expansion in a way that will rekindle expectations of higher inflation and upset reasonable confidence in the exchange value of the Canadian dollar. With this approach we have been able to facilitate a major downward adjustment in interest rates in recent months.

In current circumstances the major guide to monetary policy must be the degree of progress the Canadian economy is making in getting inflation down. Our goal is sustained economic recovery. As I said in my speech last week: as we further rid ourselves of the burden of inflation, lower interest rates can play a key role in the economic recovery we all want so badly.