Extra

THE 1982 PER JACOBSSON LECTURE

MONETARY POLICY -- FINDING A PLACE TO STAND

delivered by
Gerald K. Bouey
Governor of the Bank of Canada

Toronto, Canada
September 5th, 1982

THE 1982 PER JACOBSSON LECTURE
delivered by
Gerald K. Bouey
Governor of the Bank of Canada
at Toronto, Canada
September 5, 1982

MONETARY POLICY -- FINDING A PLACE TO STAND

Central bankers are always looking for more reliable guides to the conduct of monetary policy than they have had. Part of the reason is that they want to find a better place to stand against the constant pressures that arise from many sources, almost irrespective of economic conditions, for easier money and lower interest rates. Restraint on monetary expansion is never a popular policy. In my experience I have had much more success in convincing people that monetary policy should have been tighter at some point in the past than in convincing them of the need for restraint in the present. The temptation to put off financial discipline is always great. It is not therefore surprising that central bankers have been anxious to find some objective criterion to assist in choosing and explaining the course monetary policy should take.

Most of what I have to say today is concerned more with this search for a better analytic framework within which monetary policy choices are made than with particular policies themselves. But in the

last decade central bankers have learned some hard lessons about where monetary policy should take its stand on the question of how firmly inflation should be resisted and I shall have something to say about that too.

The remarks I have to make on these issues will necessarily mainly reflect Canadian experience, but I do know that much the same questions, much the same challenges, that we have faced in Canada have been confronted elsewhere, and I expect that a great deal of what I have to say will relate quite directly to situations elsewhere.

As you have probably already gathered, for the purpose of this lecture I use the terms 'central banking' and 'monetary policy' virtually interchangeably. I shall be discussing how monetary policy is formulated, not where it is formulated.

In so doing I am of course aware that I am also glossing over the issue of the degree of independence for the central bank within the framework of government and of public policy. This territory was covered with great care and authority by my predecessor and friend, Louis Rasminsky, when he gave the lecture under these same auspices in Rome in 1966. On that occasion he stressed the advantages of arrangements which give the central bank a sufficient measure of independence within government to be held responsible for monetary policy, and also make it clear that the elected representatives of the people have ultimate responsibility and have a suitable mechanism through which to exercise that responsibility.

Before going further, I want to make a few brief remarks about the role monetary policy should be expected to play in a developed industrial economy such as Canada.

In my own institution we operate under an Act of Parliament which in its preamble contains the following brief description of the role of monetary policy:

> Whereas it is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion.

This description, written in the mid-1930s, seems to me to stand up very well today. It recognizes that the prime focus of monetary policy should be at the macro-economic level rather than with the operation of particular segments of the economy. It also recognizes, by the important qualifying phrase "so far as may be possible within the scope of monetary action", that there are limits to the extent that some of the economic objectives mentioned can be pursued effectively by monetary means.

This point deserves further emphasis. In considering monetary policy it is important to have the clearest possible idea of what can, and what cannot, be properly expected from monetary policy in the first place.

In a developed industrial society like ours a characteristic feature is the heavy reliance that is put upon decentralized decision-making in economic matters. That decentralization is made possible by a relatively large and highly diversified private sector and the use of market mechanisms. In such societies public economic management relies mainly on influencing the framework within which markets operate, and only to a limited extent, or exceptionally, on direct controls, rationing, or administrative allocation in general. The role of monetary policy in such a society is to seek such rate of monetary expansion as will encourage the market economy to work well.

It is surely now beyond dispute that one of the prime requirements for good economic performance over time in a market economy is a money that can be trusted. Monetary policy must therefore give high priority to the preservation of the value of money. Its freedom to respond to particular situations must therefore be seen as constrained by this longer term objective.

It follows from the proper role of monetary policy that there are many economic problems that are outside its scope. There are many economic problems that cannot be effectively resolved merely by printing money, and it is a mistake to try. If a market-oriented economy does not work well with a rate of monetary expansion that is consistent with the preservation of, or a move towards, stability in the value of money, the sensible response is to track down the true sources of the problems and deal with them.

One feature of an economy that is outside the scope of monetary policy, and which I want particularly to emphasize in this lecture, is the degree of flexibility with which the economy responds to the forces operating in it, including the influence of monetary policy. I plan to return later to that question in the context of the special problem of bringing down the rate of inflation. Here it is sufficient to note that given the limits to its scope monetary policy cannot by itself ensure good over-all economic performance. As has often been stated, a good monetary policy is a necessary but not a sufficient condition.

How in these circumstances does a central bank go about deciding how to pursue a 'good' monetary policy -- one that will exert the appropriate influence on total spending in the economy? I will centre the rest of my remarks on the guides which have been used for tackling this problem in Canada. This amounts to a commentary on how thinking and practices have developed over the years that I have been involved in this business, what we seem to have learned, and what difficulties we have come up against.

Whatever else has changed over the years, the basic view of the Bank of Canada of how monetary policy works -- the process by which it has its ultimate economic effects -- has not changed. That view is that interest rates constitute the cutting edge of monetary policy. The main policy problem has thus always been seen, and is still seen, as how to come to judgements about the direction and extent of the influence that the central bank should exert on the path of short-term interest

rates. Those judgements are very difficult because of the complex process through which interest rates affect total spending in the economy.

In looking at the Canadian experience with monetary policy three separate periods can be identified. The first is the period of low and stable interest rates that followed the establishment of the Bank of Canada in 1935. The beginning of the 1950s marks the inception of the next period, one in which monetary policy played a more active role. Finally, the adoption of monetary targets in 1975 is the feature which distinguishes the third period.

In the difficult years of the Depression it was clear that the influence of the central bank should be directed toward keeping interest rates low; the economy was in need of expansionary stimulus and there was no inflation risk. In the Second World War, war finance was also based on low interest rates although this policy was accompanied by a comprehensive set of direct controls. While there was a sharp upward adjustment of prices in the immediate post-war period, widespread concern that the war years would turn out to have been just an interlude in a continuing state of economic depression played a major role in keeping serious inflationary expectations from developing and interest rates remained low. Throughout the first fifteen years of the history of the Bank of Canada, 1935-1950, the Bank Rate, the minimum rate at which the Bank makes advances, was changed only once -- it was lowered from 2 1/2 per cent to 1 1/2 per cent in 1944. The rate of monetary expansion was whatever was consistent with the maintenance of low interest rates.

For this reason measures of the money supply, although published, received little attention.

Another reason for the low interest rate policy in the early post-war period was that considerably more emphasis tended to be placed on fiscal policy as an economic stabilizer than on monetary policy. There was, as you may recall, little confidence at that time in the effectiveness of interest rate movements in influencing the course of total spending in the short run, although this view was based on evidence that now seems to have involved incredibly small changes in interest rates. To the extent that there were pressures on the exchange rate, they were managed by other means and did not intrude on monetary policy.

In the 1950s the orientation of monetary policy changed to one of playing a more active role in the stabilization of the business cycle. Initially this change stemmed from a tendency for the economy to overheat at the time of the Korean War. As time went on it was also a response to increasingly ambitious views both in Canada and abroad about the standards of over-all economic performance that ought to be attainable by good economic policy.

With this more active role for monetary policy it was not sufficient to think of policy targets solely in terms of interest rates partly because many interest rates were sticky or even rigid as a result of institutional or legislative constraints. There was moreover a considerable reluctance among the authorities to see large movements in

interest rates and monetary actions were supplemented on a number of occasions by moral suasion which also involved non-price rationing of credit. Policy was therefore framed for much of the period from 1950 to 1975 in a broader form, which we called 'credit conditions', that emphasized the availability of credit as well as its cost.

In Canada banks were the major lenders and influencing credit conditions was to a considerable extent a matter of affecting the ability and willingness of the banks to make loans. Liability management by banks was not yet in style and the amount of liquid assets held by the banking system was regarded as a major factor affecting the availability of bank credit. In its monetary management the Bank of Canada tended therefore to attach considerable importance to the extent that the banks acquired or disposed of liquid assets.

Despite the optimism in many quarters about the achievable standards of economic management, the day-to-day business of monetary decision-making was by no means a precise exercise. Indeed my recollection is that at one time we referred to the policy process as being one of trial and error but since no one liked the word 'error' to be included in a description of central bank policy we quickly adopted the more elegant term 'successive approximation' when it began to be used south of our border.

This process was described in a submission by the Bank of Canada to a Royal Commission on Banking and Finance in 1962:

> There is, of course, no formula by which the central bank can determine what are the most appropriate credit conditions or what level of cash reserves would bring them about. It must operate to a considerable extent by the method of successive approximation, constantly adjusting its operations in the light of all the evidence it can get, as it becomes available, about changing economic and financial conditions.

At this time the Bank expressed concern that over-reliance on monetary policy be avoided because of its undesirable side effects. These side effects included the uneven impact of both non-price rationing of credit and high interest rates on various classes of borrowers and the effect of volatile interest rates on financial markets, on the country's external financial position and on the maintenance of exchange rate stability. This view of the role of monetary policy implied that a large part of the stabilization burden should continue to be carried by other economic policies, especially fiscal policy. A similar view was expressed in 1964 by the Royal Commission on Banking and Finance in the following terms:

> Monetary policy is just not powerful enough to do the job by itself over any reasonable range of credit conditions, even if there were no international inhibitions about using it fully.

Despite the focus on credit conditions the money supply was not totally ignored. In the 1950s and the 1960s there were indeed periods of concern about the rapid growth of broadly-defined measures of the money supply but there were no well-established relationships which could be used to interpret these monetary aggregates.

By the late 1960s the elimination of the interest rate restrictions in banking legislation as well as elsewhere had opened the way for much greater flexibility in interest rates in Canada, a flexibility which turned out to be crucial given what later happened to international interest rates. Non-price rationing of credit, or availability, became very much less important and credit conditions really came to mean interest rates.

This general approach to monetary policy worked reasonably well for much of the period from 1950 to 1970. Despite a tendency to generate stronger and stronger levels of aggregate demand at the peak of each cycle, economic policy did not run into serious trouble so long as the public did not expect more than temporary bouts of inflation. Undoubtedly the discipline of fixed exchange rates helped to hold things together for a while. But the increasing pressures on prices from expansionist policies gradually undermined belief in the commitment to price stability by the authorities and led to expectations that inflation was more likely.

During the recession at the beginning of the 1970s, monetary policy was directed toward bringing about a relatively low level of interest rates. Fiscal policy was also eased. This had been the usual pattern but on this occasion virtually all industrial countries were in the same phase of the cycle and their policies interacted to produce a powerful, synchronized economic expansion. One of the reasons for the willingness of monetary authorities to pursue easy monetary policies at that time was related to the fact that the Bretton Woods fixed exchange

rate system was in the process of breaking down. No country wanted a rise in interest rates that would cause its currency to appreciate sharply because of a fear that a loss of international competitiveness in an already disrupted international market could put an unnecessary obstacle in the path of an economic recovery. The old problem of competitive exchange rate depreciation was back temporarily, though in a different guise. The difference was that this time it was competition to avoid exchange rate appreciation. This immediate concern about exchange rates clearly received priority over the associated risk of future inflation. I am inclined to believe that this development was a major reason why the eruption of inflation was so much greater on this occasion than in previous peacetime recoveries. It is well to remember that all this occurred before the sharp rise in international oil prices in 1973 added a further inflationary shock to the world economy.

It is no exaggeration to say that the world economy is still trying to recover from the inflation unleashed in that period.

The strength of the sudden burst of economic expansion in the early 1970s was not foreseen. In Canada, fiscal policy remained easy for some time, and monetary policy did not react quickly or vigorously to the surge in activity. When the Bank Rate was raised in April 1973 I found myself asking the rhetorical question in a public address: "Why would the Bank of Canada raise the Bank Rate when the latest unemployment figure was still as high as 5.9 per cent?". But it was already late in Canada as elsewhere. Successive increases in the Bank Rate followed, and although nominal interest rates went to historically

high levels it later became clear that they had not risen rapidly enough. The attempt to achieve appropriate interest rate levels in this period foundered mainly because of the inability to recognize what nominal interest rates were needed when actual inflation and expectations of future inflation were rising so quickly.

It was natural that central banks would look back over the period in which inflation exploded in an attempt to see what would have improved the performance of monetary policy. In Canada what this revealed was that the expansion of the money supply, particularly the narrow definition composed of currency and demand deposits, had accelerated well ahead of the rate of inflation. It appeared that a policy more closely oriented to stabilizing monetary growth would have reduced the cumulative increase in inflation that occurred. While this persuaded us that we ought to pay closer attention to what was happening to the money supply, work went on over quite a long period at the Bank of Canada before we felt that we had a reasonable basis for expressing our policy in terms of the movement of a particular monetary aggregate, and a feasible way of linking our actions in financial markets to movements in that monetary aggregate.

The decision in 1975 by the Bank of Canada to adopt a money supply target was based on the evidence that a narrowly-defined monetary aggregate (M1) was related in a reasonably stable fashion to movements in total spending in the economy and to short-term interest rates. Short-term interest rates continued to be viewed as the channel

for the transmission of policy; the role of the monetary aggregate was to assist in making judgements about the appropriate level of interest rates.

This modified approach was also a reaction to the limited help, despite increasingly sophisticated econometric models, that economic forecasting and policy simulation techniques had been able to provide to policy-makers in coping with the outbreak of inflation. The attraction of using the trend of a monetary aggregate as a guide for policy was that it limited the need for judgements about the likely evolution of economic developments in the near-term future and shifted the focus of policy to a longer time period. It gave more prominence to the need to restrain the rate of monetary expansion over time if the previous tendency of policy to have an inflation bias was to be avoided in the future.

The Bank of Canada, like many other central banks, began at this time to announce publicly its targets for monetary growth. We were aware of the important role of expectations in economic processes and were hopeful that the announcement of targets for policy would influence expectations and thereby speed the responses to policy. Moreover, the Bank would have a more solid place to stand in defending the actions that were undoubtedly going to be necessary to fight inflation.

The use of monetary targetting has become widespread in industrial countries and has unquestionably assisted in achieving a wide measure of public support for the need for monetary restraint in order to bring about a return to price stability. There is no doubt in my mind that without the adoption of guidelines for money growth by central

banks the unprecedented interest rates that have been needed to moderate inflation would have been delayed, if they would have been forthcoming at all.

As I noted earlier, the danger of coming to rely excessively on monetary policy for financial restraint had been a preoccupation for some time because of the uneven impact of unusually high interest rates. The concern was reinforced in this latter period. While interest rates were bound to rise appreciably in view of the upsurge of inflation, all central bankers would have preferred mixes of fiscal and monetary policies at home and abroad that would have obviated the need for such high interest rates.

Notwithstanding the contribution of monetary targetting in getting monetary policy on to a better track, practical problems have emerged in Canada, and I expect in other countries as well, which have reduced the usefulness of these targets as policy guides. I want now to describe the problems that we have encountered.

Perhaps the most troublesome problem in Canada is that the relationship between our target monetary aggregate -- M1 -- and the levels of spending and interest rates has not turned out to be as stable as it appeared in the mid-1970s. Inflation and high interest rates have led to a rapid pace of financial innovation, spurred on by advances in computer technology. The resulting shifts in the quantity and composition of money balances that the Canadian public chooses to hold have been substantial. These shifts cannot be ascribed to financial

deregulation because the financial system in Canada has for some time been free of the kind of regulatory impediments that would have been relevant.

These shifts in money demand have been difficult to handle. There have been periods when the movement of M1 relative to its target was known to be misleading but it was not possible to make a reliable estimate of the size of the shift except after a considerable lapse of time. The interpretation of M1 has also been complicated temporarily by problems in measuring this aggregate arising from reporting difficulties encountered by Canadian banks following revisions to the Bank Act. When confronted with a substantial and unexpected movement in money, the Bank of Canada has been obliged to look for supporting evidence that the movement reflected fundamental economic developments and not just changes in financial arrangements.

The evolution towards electronic means of making payments is likely to lead to further important adjustments in the form of money balances that the public chooses to hold. It remains to be seen what sort of adjustments to monetary targetting will be required in the face of such innovations.

So far at least, our examination of monetary aggregates that are more broadly defined does not indicate that they would provide attractive alternatives to M1.

Another very practical issue in monetary targetting has been how to cope with exchange rate disturbances. In our own case there have been a number of occasions in recent years, and especially in the past two years, when the Bank of Canada has felt obliged to react quite strongly to exchange rate movements. These instances have been connected mainly with downward movements in the Canadian dollar related to unusually high U.S. interest rates, although sometimes they have reflected developments of domestic origin.

In an open economy such as Canada's, currency depreciation is bound to have both an immediate effect on prices and a lagged secondary effect as individuals and businesses try to protect their incomes in the inflationary environment. The higher rate of inflation will in due course be reflected in a rise in the quantity of money demanded in the economy, and thus will signal the need for more monetary restraint, but by that time the damage in terms of increased inflation and strengthened expectations of future inflation will already have been done.

Other central banks have encountered similar problems. Unusually high external interest rates lead either to domestic interest rates that are higher than necessary to meet monetary targets or to a decline in the exchange value of the currency with its consequent inflationary effects. It is not possible for domestic monetary policy to avoid both of these problems at the same time. The reverse of this problem can occur if external interest rates are unusually low.

I should perhaps note in passing that for some countries, especially smaller ones, the option of operating monetary policy to stabilize the exchange rate, whether a bilateral or trade-weighted exchange rate, rather than the growth of the money supply, can be quite attractive. Such a policy guide in effect transfers much of the responsibility for the basic direction of monetary policy to a country or group of countries that are of great economic importance to the country in question and whose actions will in any case have to be accommodated by smaller countries somehow. Such a policy, if adhered to, ensures pretty much the same inflation performance over time as the country or countries with which the exchange-rate link has been established. In principle this could be better or worse than would have been achieved under some kind of purely domestic regime; in practice, exchange rate targetting makes more sense the less scope there is to realize good monetary management by focussing mainly on internal financial developments.

Given the important role of expectations in perpetuating inflation, we in the Bank of Canada have found ourselves taking a view of policy that is more forward-looking than one based solely on monetary targets on the grounds that it is wise to respond immediately to any potentially inflationary shocks rather than to wait until such shocks are reflected in higher inflation and higher money growth. This is of course a bit different from the rather pessimistic view about the state of economic knowledge which influenced much thinking immediately after the outbreak of severe inflation in the mid-1970s and was one of the bases for the advocacy at the time of a monetary rule. We do know more about

economic processes than is typically assumed by advocates of a strict adherence to such a rule. This is not to say we can forecast over-all economic developments with any degree of certainty but we do know something about the implications of various kinds of shocks. Exchange rate depreciation has been the most important of these. We have also come to the view that permitting short-term interest rate levels that are low relative to the rate of inflation is likely to lead to disproportionate incentives for increased borrowing, thereby fuelling speculative activities and contributing to inflationary pressures. On the other side, rates of interest which exceed the inflation rate by an unusually wide margin may, if they persist, exert more anti-inflationary pressure on the economy than it is capable of absorbing without major disruption. These then are considerations that we also take into account in responding to current developments.

For these various reasons the Bank of Canada's use of a monetary target as a guide to policy has been considerably qualified and we have relied a good deal on other information and analysis.

In this discussion of the evolution of our monetary policy framework, my references to the economic context have been incidental to the main theme. Now, however, I want to focus more directly on the issues raised for monetary policy by the actual situation facing us and other central banks.

At present the immediate policy problem for most central banks is not to devise ways of running monetary policy that guard against the

emergence of inflationary pressures. It is rather to ensure that monetary policy exerts sustained and appropriate downward pressure on an existing high rate of inflation and thus restores confidence in the value of money. This problem raises issues that stretch beyond questions of monetary policy technique. Looking solely at the behaviour of financial variables, whether monetary aggregates, interest rates or whatever, will not provide a sufficient basis for judging the question of how strongly to press financial restraint. That judgement will involve a consideration of how the economy responds.

Most countries have for some time had great difficulty in generating anything at all close to a decent economic performance over-all. One manifestation of these difficulties is the distressingly high levels of unemployment and large numbers of business failures that are being experienced in Canada and many other countries. It is generally recognized that much of what we find unsatisfactory about the ways our economies have been performing is the product of deep-seated, complex problems. One such problem is the way productivity has lagged throughout the industrial world for a decade or more, frustrating expectations of rapidly rising real incomes. Another, certainly for Canada, is the disconcerting manner in which rates of measured unemployment that might reasonably be thought to be consistent with avoiding inflation have evidently increased from where they were a number of years ago. It is also true, however, that much of the clearly inadequate economic performance recently is related to the stresses involved in the adjustment of the economy to a less inflationary environment.

Reducing inflation has proven to be a difficult and wrenching process. One basic reason is that expectations about future inflation are deeply ingrained. One of the facts of life that policy-makers have had to contend with world-wide has been a general skepticism among the public about the willingness or ability of the authorities to take the steps required to reduce inflation and to persevere in the face of the inevitable strains involved. The history for many countries had been one of taking chances in economic policy on the side of inflation whenever there appeared to be an option. Even as inflation mounted and was increasingly recognized to be a truly serious problem, skepticism over the likelihood of its ever coming under control was reinforced by increasingly frequent suggestions that it should be 'lived with' at whatever rate it had then reached. Thus nowadays it does not take much evidence of weakness of purpose, or evidence even of cross purposes, on the part of economic policy authorities to set off anticipatory expectations in asset markets of all kinds. These episodes serve as a salutary reminder that the days when it was thought that a quick demand boost could be given to the economy without worrying about inflation are over.

Expectations of future inflation both encourage, and are encouraged by, uncompetitive wage and price-setting behaviour. Such behaviour can be an obstacle to good economic performance at any time, but it is likely to be even harder to contend with when the economy is being pressed towards achieving lower rates of inflation. There may be particular business and labour groups in the economy that believe they can safely ignore general market pressures either because the market for their products or services is protected by one means or another or

because they can control the supply of their goods or services sufficiently well to insist on inflationary price and income increases. In some cases the saving of jobs appears to be given a lower priority than the maintenance of high income settlements. To the extent that there are reactions like this an anti-inflationary climate will generate cutbacks in production, business failures, and increases in unemployment rather than better cost and price performance.

If the economy does not respond well to market pressures, this does not mean that the central bank should abandon its efforts. The persistence and credibility of anti-inflationary policies is necessary to change ingrained expectations, and this credibility can only be achieved by actual evidence of success. Furthermore, there would be no point in trying to compensate for deficiencies in the economic structure by printing money at a faster rate. The solution lies elsewhere. A country that depends heavily on market-oriented policies such as fiscal and monetary policy cannot afford to be indifferent as to how well its markets for goods and services work.

In current circumstances the room for manoeuvre for monetary policy is clearly limited. The basic requirement is that it must unmistakably be pointed in the direction of restraint. But there can be some scope for judging how much restraint is required in the light of the developing circumstances of the economy. The process by which the economy adjusts to declining rates of inflation is hardly a smooth one and it is bound to take time. In this area, as in many others, the important aim should be to establish and keep momentum. If considerable

progress has been made in reducing inflation, and if the market situation has become weak in the process, a lesser degree of restraint should be sufficient to continue to make progress against inflation.

In light of these comments you will not be surprised with my conclusions in regard to finding a place to stand. There is no question that targets for monetary growth have provided us with help in warding off pressure for more rapid monetary expansion and protection against cumulative error. Even though we have not found that they can substitute for the wide range of judgements that have to be made, they added a useful measure of discipline to the process of determining the course of monetary policy. But monetary targets have not, at least in Canada, provided the clear place to stand for which some had hoped.

I recognize that the experience of different countries has varied and some central bankers may feel that monetary targetting has brought them closer to a solid place to stand than I believe it has in Canada.

So far as the objectives of monetary policy are concerned I believe we have learned from the experience of the last decade where we must stand. We must be determined not to temporize with inflation. Regardless of what operating guides have been used there has been too great a tendency for too long to take risks on the side of inflation. Since it has proven so hard to halt the process we now know for certain that we should not give inflation a place to start. Economic performance

over time will be better if monetary policy never loses sight of the goal of maintaining the value of money.