Overview: Central Bank Perspectives

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I'd like to share with you some thoughts on three main areas for monetary policy, with the benefit of the exposure they have been given these past couple of days. I will start with some remarks on monetary policy objectives, then comment more briefly on some points related to monetary policy transmission, and end on the vexed question of the international dimension.

My remarks will likely reflect to a degree the fact that Canada is a small "large economy."

The Bank of Canada Act, in its preamble, calls upon the Bank "to regulate currency and credit 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."

Now, this is a long list of objectives for one instrument. I trust, therefore, that you'll be gratified to learn that the preamble continues " . . . so far as may be possible within the scope of monetary action."

And the one thing that I would emphasize in this is that what is very clearly within the scope of monetary action is to preserve the value of money—to strive to provide a solid anchor for nominal values in the economic system.

The dimension of monetary policy is right for this purpose, even if it is not the only public policy affecting aggregate spending. And experience tells us that the value of money will not, realistically, be preserved—broad price stability will not be attained—unless monetary policy is framed and executed in such a way as to give price stability

strategic importance. If monetary or credit aggregates as intermediate targets or information variables help in this endeavor, they should be used.

Price stability is a valuable input into a well-functioning economy. In particular, the persistently popular notion that price stability gets in the way of growth does not, in my view, bear critical scrutiny. Since our economies are based on money, markets, and information, the reverse has to be true.

This truth is, of course, well brought out in those many cases where the domestic monetary system has been badly treated, for whatever reason that seemed good at the time. But even if we discard the extremes, we should not discard the key point. What we can most usefully worry about, and encourage others to think about, now and in the future, is how to assure price stability.

The policy alternative to price stability might be characterized as a policy of making gestures at holding the rate of inflation where it happens to be. Given the element of inertia in cost and price formation, such a rate of inflation might conceivably be held in the short run without necessarily provoking an erosion of confidence. And any inflation slippage can be attributed to bad luck. In practice, this kind of approach is bound to lead to a ratcheting up of inflation and an erosion of confidence, because the risks with inflation are taken systematically in an upward direction. Eventually, of course, the price and cost pressures have to be subdued, but then in a more wrenching manner than would have been needed if price stability had been sought earlier. Furthermore, you don't really get back to where you started, because credibility has been lost in the process, and restoring credibility seems to take longer still.

Any emphasis on the responsibility of monetary policy for price stability does not imply that fiscal policy and monetary policy are two solitudes—just that they have different qualities and are, therefore, not simple substitutes. The stance of fiscal policy can make monetary policy's job easier. And looking at it the other way, there is certainly a feedback from monetary policy to the stance of fiscal policy through monetary policy's effect on interest charges on public debt. Still, the distinction between monetary and fiscal policy, in this age of deficits and public debt overhangs, is a vital one to underline. It emphasizes that monetary policy should not, in the end, be aligned in such a way as to make financing fiscal deficits either easier or more difficult.

Monetary policy's macroeconomic concerns—for monetary expansion and total spending, for the path of inflation, and for price stability—are challenges enough to be getting on with.

In this vein, let me emphasize one thing that is'different about the late 1980s, compared with a period that I think about quite a bit these days, the late 1960s. What is different is that now we have the dubious benefit of having experienced the economic vicissitudes of the 1970s—inflation, recession, stagflation. Many countries' monetary policies in the late 1960s, and very early 1970s for that matter, were not, in retrospect, as unyielding in resisting inflation as they might usefully have been. The reasons are complex, as they were bound to be, and were well-analyzed by Arthur Burns in his Per Jacobsson Lecture, "The Anguish of Central Banking." However, without any doubt, the result was that the inflation problem was allowed to fester. It then got out of hand in ways we all know too well, and that is in .important measure why the 1970s as a whole were such bad economic news. So given this lesson, and given the readiness of monetary authorities to act on it, we can trust that the 1990s will, to that crucial extent, not be like the 1970s.

I have managed to get this far without mentioning the exchange rate. Let me now introduce it.

My first comment is somewhat parochial. Our colleagues across the Pacific seem to see us as more tied in to the U.S. dollar than we see ourselves. This is not the place to speak extensively on the subject, but I should emphasize that in Canada we do operate under a flexible exchange rate regime and find no reason to change at this time. Some among you will recall that Canada, reflecting the world-price volatility of natural resource output, which makes up a sizable part of our total output, and a large share of our exports, was one of the more inveterate floaters through the period of the Bretton Woods regime. Perhaps my counterparts' comments reflect the fact that while the Canadian dollar has certainly moved vis-à-vis the U.S. dollar in recent years, the amplitude has, unsurprisingly I think, not been nearly as great as for the Australian dollar or the Japanese yen.

One of the oldest phrases in the monetary policy hymn book, coming right after "carrying the burden," is the acknowledged need to balance external and domestic objectives. In this spirit, let me recall for you one phrase of our preamble " . . . to control and protect the external value of the national monetary unit . . . " This can, quite

reasonably, be taken to mean that monetary policy should have a special care for the exchange rate. This is at one level reasonable because monetary policy is technically well-fitted to the task—certainly better than fiscal policy. Indeed, there is almost no comparison. And as we have been reminded today, with the best will in the world, exchange market intervention cannot be viewed as playing more than a stopgap role.

However, while recognizing the technical point, I would suggest that we not lose sight of what is really important here. For example, inviting you to consider again our preamble, let me suggest that the surest way to "protect the external value of the national currency unit" is by holding to a domestic monetary framework that protects its domestic purchasing power. Put another way, there cannot really be an exchange rate policy divorced from the fundamental principles driving monetary policy.

I'll come back to some aspects of this question a little later in the context of international considerations, but first some observations on monetary policy transmission.

My first is that the growth in the relative size of the public debt, especially when public debt is heavily weighted with floating rate debt, means we probably have to accept the fact that short-term interest rates may well have to move more, or to hang in more, to have the same impact on aggregate spending as earlier. Furthermore, everything we see indicates that the channels of private sector financing are so much more flexible than they used to be. This also means that interest rates have to work harder than before.

On the other hand, with floating rate debt much more common than it used to be among private borrowers as well, interest rate changes have more leverage on the current decisions of past borrowers and not just on those currently contemplating a spending decision. However, in this general area of private sector debt, let me point out also that the Canadian corporate sector has not seen its indebtedness, and interest rate risk, pushed up in the way that has apparently occurred in the United States and was analyzed yesterday by Ben Friedman.

My final observation on transmission is in a somewhat different category. Since actions of monetary easing or tightening pop out in both exchange markets and money markets, it is quite appropriate at one level at least to regard the exchange rate as part of the monetary

transmission mechanism. Indeed, it is possible to construct a "monetary conditions index" that incorporates both effects, weighted by their estimated shorter- to medium-term impact on spending. One important caveat, especially in the case of Canada, where we have undergone major swings in our international terms of trade reflecting fluctuations in world commodity prices, is that not all exchange rate movements are to be laid at the door of monetary policy. But in any case, it is clear that taking into account the transmission through the exchange market can add measurably to one's view of the strength of the transmission to the domestic economy from monetary policy actions.

However, since exchange rates are ratios between respective national monies, this brings me right up against my final set of preoccupations, those regarding the international dimension.

As I noted at the beginning, the international dimension of monetary policy is, in my view, a particularly difficult aspect to grapple with. And the Kansas City Fed, not ducking the issues, has allocated a good half of the symposium's time to it. Echoing Bob Solomon, perhaps next year the Kansas City Fed will follow up with a symposium on the international dimension of fiscal policy. Let me just note here that it was very appropriate for fiscal policy to be referred to this morning.

The essence of the challenge is easy to catch—"hang together or hang separately;" "never send to know for whom the bell tolls," and so on. Is there really a choice in a strongly interconnected world between policy autonomy and some form of policy coordination? In putting it this way, I am accepting the point, implicit it seems for those choosing the program wording for this conference, that the weaker form exercise of systematic cooperation, which is clearly benign, in practice leads to the stronger form, coordination. At the same time, accepting, like the universe, coordination does not imply that coordination has to be continuous or at the same intensity all the time.

And, of course, most of the practically interesting and important questions lie somewhere between the poles of all-out coordination and all-out autonomy. Furthermore, they have, like all interesting and important questions, given rise to a vast literature, although not to date generating any very robust, that is, all-purpose, analytical conclusions. Still, the coordination process has continued, and will

continue, with, at the very least, the justification that it can help to block off one clearly damaging possibility—that of the industrial world, and therefore everyone else, sliding into a protectionism born of frustration with current account imbalances. While this justification may indeed be compelling, it must also be conceded that it is hardly inspiring.

In any event, let me orient my observations by asking what international economic coordination implies for monetary policy.

I began these comments by emphasizing the crucial responsibility of monetary policy for monetary stability. This was in a national context. The issue that concerns me is how, if at all, monetary stability can be pursued in a global coordination context. And I think that it may safely be added that this is certainly an issue for the 1990s, because it has not been settled in the 1980s.

There may, of course, be many reasons why it has not been settled, not least of which is the inherent difficulty of constructing international monetary arrangements among sovereign nations. It will not be easy in Europe, despite the already existing strong sense of community, as Governor Leigh-Pemberton reminded us yesterday.

The point, however, that I want to dwell upon is more specific. Whatever the theory of international economic coordination, the way the process seems to have worked over the most recent years has been to emphasize the role of monetary policies, policies of achieving particular patterns of short-term interest rate differentials among countries, in stabilizing exchange rates while the necessary fiscal or structural changes are made to address the underlying imbalances.

This may not be so bad, as a kind of short-term fix. As I noted earlier, monetary policy has a comparative advantage over other instruments in exchange rate matters. But there are also very evident dangers that stem from the fact that the approach is essentially relativistic—there is no clear central anchor—and the undeniable fact that the saving-investment imbalances are not being corrected very quickly.

There is another element to this—an element that could, in fact, have implications within Europe, given the intracontinental current account differences, as well as on the broader international scene. Since these saving-investment imbalances are more readily tolerated on a rising tide of demand, the temptation is evidently more than usually present to search for reasons for seeing the economic system

as demand deficient. Clearly the potential of the combination of a relativistic, or non-anchored, approach to monetary policy, with a presumption that the problem to be guarded against most strongly is a shortage of spending, can be a powerful force behind inflation.

From this angle, the broad challenge to monetary policies may be to avoid being put upon—to avoid playing too many roles and finishing up making things worse both domestically and internationally. But, of course, the extent with which this is avoided brings us into areas beyond the strict purview of monetary policy.