David Dodge: The Bank of Canada and monetary policy: future directions

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Toronto Board of Trade, Toronto, Ontario, 20 February 2001.

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It's a pleasure to be here today, in my home town of Toronto, for my first public speech as Governor of the Bank of Canada. And I am particularly pleased to be speaking to the Board of Trade. One of my great delights as a boy was when my father would bring me to the dining room of the Old Board of Trade for lunch in June, if I had done well in school that year! That was my first contact with the Toronto business and financial community—a valuable contact that I have sought to maintain over the years. And it is a contact that I hope to strengthen while I am at the Bank of Canada.

The Bank is well respected both inside and outside Canada for the quality of its professionals and the work that it does. I am honoured to join it and to lead it over the next seven years. My task will be to ensure that we build on the Bank's record to date and that we strengthen and deepen the progress made so far in fulfilling our responsibilities to Canadians.

There are three main issues I want to address publicly as I begin my term: the Bank's contribution to good economic performance; the Bank's contribution to promoting financial stability, both nationally and internationally; and the importance of open and frank dialogue with business, labour, and the general public.

Today, I would like to focus my comments on the first and the third of those issues. I hope to address financial stability as part of my next public speech. And I will conclude with a few remarks on the current economic situation.

The Bank's contribution to good economic performance

As the country's central bank, the Bank of Canada has a commitment to contribute to the economic well-being of Canadians. Fundamentally, this means that we must conduct monetary policy so as to promote sustained economic growth, create conditions conducive to rising investment, employment, and incomes, and encourage a more stable macroeconomic environment. How can the Bank of Canada foster such an outcome?

...low, stable, and predictable inflation

The best contribution that the Bank can make to good economic performance is to preserve confidence in the future value of money. In practical terms, this means that Canadians should not have to worry about the effects of inflation when they make everyday decisions as consumers, business people, savers, and investors. It means that they should be able to go about their affairs confidently, knowing that they can count on their central bank to do whatever is necessary to keep future inflation low, stable, and predictable. In this way, they will be able to make sounder economic decisions, which will lead to better overall economic performance and rising incomes.

Over the past several years, the Canadian economy has experienced low and stable inflation and a strong rate of expansion. Moreover, economic activity has been less variable than in the 1970s and 1980s, even though we had to face some important economic shocks, such as the Mexican and the Asian crises. Employment and personal incomes have risen, and business investment in machinery, equipment, and new technology has increased very substantially, particularly since 1996. At the same time, low inflation has encouraged Canadian businesses to operate more efficiently and to focus on cost control and productivity improvements.

That is quite a change from our experience in the 1970s and 1980s. That experience amply demonstrated what a terrible price the economy and the people pay for high, unstable, and unpredictable inflation. I am thinking here of the increased uncertainty about the future, the distortion of vital signals and information that people rely on to make important decisions, the ups and downs in output and employment, and the waste of valuable economic resources as they are diverted from productive investments to speculative activities.

All of this should be enough to strengthen our collective resolve not to let inflation break out again. And it convinces me that the focus of Canadian monetary policy since the early 1990s on low and predictable inflation as an essential building block of a productive, well-functioning economy has been exactly right.

While low inflation is a necessary condition for good economic performance, it is not sufficient by itself. Other factors are also crucial. Clearly, it is very important that we all continue to work to improve the structure of our economy and the skills of our labour force, and to ensure that our product and labour markets operate efficiently. It is also critical that over the next decade all levels of government continue to focus on reducing their net indebtedness to lessen Canada's vulnerability to external shocks and to prepare for the pressures we will face with the projected decline in our working-age population.

Canada's monetary policy approach: inflation-control targets and a flexible exchange rate

Let me now turn to the role of the inflation-control targets and the floating exchange rate in Canadian monetary policy.

Explicit inflation-control targets were jointly introduced by the Bank and the Government of Canada in 1991. Since 1995, the target has been to hold the trend of inflation inside a range of 1 to 3 per cent, with a focus on the midpoint of 2 per cent.

Inflation targets provide an anchor for policy and an anchor for people's inflation expectations. They supply the Bank with an effective mechanism for assessing and dealing with demand pressures in the economy in a way that reduces fluctuations in output. Here's how this ‘stabilizer' feature of the targets works—bearing in mind that monetary policy actions take anywhere from one to two years to have their full effects on the economy and prices. If total demand was pressing on the economy's capacity to produce, so that the future trend of inflation looked likely to move towards the top of the target range, the Bank would tighten in order to reduce demand and inflation pressures. Equally importantly, in a symmetric fashion, if demand was weak and inflation looked likely to move towards the bottom of the range, the Bank would ease, providing more room for the economy to expand to its production potential.

Moreover, the focus on inflation control can help the Bank to gauge where the economy's capacity to produce really is, especially after periods of widespread restructuring that may have raised capacity above the levels estimated on the basis of past experience. By comparing actual inflation relative to what the Bank expected, we can draw inferences about the limits of capacity, which is important in setting monetary policy.

The basic point here is that the focus on inflation control and the clarity of the targets provide the Bank with an effective mechanism for guiding monetary policy in a way that reduces output volatility and helps to assess the economy's production potential.

What about the exchange rate, how does it fit in all this? If the inflation targets are the anchor of our monetary policy, we need a flexible exchange rate. That much is clear. But in addition, a floating exchange rate allows the economy to adjust to economic disturbances, including fluctuations in external demand for our products. A classic example of this is a sharp movement in the relative price of our exports compared with our imports. In cases like this, movements in the relative value of the Canadian dollar help our economy to adjust more quickly than if the exchange rate did not move. And when the currency does move in response to shocks, the inflation target serves to anchor expectations about its value, thus facilitating the adjustment process.

All this is to say that, in my view, inflation-control targets and a flexible exchange rate have worked well and continue to make sense for Canada in the foreseeable future.

Openness, transparency, and public communications

So far, I have explained why I consider an ongoing commitment by the Bank to low and predictable inflation to be of paramount importance to sustained strong economic performance in Canada. I have also outlined why I think that the Bank should continue to pursue the objective of low inflation within the current framework of inflation targets supported by a floating exchange rate.

All this is fine, you may say, but how will the Bank ensure that it continues to deliver a credible, effective monetary policy?

In a world subject to all kinds of shocks, and with financial markets increasingly more open and globalized, there are no guarantees that monetary policy will be successful at all times and under all circumstances. Still, it helps if those who are affected by policy decisions — the financial markets and the general public — understand what their central bank is doing, and why.

Put another way, central bank actions will likely be more successful if they are better understood and more predictable. Financial markets will then likely respond more effectively, and indeed anticipate, monetary policy actions. And the general public will be better able to take monetary policy into account when making plans for the future. Transparency actually leads to better policy outcomes.

In Canada, the move towards greater openness, transparency, and accountability in monetary policy received a big boost with the adoption of the inflation targets in 1991. The targets established a clear objective for monetary policy. And they set a precise yardstick for measuring the Bank of Canada's success in meeting that objective. The Bank's explicit inflation target and our commitment to achieving it, have provided strong incentives for us to be as candid as possible about the external and domestic developments that are likely to influence inflation and the ability of monetary policy to respond to them.

Under the stewardship of my predecessor, Governor Thiessen, who placed particular emphasis on encouraging greater openness and more effective two-way communications, the Bank made important strides in this area. Today, we provide large amounts of data and commentary on monetary policy in our regular publications and on our Web site. We also discuss the outlook for the economy, inflation, and monetary policy in the *Monetary Policy Report*, the *Updates to the Monetary Policy Report*, and in speeches by Bank officials. Our latest initiative to improve public understanding of the Bank's actions is the adoption of a system of fixed dates for the announcement of decisions on the Bank Rate. The press release that we issue on each of these dates gives our latest assessment of the economy and the rationale for changing or not changing the Bank Rate.

Communication, however, goes both ways. The Bank also needs to understand what is happening in the markets and in all key sectors of the economy and across the regions. We need your input, your information, and your views. We can only formulate good policy if we are good listeners. So I encourage you to talk to us. The phone lines and doors at our regional offices, here in Toronto and across the country, are open.

Recent economic developments

Constructive two-way communication is particularly critical in times of increased uncertainty about the future. So let me now say a few words about how the Bank views the current economic situation.

The Canadian economy began 2001 from a strong base—expanding by an estimated 5 per cent, on average, in 2000 and with solid growth continuing right through the second half of last year despite the slowdown of the U.S. economy.

In our last *Update* to the *Monetary Policy Report*, which was prepared on 23 January and released on 6 February, we revised down our projection for economic growth in Canada this year to about 3 per cent, primarily because of the more abrupt weakening of U.S. economic activity. That projection assumed that the U.S. economy would expand by 2 to 2.5 per cent, on average, in 2001, with a weak first half followed by a relatively strong rebound in the second half.

When we released the *Update* on 6 February, we pointed out that, on the basis of accumulating evidence, it appeared that U.S. economic activity in the first half of the year would be weaker than we had projected on 23 January, even though we still expected a reasonable rebound in the second half of the year. We noted that this posed some near-term risks for the Canadian economic outlook.

But, as we also pointed out then, despite the near-term uncertainties, the Bank remains generally positive about Canada's economic prospects for the year, given productivity increases and rising disposable incomes aided by tax cuts that are working to sustain domestic demand growth.

Of course, there are some sectors and regions of the country that will feel the effects of the U.S. slowdown more than others, for example, those with heavier concentration in the production of cars and equipment, notably equipment related to communications and information technology. Offsetting those, there will be generally solid growth in construction and services, and particularly strong growth in energy-related sectors.

Canadian and international data that have become available since 6 February have not caused us to alter the views outlined at that time.

The Bank will continue to monitor the evolving situation closely, and we will have more to say on the subject in the press release on our next fixed announcement date, 6 March.

Concluding thoughts

Let me now conclude by underscoring my two main messages today.

First, low, stable, and predictable inflation is the best contribution that monetary policy and the Bank can make to a productive, well-functioning economy.

Second, effective dialogue between the Bank, the markets, and the general public is vital to the success of monetary policy.

On both counts, my colleagues and I are determined to carry forward the Bank's commitment to Canadians.