Paul Jenkins: What monetary policy can and cannot do

Remarks by Mr Paul Jenkins, Senior Deputy Governor of the Bank of Canada, to the Canadian Institute of Actuaries, Ottawa, Ontario, 29 June 2006.

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I am very pleased to be here today.

As Canada's central bank, we are committed to conduct monetary policy in a way that fosters confidence in the value of money. This is our primary responsibility. But the Bank has a number of other functions that are very important to economic life in Canada. We promote the safety and soundness of the financial system. We supply quality bank notes that are readily accepted without concerns about counterfeiting. We provide efficient and effective central banking and debt-management services. And, of course, we communicate our objectives openly and effectively as part of our commitment to be accountable for our actions.

Today, I will focus on our main function - the conduct of monetary policy. Specifically, I want to talk about what monetary policy can do and, by implication, what it cannot do.

The Bank's monetary policy mandate

The Bank of Canada Act of 1934 requires us to "*regulate credit and currency in the best interest of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate . . . fluctuations in the general level of production, trade, prices and employment, so far as it may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of Canada*."

This is a fairly broad mandate, with multiple policy objectives. So one can understand why people might think that monetary policy can do more than it really can.

But why does the preamble say "*so far as may be possible within the scope of monetary action?*" I believe that this is how the legislators meant to recognize the complexity of the economy and the fact that not all of the policy objectives in the preamble would be achievable through monetary policy action alone.

As economists, we deal with this complexity by looking separately at different areas and aspects of the economy - industries, sectors, regions, various demand components such as consumption, investment, government spending, etc. Then we add up all this information to get a better overall picture before taking policy action that is appropriate for the economy as a whole. We can use a similar approach with the preamble - pulling apart its various pieces and focusing on them separately.

Long-run economic performance

So let me start with the stated objective of monetary policy, which is "… to regulate credit and currency in the best interest of the economic life of the nation… and generally to promote the economic and financial welfare of Canada."

This means that the Bank should conduct monetary policy so as to provide conditions that will allow the economy to expand in line with its full production potential. By production potential I mean the highest level and growth rate of output that can be sustained over the long run without triggering inflation pressures. Over time, gains in employment and incomes that go with an economy operating at potential will lead to rising living standards, maximizing our national welfare.

What are the key factors that determine potential output? Quantity and quality of labour are certainly among them, as are investment in physical capital (that is, machinery and equipment, buildings, and infrastructure), technological innovation, and managerial and entrepreneurial know-how. So, what role can monetary policy play here? The fact is that none of these factors are determined directly by monetary policy. But the Bank can make an important contribution by instilling confidence in the public, specifically about the future value of money.

This is fundamental. And it is in fact what monetary policy can deliver on a consistent basis. Over the long haul, the single, most direct contribution that monetary policy can make to sound economic performance is by providing Canadians with confidence that their money will keep its purchasing power. When inflation is low and stable, and when we all trust that it will stay that way, market signals are sent and received more clearly. And this leads to a more efficient allocation of economic and financial resources, which in turn helps to achieve our economic potential, in terms of growth in output, employment, and incomes.

Short-term economic fluctuations

So that's the long run. But what can monetary policy do in the short term to "… mitigate by its influence fluctuations in the general level of production, trade, prices and employment," as instructed in the preamble?

Consistent with our mandate, we work to reduce short-term volatility in output and employment. We cannot, of course, hope to do away with the business cycle altogether. But at a minimum, we can conduct monetary policy so that the economic ups and downs are not exaggerated, and in fact smoothed out. Again, experience has taught us that a policy of low and stable inflation works best to stabilize the economy in the short run.

How do we go about achieving a more stable economy through our focus on low and stable inflation? Theory tells us that we can provide confidence in the value of money in one of two ways. By fixing the *external* value of our currency to that of a low-inflation country and letting domestic prices move around in response to shocks. Or, by controlling domestic inflation directly and allowing our currency to float. We cannot target both the exchange rate and *domestic* inflation because monetary policy has only *one instrument* to work with - the policy interest rate. So realistically, it can aim only at *one target*.

In Canada, we have chosen the second option - a policy framework that combines an explicit target for domestic inflation and a flexible exchange rate. This allows us to conduct an independent monetary policy that both provides confidence in the value of money and helps to stabilize the economy in response to shocks.

Let me expand on this latter point. The Bank operates *symmetrically* around an inflation target of 2 per cent - caring equally about inflation falling below or rising above that target. And so we take action to lower, or raise, our policy interest rate to bring inflation back up, or bring it down, to 2 per cent over the medium term. This symmetric approach to inflation control helps keep the economy expanding near its trend growth of potential.

A floating exchange rate also contributes to stabilizing output around potential. As a very open economy and as major producers of commodities, we are very much affected by large swings in the world demand and the prices for our products. Such swings cause our terms of trade - the prices we get for our exports relative to the prices we pay for imported goods - to move around a lot.

Because wages are sticky in the short run, a fixed exchange rate would force the economy to adjust to terms-of-trade shocks mainly through changes in output and employment - and the result would be exaggerated swings in economic activity. But an exchange rate that floats will absorb some of the movements in relative prices and, in this way, help the economy adjust with less overall fluctuation in output and employment.

All told, the inflation target and our flexible exchange rate work well together - indeed reinforcing each other - to provide an effective stabilization mechanism for the economy.

This pretty much covers what monetary policy can realistically do to support economic growth in the long run and to smooth out short-term fluctuations.

Other things people expect monetary policy to do

Let me now give you a flavour of the specific concerns and problems monetary policy is often asked to address directly - and, for the most part, cannot. These no doubt will sound familiar as the Canadian economy has been going through a period of adjustment during which the challenges for many industries and their employees have become more intense than usual.

Moderate movements in the exchange rate

Topping the list of concerns are exchange rate movements. Any significant upward or downward movement in the Canadian dollar is virtually guaranteed to bring forth pleas for central bank action to, at least, moderate the movement and lessen its effects on the economy.

We went through this in 1997-98, when the Canadian dollar depreciated markedly in response to the decline in world demand and commodity prices. And since 2003, we have repeatedly been urged to deal with the reverse situation - that is, a sharp appreciation of our currency, primarily reflecting strong world demand and high prices for energy and other commodities.

In response, we have stressed that movements in our currency are largely a *reflection* of market forces at work in the world environment in which Canada operates. In other words, the changes that we have seen in recent years represent a global reality. We simply cannot wish them away. And they will continue, regardless of the level of our policy interest rate and regardless of whether we have a fixed or a floating exchange rate. Monetary policy cannot change the reality of these developments. Nor can it somehow eliminate the need for our economy to adjust to global forces and trends that are fundamental in nature.

To be clear, this is emphatically not to say that, in setting policy, we won't take into account the effects that any adjustments related to global change - including the reallocation of resources across sectors - are likely to have on the production capacity of our economy. Nor does it say that monetary policy will not take into account any effects that global developments and relative price movements will have on aggregate demand for Canadian products. Indeed, before announcing our interest rate decisions eight times a year, we assess all of the factors that have implications for the balance of demand and supply in the economy, and thus for the conduct of monetary policy. Exchange rate movements *are* among those factors.

But I must clarify that the response of monetary policy to exchange rate movements depends on the reason for those movements. More importantly, it depends on the overall net effect that such movements and other developments are expected to have on aggregate demand in Canada.

In general, there are two types of exchange rate movement. The first reflects a direct real change in the demand for Canadian products stemming from a strengthening (or weakening) of world economic activity and any associated changes in the prices of those products. The second type does not reflect a direct change in the demand for Canadian products. Instead, it may reflect a portfolio adjustment - in favour of, or away from, Canadian financial assets. Or it may be part of a broader realignment of major currencies that is required to resolve the global imbalances (by which I mean the persistent large U.S. current account deficit mirrored by large surpluses elsewhere, notably in Asia and in many oil-exporting countries).

Let me now relate all this more closely to our recent experience in Canada, and explain how monetary policy can be expected to respond to these different types of currency movements.

Consider the sharp appreciation of the Canadian dollar since 2003. This movement has largely reflected strong world demand and prices for our energy and non-energy commodities. In this case, the higher Canadian dollar has been working to dampen the initial increase in demand for our products and to encourage a rotation of economic activity towards commodities. To the extent that the dampening effect of the appreciation on aggregate demand exactly offsets the initial increase in demand, thereby keeping overall supply and demand in balance, there would be no need for monetary policy to respond.

Now, consider an upward movement in the Canadian dollar that reflects financial market developments that have little to do with an increase in the demand for Canadian products. Movements reflecting a general weakness of the U.S. dollar against major floating currencies, related to the large global imbalances, are of this type. An appreciation of the Canadian dollar reflecting these factors would have a dampening effect on aggregate demand in Canada. So, if such a movement persisted, other things equal, there would be a need for offsetting monetary policy action.

Of course, in practice, it is difficult to gauge precisely the relative importance of these two types of movements. Often, they may be concurrent, making it particularly challenging to sort out the implications for the economy and for monetary policy.

Reduce differences in sectoral and regional economic performance

I will now turn to another, not unrelated, issue that some Canadians expect us to address. And that is, the notable differences in performance we now see in certain sectors and regions of our economy.

To put these trends in perspective, it is important to understand what drives them. The key factors at play here are the strong world demand and prices for energy and non-energy commodities, and the decline in the prices of many manufactured goods, but especially consumer goods, because of strong global competition.

These developments and the differing economic circumstances across regions are the reason why some people argue for a monetary policy that is differentiated by region.

The Bank's response is that all Canadian regions are part of the same currency union; so it is simply not possible to deliver different interest rates or exchange rates to different parts of the country. Monetary policy is *national* in nature and scope, with each region having its *relative weight* in the aggregate economy. This means that our monetary policy actions have to be directed at balancing aggregate demand and supply in the economy as a whole in order to keep the national rate of inflation on target. Thus, monetary policy cannot be used to eliminate or to smooth out differential growth rates in specific sectors or regions.

But even if this were possible, there is another good reason why monetary policy should remain focused on the aggregate economic picture. As I said before, the movements we now see in relative prices reflect *real* changes in the global economy. Through these relative price movements, markets are essentially telling us that there has been a fundamental change in the type of products the rest of the world wants to buy from us. So, we have to adapt and shift production towards those goods and services most in demand. Monetary policy action (or indeed any other policy action) that would thwart those market signals and impede the adjustment process would not serve Canada well over the long run.

Adjustment is never easy or painless. And the Bank fully appreciates the difficulties that Canadian companies, particularly manufacturers and their employees, are currently facing. Monetary policy can help the adjustment process by keeping inflation at 2 per cent and the national economy operating close to capacity. When inflation is low and stable, businesses can read price signals more clearly, which helps them to make informed, sound decisions. And when the economy is operating at capacity, production resources can be more effectively reallocated from sectors where demand is relatively weak to where demand is relatively strong.

Recent economic developments

Let me now say a word about the economy. Since the Bank's last fixed announcement date on 24 May, a number of economic indicators have been published. Some of the new data have been stronger than expected, others have been weaker. But on balance, the economic projection we set out in our April *Monetary Policy Report* appears to be reasonable.

And as we said on 24 May, we will continue to monitor economic and financial developments in the global and Canadian economies relative to the projection in our April *Report*. But it is important to remember that, in setting monetary policy, we always try to develop a complete picture of the economy. This way, we do not unduly react to any single piece of information. In line with this, as we lead up to our next decision date of 11 July, we will be looking to put all of the pieces together into a complete picture. And we will present that picture in our *Monetary Policy Report Update* two days later.

Concluding thoughts

This brings me to the end of my remarks. Let me then summarize my key points.

Clarity about what monetary policy can, in fact, deliver is fundamental to our job as central bankers. Experience in Canada and around the world has taught us that preserving confidence in the value of money is the unique contribution that monetary policy can make to sustained economic performance and rising standards of living.

Our commitment is to keep inflation low, stable, and predictable. This is the best way for monetary policy to help output and employment remain strong, and to facilitate the adjustment of our economy to global forces.