David Dodge: The conduct of monetary policy in the presence of economic shocks

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the National Association for Business Economics, Washington, D.C., 26 March 2002.

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Globalization - the trend towards greater economic integration around the world - has brought important benefits to us all. It has boosted world trade, opened up access to sources of global finance, and facilitated the diffusion of far-reaching technological advances in transportation, communications, and information processing.

A more integrated world also tends to speed up the transmission of economic and financial disturbances across national frontiers and increase their spillover effects. Over the past decade, monetary authorities around the world have had to deal with a number of such disturbances. In 1994-95, we had the Mexican financial crisis. In 1997-98, we had the Asian and Russian crises. And last year we had the global economic slowdown, which was greatly exacerbated by the tragic events of 11 September in the United States.

To be sure, the conduct of monetary policy has become more complicated and challenging - but not impossible or ineffective. In fact, I would argue that in most countries, including Canada, monetary policy has been very effective in mitigating the impact of global shocks on the domestic economy.

Today, I would like to discuss how Canadian monetary policy has been conducted in the presence of economic surprises or shocks - both domestic and external. I would also like to add some thoughts on the issue of the appropriate monetary response, nationally and internationally, to common economic disturbances.

Economic surprises and Canada's inflation-targeting approach to monetary policy

To put things in context, let me start by providing a bit of background about Canada's inflation-targeting system.

When it comes to conducting monetary policy, our formal mandate is not dissimilar to that of the U.S. Federal Reserve or to those of many other central banks. The preamble to the Bank of Canada Act enjoins the Bank "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 Canada."

We have chosen to achieve the objectives of the Act through a policy focused on inflation control. This is because we believe that a monetary policy that consistently delivers low, stable, and predictable inflation is likely to be the greatest contribution that the central bank can make to sustained growth in output and employment.

Since 1991, the Bank and the Government of Canada have agreed to pursue low inflation within a framework based on an explicit inflation target. The current agreement, which runs to the end of 2006, aims at continuing to keep inflation at the 2 per cent target midpoint of a 1 to 3 per cent range over the medium term.

There are two elements I would like to underscore here - the emphasis we place on the 2 per cent midpoint as our *target* and the emphasis on the *medium term*. The significance of the first will become apparent in a moment. As for the focus on the medium term, it has to do with the fact that monetary policy actions take anywhere between one and two years to have their full effects on output and inflation. So, when setting monetary policy, we have to consider what will be the effect of actions we take today on the economy and on inflation several months down the road.

In practice, setting monetary policy means raising or lowering interest rates to maintain a balance between the demand for goods and services and the economy's capacity to supply those goods and services. As long as there is a balance between demand and supply, inflation will remain stable.

When we look at it this way, the rate of inflation is more than a number that tells us how the purchasing power of the average consumer is holding up. It is also a measure that the central bank can use to gauge how close to capacity the economy actually is. The presence or absence of inflationary pressures can tell us a lot about the balance between demand and supply. Our objective is to help the economy achieve potential output - that is to say, the maximum level of output and employment that can be sustained over the medium term without putting upward pressure on inflation.

Over the past decade, a monetary policy based on an inflation target has helped us realize important economic benefits, particularly solid gains in output, employment, and incomes. It has also helped us to avoid the boom and bust cycles of the past, even in the presence of important surprises. This is because the forward-looking framework of inflation targeting works like an *automatic stabilizer* for the economy, with interest rates being raised or lowered in response to expected movements in future inflation relative to our 2 per cent target midpoint. For the most part, such movements reflect changes in the pressure of demand on potential output.

Thus, our focus on the 2 per cent *target* midpoint allows us to operate monetary policy *symmetrically* in response to surprises in demand. And this helps to reduce the ups and downs of the business cycle and to promote sustained economic growth.

The forward-looking framework of inflation targeting also allows us to handle temporary supply shocks, so long as these shocks do not feed into inflation expectations. The monetary credibility gained through our inflation-targeting system means that changes in volatile energy or food prices no longer feed into other prices and into wages the way they did in the past. That is why, unlike some other central banks, we focus on the underlying trend of inflation, and use as our operating guide a core rate that excludes the eight most volatile components of the consumer price index (CPI) and the effect of changes in indirect taxes on the remaining components. Such a measure of core inflation is a better predictor of future inflation than the total CPI. With this approach, monetary policy responds only to fundamental trends and does not turn temporary price shocks into something that can destabilize the economy.

How the Bank of Canada deals with international disturbances

So far, I have described how our monetary policy framework, based on an inflation target, helps us respond to, and deal with, important surprises that have an impact on our economy.

I would now like to say a few words about how the Bank of Canada incorporates external economic shocks into its decision-making process.

Canada is a small and very open economy. We export more than 40 per cent of what we produce and, in general, we are price-takers (that is to say, the prices of what we buy and sell abroad are largely determined in world markets). Thus, the external environment is extraordinarily important to us.

As part of its decision-making process, the Bank has always followed world economic developments very closely. The Bank's Governing Council starts its deliberations by looking at changes in the external environment. In particular, we focus on economic prospects for the United States and the major overseas countries, as well as on world commodity prices. Then we look at the implications of all this for aggregate demand in Canada. Next, we focus on domestic demand, taking into account anecdotal information gathered by our regional offices, as well as trends in credit, money, and financial markets. All this feeds into our decision on interest rates.

Let me try and relate this to recent experience. Take last year, for example. Through the first half of 2001, we moved to loosen monetary policy at a measured pace. This approach was based on a view that the economic slowdown in the United States, although sharper than initially expected, would lead to only a moderate slowing of growth in Canada.

By midsummer, however, evidence had begun to accumulate that the slowdown in the United States and elsewhere would be deeper and last longer than anticipated. Because of this, and because of signs that domestic demand in Canada was softening, we came to the conclusion, as we looked ahead, that our economy would be operating substantially below potential for some time, and that inflation would fall below target. The extraordinary uncertainty introduced by the 11 September terrorist acts in the United States pushed the recovery further back, so that, even under a relatively optimistic scenario, our economy was expected to be operating at levels below capacity well into 2003. That is why, as of mid-September and through to the end of 2001, we stepped up the pace of interest rate reductions.

As I said in my last speech in Paris earlier this month, more recently, there have been encouraging signs of a turnaround in the world economy, and the latest economic indicators for Canada show that a recovery is indeed underway.

What should be the international policy response to common shocks?

Having discussed how Canadian monetary policy has been conducted in the presence of economic shocks, I would now like to broaden the scope of my presentation somewhat by providing some thoughts on the appropriate international policy response to common shocks.

Clearly, it is very important that individual central banks do their best to assess the implications of such shocks and that they respond promptly, within their respective monetary policy arrangements, to mitigate the effects on their own economies and on the world economy as a whole.

But given the increasing interconnectedness of national economies, a legitimate question is whether there should not be greater policy cooperation, or even concerted action, in response to major common shocks.

Here's how I respond to that question, and I will certainly be very interested to hear the views of others.

First, let me note that we central bankers greatly value our bi-monthly meetings at the Bank for International Settlements, and our regular meetings at the International Monetary Fund, where we systematically discuss the world economic situation. So there is an important process in place for exchanging information on what is going on in our domestic economies as well as globally.

Now, when it comes to policy *action*, I would argue that the best way to deal with common shocks, such as last year's global economic slowdown and the 11 September events, is prompt response by individual central banks. This response should be based on individual circumstances. But it should also take into account what is happening elsewhere and what fiscal and monetary authorities around the world are doing to deal with the situation. Otherwise, there is a risk that individual central banks will either under- or overreact, with potentially undesired consequences for the world economy.

But the way that I and a number of my central bank colleagues around the world see it, prompt action does not mean concerted action. Indeed, to be clear, I would say yes to co-operation; yes to exchange of information; and yes to taking into account what is happening elsewhere. But I do not believe that formal coordination or concerted action are necessary.

Provided that there is a good collective appreciation of the significance of certain global shocks, there is no reason why individual monetary authorities should not be the ones to take action tailored to their own domestic circumstances to deal with the implications.

For example, in the days immediately after 11 September, there was no formal joint decision-making, although the major central banks did exchange information, leading to a shared appreciation of the grave risks for the world economy. And policy action was taken quickly—although not simultaneously and not by equal amounts.

Judging from the signs of economic recovery we are now seeing around the globe, I would say that this process of international consultation and prompt policy action by individual central banks worked well to help us weather the very difficult circumstances we all faced last year.

I would also like to highlight the significance of personal contacts among central bankers. Regular contacts build trust. And trust is very important when we have to act quickly, as we did last September to deal with the pressures faced by financial institutions, markets, and infrastructures immediately following the terrorist attacks. For example, in Canada, we were able to move very quickly and secure a temporary increase of our existing swap facility with the U.S. Federal Reserve. This arrangement was made to facilitate the functioning of Canadian financial markets and to provide liquidity in U.S. dollars to Canadian banks to settle their U.S.-dollar transactions, if the need arose.

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Let me conclude. Last year, as in previous episodes over the past decade, Canada's inflation-targeting approach to monetary policy allowed the Bank to respond quickly and successfully to buffer the effects of worldwide shocks on our economy.

In a very open and increasingly integrated world, it is important that individual central banks take prompt action, based on their own circumstances and needs, but taking also into account what is going on outside their borders. Such action has the best chance of mitigating the effects of global shocks on their economies and, by extension, on the international economy.

When we all do what is right for our domestic economies, we are also most likely to do what is right for the world economy.