

Zeroing In

Canadian Monetary Policy

Milton Friedman's view of the self-stabilizing process at work in the macroeconomy has had an important impact on Bank of Canada policy-makers, who believe that their major task is minimizing inflation. In the words of recent Bank governor Gordon Thiessen:

There is no question that monetary policy has a short-term influence on demand, production, and employment, but surely the notion of a long-run inverse tradeoff between inflation and unemployment has been widely discredited. In the long run the impact of monetary policy is on inflation, and the central bank must set its objective in terms of the variable it can expect to influence.¹

Long-Term Interest Rates

The Bank's emphasis on reducing inflation is strengthened by its view (not shared by all economists) that long-term interest rates are increasingly determined by global forces.² Important factors include the global demand and supply of loanable funds, which set a global equilibrium interest rate, and Canada's risk premium, which is the extra interest rate demanded by lenders to make up for the uncertainty associated with Canadian economic prospects.

Canada's risk premium is based partly on fiscal policy and partly on political conditions. For example, a rise in Canada's government debt or heightened uncertainty over Canada's political future lead international lenders to demand a higher return on Canadian-dollar bonds to make up for the added risk of future repayment difficulties and volatile financial markets. Inflation may also affect Canada's risk premium. If lenders expect Canada's inflation to stay low, they accept not only a smaller inflation premium on *nominal* interest rates but also lower *real* interest rates, since low inflation enhances stability in financial markets. If this analysis is valid, then the main way the Bank can reduce long-term real interest rates (since fiscal policy and political conditions are out of their hands) is by reducing inflation.

Zero-Inflation Policy

Given this view of contemporary monetary policy, Thiessen's predecessor, John Crow, adopted what he called a zero-inflation policy, though a better term might be a "low inflation" policy. In 1991, specific targets for inflation (based on rises in the CPI) were introduced—3 percent by the end of 1992, 2.5 percent by the middle of 1994, and a range between 1 to 3 percent by 1995. The 1 to 3 percent range is now the Bank's official policy, and it is likely to be continued for the foreseeable future.

While the Bank has consistently met its inflation targets, opinions differ on the wisdom of this policy. Some economists oppose what they see as the Bank's single-minded obsession with minimizing inflation. For these economists, the Bank does have a role to play in reducing unemployment, especially during economic contractions. They also criticize the Bank's timing in its initial pursuit of low inflation, arguing that unemployment was pushed up just when the economy was least able to withstand it—during the 1990–1991 recession and the fragile recovery that followed.

Supporters of the Bank's strategy contend that low inflation could not have been reached without a short-term rise in unemployment, and they credit the Bank with having promoted the stability and competitiveness of the Canadian economy. In the long run, these economists say, lower interest rates caused employment and real output in Canada to be higher than otherwise because of the Bank's inflation medicine.

Another issue has also entered this debate—the effects of the Bank's zero-inflation policy on government debt. By pushing down output and employment, the critics of the policy say, the Bank caused tax revenues to decline for all levels of government. A vicious cycle was created in the early 1990s, with the sagging tax intake for Canadian governments leading to ever-higher budget deficits, debts, and debt charges. Supporters of the Bank admit that the short-term effect of the zero-inflation policy was to increase government deficits and debts, but they contend that lower real interest rates resulting in the long run from the Bank's policy are now having a dampening effect on government deficits and debts.

The Monetary Conditions Index

To ensure that it meets its long-term targets, the Bank of Canada uses an intermediate policy tool

to help it react quickly to day-to-day trends in financial markets. The monetary conditions index (MCI) incorporates two variables: the Canadian short-term interest rate and the external value of the Canadian dollar. A change in either variable shifts aggregate demand in the opposite direction. For example, a lower short-term interest rate raises both investment spending and the consumption of durable items, while a lower Canadian dollar stimulates net export spending. In either case, aggregate demand shifts rightwards, increasing real output as well as the price level. In contrast, a rise in either the short-term interest rate or the Canadian dollar causes aggregate demand to shift leftwards, putting downward pressure on real output and the price level.

The representative interest rate in the MCI is the rate on three-month corporate paper, which is short-term debt issued by large Canadian corporations. The exchange rate is measured using a trade-weighted index of the Canadian dollar's value against the six currencies of the other members of the so-called Group of 10 (G-10) countries, who cooperate on issues connected with banking regulation. Confusingly, the Group of 10 is made up of 11 nations—the members of G-7 (the United States, Japan, Germany, France, the United Kingdom, Italy and Canada) plus the Netherlands, Belgium, Sweden, and Switzerland. The index of its six currencies (in addition to the Canadian dollar) is known as the C-6 index.

A change in the MCI is found by calculating changes in the corporate paper rate and the C-6 index, which are weighted on the basis of their estimated effects on aggregate demand. A percentage point shift in the corporate paper rate is given a weighting of 1, while a 1 percent movement in the C-6 exchange rate has a weighting of one-third. Changes in the MCI are, therefore, similar to percentage-point changes in interest rates, with a drop in the index being expansionary and

a rise being contractionary, regardless of which element of the index varies.

For example, a 1-percentage-point increase in the corporate paper rate results in an automatic rise of 1 percentage point in the MCI. Alterations in the trade-weighted C-6 index depend primarily on fluctuations in the value of the Canadian dollar in terms of the American dollar, whose weight in the C-6 index is about four-fifths. So, a 1.25 percent drop in the Canadian dollar's exchange rate against the American dollar will cause the C-6 index to fall by 1 percent, which will lead to a one-third percentage-point drop in the MCI.

After mapping out desired values for the monetary conditions index several months into the future, on the basis of inflation targets and projected economic conditions, the Bank conducts monetary policy to meet these MCI values. For example, unexpected signs of a weaker economy lead the Bank to lower its desired MCI so that a fall in short-term interest rates and/or the Canadian dollar's value can help stimulate aggregate demand and real output.

The MCI's use is important in understanding why the Bank of Canada varies short-term interest rates. Once the prevailing exchange rates are taken into account, the desired MCI range translates into the Bank's target band for the 50-basis-point target range for the overnight rate, with the target rate being set at the midpoint of this range. The range is then adjusted whenever the exchange rate undergoes a significant movement or more economic conditions change.

Notes

1. Gordon Thiessen, "Uncertainty and the Transmission of Monetary Policy," the HERMES-Glendon Lecture reprinted in *Bank of Canada Review*, Summer 1995, p. 51.

2. *Ibid.*, pp. 45-46.

1. Explain how each of the following events would affect the risk premium on long-term Canadian-dollar bonds:
 - a. Canada's federal government introduces a large tax cut
 - b. A constitutional accord in Canada improves the prospects for national unity
 - c. Canada's inflation rate rises against its American counterpart
2. Using the concepts outlined in the chapter, explain the statement by Gordon Thiessen quoted in this article.

3. If there are unexpected signs of an upcoming boom in the Canadian economy, how will the Bank of Canada adjust its desired value for the monetary conditions index?
4. (Policy Discussion Question)
Using *The Benefits of Low Inflation* (<http://www.bankofcanada/backgrounders/bg-i2.htm>) as a guide, explain what benefits the Bank of Canada sees in adopting low inflation as its primary policy goal.



<http://www.bankofcanada/english/backgrounders/bg-i2.htm>