# The Great Canadian Disinflation

*The Economics and Politics of Monetary Policy in Canada, 1988–93*

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# Chapter 1

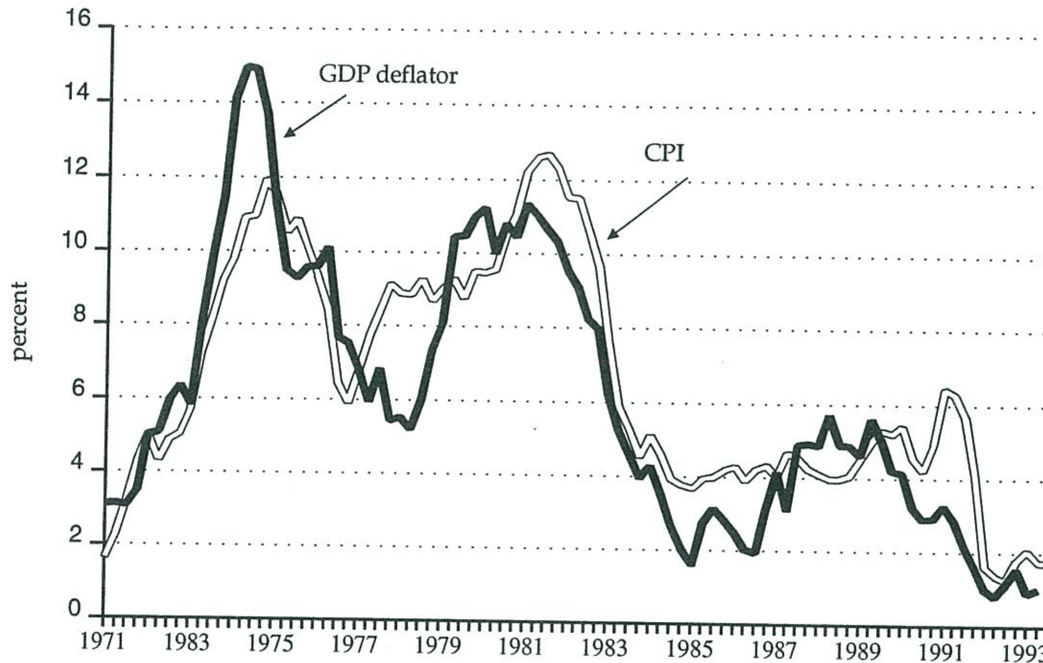
## *Overview*

Falling inflation has been a worldwide phenomenon over the past five years. If those recent improvements are sustained, historians will record that the early 1990s saw the end of a quarter-century of generalized inflation throughout the developed world. Canada has participated fully in this process — indeed, with greater vigor than many other countries — primarily through a Bank of Canada policy of working toward price stability.

The change has been striking (see Figure 1). During the 1970s, the annual rates of increase in the consumer price index (CPI) and the gross domestic product (GDP) deflator — the two standard measures of the country's inflation — were typically in the 10 percent range. Inflation did fall sharply following the 1981–82 recession, but the mid-1980s saw a halt and then a reversal in this movement. By 1988, it was clear that this setback was not simply a temporary phenomenon. Increases in the GDP deflator had moved into the 4.5 to 5.0 percent range by mid-1988, while the year-over-year increase in the CPI was back above 5 percent. Inflation was clearly on the rise again. Yet today (fall 1993), a mere five years later, Canada's inflation rate is in the 0 to 2 percent range. Moreover, it shows no sign of a sustained rebound. The Bank of Canada's objective of stability in the general price level appears to have been all but attained.

This transition has clearly been a major event in Canada's recent macroeconomic history: an intentional policy shift by the Bank of Canada in pursuit of the gains that both economic theory and historical experience suggest may be achieved by eliminating inflation. In this sense, we regard it as a major experiment in macroeconomic policy. This monograph attempts to tell the story of that experiment.

**Figure 1:** ***Inflation in Canada, 1971–93***
(annual changes in the CPI and the GDP deflator)




## Highlights of the Study

A specific purpose of this study is to highlight some key lessons, economic and political, that emerge from the recent Canadian disinflation. Anticipating our conclusions somewhat, four of the most critical lessons are listed here.

### "Made in Canada" Disinflation

An important economic lesson arises from the fact that, notwithstanding parallel developments abroad, Canada's lower inflation has not been imported. It is "made in Canada." Canadian experience differs markedly in this respect from that of those Western European countries that seem to have lowered inflation during the 1980s by pegging their currencies to the German mark. Canada's exchange rate is largely market determined, with Bank of Canada interventions directed toward smoothing its movements rather than aiming at a specified level.

Thus, Canada's experience provides clearcut evidence that, even in a small and extremely open economy, monetary discipline does not have to be imposed externally by way of a fixed exchange rate to be effective. Indeed, given the troubles that the European Exchange Rate Mechanism has encountered as various member countries have found different policies to be domestically desirable, Canada's record suggests that monetary discipline is likely to prove durable only when it is imposed from within.

## The Centrality of Monetary Aggregates in Monetary Policy

The Canadian experience has provided a technical experiment in the execution of monetary policy. Economists' debate over the significance of monetary aggregates in the transmission of central bank policy to the economy has ebbed and flowed over the past 20 years, with the monetarists, who regard them as critically important, having apparently received the worst of it since the late 1970s. In Canada's case, this ebb and flow was encapsulated in the adoption and later abandonment of targets for the narrow monetary aggregate, M1. The policy depended on the existence of a stable relationship between M1 growth and inflation, a relationship that apparently broke down in the early 1980s.

Canada's experience over the past five years, however, suggests strongly that the growth rates of monetary aggregates can and should serve as central indicators and perhaps as targets for the Bank of Canada. Changes in the growth of M1 consistently signaled upcoming changes in output and, after a longer lag, inflation. Throughout the period, M1 growth was, in this sense, an excellent indicator of monetary conditions. The broader aggregates, M2 and M2+, which the Bank repeatedly has acknowledged to be indicators of key importance in the design of policy, have also behaved in a manner consistent with monetarist theory. Preceding the fall of inflation was a fall in money growth, first and most markedly in M1 and subsequently in these broader aggregates.

Although there are indications that the Bank of Canada took the behavior of the monetary aggregates more seriously as disinflation progressed, it seems fair to say that it has usually accorded them little causative significance, believing that they simply reflect movements in variables determining demand for money. Hence, on more than one occasion, it has been too slow to react to monetary signals of the state of the economy in general and of the consequences of its own past actions in particular. In our view, the result has been that the road toward price stability in Canada has been more bumpy than was necessary.

## Slowly Changing Expectations: Seeing Is Believing

Canada's recent experience provides evidence on two related subjects much debated among economists: the importance of expectations in modifying behavior in response to a shift in policy, and the extent to which policymakers can generate changes in expectations to ease the pain of transition. The rational expectations school of economists says that if a shift to anti-inflationary policies is sufficiently credible, individuals and businesses will adjust their behavior accordingly, thereby decreasing the output and employment losses associated with reducing inflation. Canada's experience shows how difficult establishing this credibility can be in the real world.

Extensive earlier experience with inflation and unfulfilled Bank of Canada promises to eradicate it, combined with the gradualness of the shift in the conduct of monetary policy after 1988, seem to have led economic forecasters in particular and Canadians generally to discount the Bank's expressed intent. Although this fact is disappointing to those who hoped for an easy transition to lower inflation, it bolsters the case for price stability as a policy goal: the slow adaptation of expectations to new states of the world is one of the key reasons why continued but variable inflation is likely to be harmful and why it is important to establish a firm, long-run anchor for expectations.

## The Bank of Canada's Autonomy

The experience of the past five years sheds considerable light on the current state and possible future evolution of relations between the Bank of Canada and the federal government. The target of price stability was initially set not by elected politicians but by the governor of the Bank of Canada, an appointed official. It had been in place for three years before it received the explicit and unambiguous endorsement of the federal government. The fact that it was the governor of the Bank of Canada, rather than, say, the minister of finance, who first articulated the price stability target has meant that an interesting political experiment about the nature and significance of central bank autonomy has run alongside the technical one of using monetary policy to eliminate inflation.

The Bank's energy in pursuing its stated aims using preannounced means and the visible effectiveness of its policies in bringing inflation down have done much to create credibility for it. That credibility, in turn, appears to have enhanced the Bank's autonomy in carrying out its day-to-day policies. Moreover, although the *Bank of Canada Act* leaves no doubt as to the primacy of the elected government in the event of an irreconcilable conflict, the Bank's reinforced credibility may well strengthen its position in disagreements insufficiently serious to precipitate formal action on the part of the government.

One may also speculate that we are witnessing the growth of a new general view about the powers and appropriate aims of monetary policy in Canada. This consensus, which sees inflation as the only variable over which monetary policy has long-run control and insists that the main aim should be to contain or eliminate it, is evident in the 1992 tripartisan Manley Report on the mandate and governance of the Bank of Canada.[1] If this agreement holds, it may mark a major step toward a new political framework for central

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1 Canada, Parliament, House of Commons, Standing Committee on Finance, Subcommittee on the Bank of Canada, *The Mandate and Governance of the Bank of Canada* (Ottawa, February 1992).

banking, one in which the elected government sets a long-ter inflation target (likely a very low or zero one) and leaves the centr bank free to achieve it. Such a regime would almost certainly deliv sounder and more stable monetary policy than the regime th prevailed over the previous quarter-century.

## Reader's Guide

The rest of this study is divided into four parts. Part I provides general overview of the main problems addressed. Chapter 2 r views the costs of inflation, both the relatively straightforward ec nomic costs, such as deadweight losses and redistributional effect and more complex problems, such as the costs that arise whe uncertainty about politically motivated changes in inflation rat and central bank policies becomes important in citizens' thinking. also discusses the insights of economic theory into the costs reducing inflation and asks whether some of them are permaner Chapter 3 makes the case for a central bank accountable to th electorate for the overall direction of policy but autonomous in i day-to-day operations. It deals briefly with the history of the Bar of Canada and shows how it had been moving toward great autonomy even before the 1988–92 disinflation.

Part II provides some theoretical background to the study monetary policy in Canada. Chapter 4 analyzes the connectior between money and inflation. It also describes the transmission monetary impulses to the economy in Canada, highlighting th apparently crucial role played by the narrow aggregate, M1. Chapte 5 discusses the respective roles of the foreign exchange rate an interest rates in this transmission and shows how various intere rate spreads can be used in gauging monetary conditions in th economy and the policy stance of the Bank of Canada.

Part III describes the disinflation experiment itself. Chapter deals with Canadian economic conditions and central bank state ments in the immediate runup, showing how the events of th previous decade, particularly the excessive monetary ease of 198

about the interaction between the price stability program and fis
and trade policy. On the benefit side, we note gains on the redistril
tive front. Finally, we marshal evidence from professional foreca
of inflation and interest rates to argue that the changes in expec
tions that may produce higher levels or faster growth of incomes a
output are coming about only slowly.

Chapter 11 addresses some institutional and technical issu
related to the question of how best to remove uncertainty abo
future inflation and central bank policies from economic decisio
making. Chapter 12 recapitulates the main conclusions of the stu