

Two Percent Target

**Canadian Monetary
Policy Since 1991**



C.D. Howe Institute



David E.W. Laidler and William B.P. Robson

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Two Percent Target

*The Context, Theory,
and Practice of
Canadian Monetary Policy
since 1991*

*David Laidler
William B.P. Robson*

Policy Study 38

C.D. Howe Institute

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Contents

<i>Foreword</i>	vii
<i>Preface</i>	ix
PART I: Introduction and Overview	
1 <i>Canadian Monetary Policy and Its Background since the Early 1990s</i>	3
A Brief Macroeconomic History	3
Explaining the Situation in 1990	10
The Monetary Policy Regime in the 1990s.....	12
The Evolution of Monetary Policy Debates.....	16
Outline of the Rest of the Book	22
PART II: Central Banking and the Canadian Economy	
2 <i>The Bank of Canada and Canada's Monetary System</i>	27
Money, Central Banking, and the Economy	27
The Bank of Canada	32
3 <i>The Economics of Monetary Policy</i>	43
What Monetary Policy Can and Cannot Do	43
How Monetary Policy Affects Aggregate Demand	54
4 <i>Monetary Policy, Fiscal Policy, and Politics</i>	69
Interactions between Monetary and Fiscal Policy	69
Credibility, Transparency, and Accountability	75
PART III: Canadian Experience since the Beginning of the 1990s	
5 <i>The Context and Consequences of Monetary Policy Actions</i>	89
The International Background	89
Canada's Recession and Recovery after the Early 1990s	102
6 <i>Adjustments to the Policy Framework</i>	113
The Basic Framework	113
The Development of the Bank of Canada's Operating Procedures	119
Key Themes in the Development of Monetary Policy since the Early 1990s	133

PART IV: Lessons from Recent Canadian Experience

7	<i>Assessing the Experience</i>	137
	Low Inflation and the Monetary-Fiscal Mix	137
	The Effects of Low Inflation	139
	The Vexed Question of the Exchange Rate	155
	Concluding Comment.....	173
8	<i>Issues for the Next Decade</i>	175
	Options for North American Monetary Integration.....	175
	Fine Tuning the Current Monetary Order	184
9	<i>Concluding Remarks</i>	197
	<i>References</i>	201
	<i>About the Authors</i>	211
	<i>Members of the C.D. Howe Institute</i>	213

Boxes

1	Measuring Canada's Money Stock.....	45
2	Purchasing Power Parity and Foreign Exchange Rates	157
3	The Bank of Canada Equation and the Canadian Dollar Exchange Rate	166

Figures

1	Growth of Real GDP, Canada, 1976–2003	4
2	Rates of Employment, Participation, and Unemployment, Canada, 1976–2003.....	5
3	Consumer Price Inflation, Canada, 1976–2003	6
4	Federal and Provincial Budget Balances, 1976–2002	6
5	Federal and Provincial Government Net Assets, 1976–2002	7
6	One-Month Interest Rates, Canada and the United States, 1976–2003.....	8
7	Ten-Year Interest Rates, Canada and the United States, 1976–2003	8
8	Canadian-U.S. Dollar Exchange Rate, 1976–2003.....	9
9	Prices of Canadian Commodity Exports, 1976–2003	11
10	Short-Term Interest Rates and the Growth of M1, Canada, 1985–2003	13
11	Consumer Price Inflation and the Target Band, Canada, 1990–2003	15
12	Excess Money Growth and Inflation in 25 OECD Countries, 1970–2002.....	46
13	Excess Money Growth and Inflation, Canada, 1965–2003	47
14	Money, Output, and Changes in Inflation, Canada, 1970–2003.....	48
15	Short- and Long-Term Interest Rates, Canada, 1976–2003	93
16	Growth of Real GDP, United States, 1976–2003	94
17	Consumer Price Inflation, United States, 1976–2003	95
18	Real Effective Exchange Rate of the U.S. Dollar, 1976–2003.....	96

19	Goods and Services Trade, Canada, 1990–2003	97
20	Short-Term Interest Rates and the Canadian-U.S. Dollar Exchange Rate, 1990–2003	101
21	M1 Growth and the M1 Growth Gap, Canada, 1985–2003	103
22	CPI and GDP Inflation, Canada, 1985–2003	104
23	Nominal and Real-Return Bond Yields, Canada, 1992–2003	109
24	Total and Core CPI Inflation and the Target Band, Canada, 1990–2003	119
25	One-Day Interest Rates, Canada and the United States, 1990–2000	127
26	Standard Deviation of Annual Change in the CPI, Canada, 1976–2003	142
27	Days Lost to Strikes as a Share of Employee-Days, Canada, 1976–2003	143
28	Average Length of New Collective Bargaining Agreements, Canada, 1978–2003	144
29	Share of New Collective Bargaining Agreements with COLA, Canada 1978–2003	144
30	Short-Term Business Credit as a Share of Total Business Credit, Canada, 1976–2003	145
31	Maturities of Fixed-Term Mortgages, Canada, December 1995 and December 2003	145
32	Nonresidential Fixed Investment Relative to GDP, Canada, 1976–2003	146
33	Standard Deviation of Interest Rates, Canada, 1976–2003	147
34	Standard Deviation of Quarterly Changes in Real GDP, Canada, 1976–2003	148
35	Growth of Business Sector Output per Hour, Canada and the United States, 1976–2002	153
36	Growth of Multifactor Productivity in the Business Sector, Canada and the United States, 1976–2002	154
37	Canadian Dollar Foreign Exchange Rates, 1980–2003	154
38	U.S. and Canadian Dollar Nominal and Real Exchange Rates, 1976–2003	161
39	Prices of Canadian Commodity Exports in U.S. Dollars, 1976–2002	162
40	Nominal Canadian-U.S. Dollar Exchange Rate and Dynamic Forecast with the Bank of Canada Equation Fitted over the Period 1973:Q1 to 2004:Q1	165
41	Multifactor Productivity Growth by Industry, Canada and the United States, 1995–2000	170
42	Price-Level Expectations under Inflation and Price-Level Targets	187
43	Distribution of 12-Month CPI Inflation Rates, Canada, 1995–2003	188

Table

1	Bank of Canada Balance Sheet, GDP, Prices, and Federal Government Debt, 1990 and 2003	73
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Foreword

More than ten years have passed since the C.D. Howe Institute published *The Great Canadian Disinflation: The Economics and Politics of Monetary Policy in Canada, 1988–93*, David Laidler and William Robson's Douglas Purvis Award-winning study of the Bank of Canada's efforts to re-establish a stable monetary environment after some two decades of high and volatile inflation.

In 1993, Canada was slowly emerging from the painful recession that had accompanied the monetary squeeze at the beginning of the decade, and inflation targeting was a recent innovation. At that time, monetary policy was a topic of acrimonious political discussion. Not only was the new targeting regime untried, but it was vulnerable to pressures from serious fiscal imbalances, and political developments seemed to threaten even the limited policy autonomy the Bank of Canada needed to implement it.

It is hard now to recall the charged atmosphere that surrounded monetary policy debates at that time. While financial-market participants continue to watch central bank actions closely, public interest in the topic has ebbed, and the third renewal of inflation targets in 2000 passed almost without comment. This new state of affairs arises, in large measure, from the success of the same policies that created so much controversy earlier. Inflation was already low in 1994, and it has remained there since, to the point that most Canadians take its continuation for granted; the Bank of Canada probably commands more public respect than at any time since the mid-1950s; the fiscal situation has improved; and, remarkably, the recession of 1991–92 has as yet had no successor.

In their new book, Laidler and Robson explore this remarkable transition, and document monetary policy's role in bringing it about. While inflation targeting does not deserve all the credit for the Canadian economy's successes of the past decade, Laidler and Robson argue that it played a key role in establishing a background of monetary stability that underlay them. At the same time, they note serious macroeconomic problems that remain unsolved —

Canada's disappointing productivity performance relative to the U.S., and the sometimes disconcerting instability of the Canada-U.S. dollar exchange rate, to give two examples. They also warn that the unobtrusiveness of Canada's successful monetary policy regime does not render it politically secure, and they make a strong case for maintaining and, if possible, strengthening it. Above all, Laidler and Robson show we can learn as much from policy successes as from failures. If the economic circumstances in which their new book appears are less dramatic than those of a decade ago, the lessons from this latest transition are every bit as important and interesting as those of its predecessor.

The C.D. Howe Institute's first study of monetary policy, Thomas J. Courchene's *Money, Inflation and the Bank of Canada: An Analysis of Canadian Monetary Policy from 1970 to early 1975*, documented the onset of the great inflation that dominated Canada's monetary history in the final quarter of the last century. We can hope that this latest addition to the series will turn out to document the first decade of a new era of monetary stability.

While the analysis and opinions in this book are the responsibility of its authors and do not necessarily represent the views of the Institute's members or directors, it exemplifies the C.D. Howe Institute's mission to promote understanding and debate on matters of national interest by presenting views soundly based on economic theory and careful empirical research.

Jack M. Mintz
President and
Chief Executive Officer

Preface

Monetary policy is both one of the simplest and one of the most complex fields of economic policy. The daily operations of Canada's central bank are, at bottom, straightforward — the Bank of Canada controls the cost of very short-term funds to Canada's banking system. Yet that activity has important indirect effects on such key variables as long-term interest rates and the exchange rate, and on the growth of credit and money in the Canadian economy — which, in turn, affect volumes of spending and hence real incomes and employment, as well as the rate of inflation.

These indirect effects matter enormously to Canadians generally and often inspire controversy. The goals the Bank of Canada should pursue — the current inflation target, a different inflation target, or some other objective altogether, such as a fixed value for the exchange rate or a high level of employment — and the tactics it should use to achieve those goals generate disagreement among economists and the public alike. Our purpose in writing this volume is to explore the nature and conduct of Canadian monetary policy from the early 1990s to the early 2000s in a manner that bridges the gap between the simple core of the Bank's operations and the complex ways they play out in the economy and hence in debates about the direction of Canadian society.

Some of this analysis and narrative draws on our earlier work, including our 1993 book *The Great Canadian Disinflation*. We have, however, tried to make this a free-standing volume: we provide references for readers who wish to follow up specific subjects in more detail, but such further inquiry is never essential. We hope our description and analysis of the Bank's actions and their consequences will be interesting and useful for students of monetary policy in Canada, both those for whom it is a matter of professional concern and those for whom it is of more formal academic interest.

We have tried to make our account of Canadian monetary history over the past dozen years or so reasonably accessible to non-experts. True, the discussion of the economics of monetary policy

in Chapter 3 will be easier for readers with some background in monetary and macroeconomics, and Chapter 6, on the framework for the Bank of Canada's conduct of policy, will be of most use to readers whose interest lies in the high-frequency interaction of the Bank's actions and statements with financial markets. In general, however, the principal prerequisite for useful perusal of this book should be, not technical expertise, but interest in Canada's experience since the early 1990s and the economic and political influences on monetary policy that helped shape it.

Because monetary policy inspires controversy, we think it fair to warn at the outset that, while we seek to avoid polemics and to give fair accounts of points of view that differ from ours, we do take several positions on which there is no consensus.

To begin with, while Canada was only one among many countries to experience a lasting reduction in inflation in the 1990s, our view is that the major common force here was the spread of ideas about what domestic monetary policy can and should do, rather than the competitive pressures generated by increasing globalization or some other external force. We hope we have paid adequate attention in what follows to developments in the world economy as they have affected Canada, but our narrative reflects and also, we hope, supports the opinion that, in the modern world, domestic monetary policy still matters a great deal. This judgment, rather than simple parochialism, leads us to believe that the study of monetary policy in a single country such as Canada is worthwhile.

Our belief that domestic monetary policy's influence remains important also informs our judgment that those who make such policy must be accountable in a meaningful way to the electorate whose lives their decisions affect. Political control over central banking is a sensitive subject — to us, respect for democratic principles does not imply that elected politicians should set interest rates, but neither can we defend leaving responsibility for setting fundamental goals such as the behaviour of the price level solely to the Bank of Canada. This consideration also strongly shapes our views on Canada's international monetary relations. To us, the choice of whether or not to seek some kind of North American monetary union raises not just technical questions about competing

exchange rate regimes, but also political questions about the accountability of policymakers to those they serve.

In some places, too, our views on technical issues in the conduct of monetary policy are at odds with those of other observers. We are convinced, for example, that the interaction between the supply of and the demand for money plays a key role in the transmission of central bank policy to the economy. We further believe that this view is supported by abundant empirical evidence of a close long-run correlation between money growth and inflation, and of shorter-run relationships in which variations in money growth precede the output and inflation rate fluctuations associated with them. These considerations have led us to treat the instability in the demand for various monetary aggregates that has been evident at times in Canada and other economies since the early 1980s as a complication in analyzing money's role in monetary policy processes, rather than a justification for ignoring it. Therefore, the stock of money plays a larger role in our story than is nowadays fashionable.

Other points of controversy — for example, the sources of movements in the foreign exchange value of the Canadian dollar and how much attention the Bank of Canada should pay to those movements — will also become apparent throughout the book. We do not apologize for having a point of view, but we do hope we have succeeded in presenting that point of view, and some alternatives to it, fairly and without rancour. If we have succeeded, we trust our look at the debates over the tactics and goals of monetary policy in Canada will illuminate several outstanding issues that will continue to cause controversy in the years ahead, and perhaps assist Canadians to confront them successfully.

Last but hardly least, we are delighted to acknowledge the able assistance and wise counsel of many collaborators and reviewers. Our colleagues at the C.D. Howe Institute, Payam Pakravan, Yvan Guillemette, and Jan Moffatt, helped us find source documents and data. Lloyd Atkinson, John Crow, Charles Freedman, David Johnson, Leigh MacDonald, Michael Parkin, Andrew Spence, Gordon Thiessen, and a number of anonymous officials and reviewers made copious suggestions for improvement. The controversy that

surrounds many issues related to monetary policy makes it all the more appropriate for us to emphasize that none of these reviewers necessarily endorses the positions we have taken — for those positions, and for any errors that remain, we alone are responsible.

David Laidler
William B.P. Robson

About the Authors

David Laidler is Canadian Bankers Association (CBA) Scholar at the C.D. Howe Institute. He has been a Fellow of the Royal Society of Canada since 1981, and is Bank of Montreal Professor at the University of Western Ontario. He was educated at the London School of Economics, the University of Syracuse, and the University of Chicago. Prior to becoming Professor of Economics at UWO in 1975, he held full-time academic appointments at the London School of Economics (1960–61), the University of California at Berkeley (1963–66), the University of Essex (1966–69), and the University of Manchester (1969–75). In 1998 and 1999, he was Visiting Economist and Special Adviser at the Bank of Canada.

Professor Laidler's fields of interest are monetary economics and the history of economic thought, and he has written numerous academic articles and books in these areas. His most recent large-scale academic publication is *Fabricating the Keynesian Revolution: Studies of the Interwar Literature on Money, the Cycle and Unemployment* (Cambridge University Press, 1999). Professor Laidler has been responsible, alone and in collaboration with members of the C.D. Howe Institute staff, for a large number of Institute publications on monetary policy questions. *The Great Canadian Disinflation: The Economics and Politics of Monetary Policy in Canada, 1988–93* (1993), co-authored with William Robson, was awarded the Canadian Economics Association's Doug Purvis Memorial Prize for excellence in writing on Canadian economic policy in 1994.

William B.P. Robson has a B.A. from the University of Toronto and an M.A. from the Norman Paterson School of International Affairs at Carleton University. He specializes in Canadian fiscal and monetary policy. He has written extensively on government budgets, pension, and health-care financing, and on inflation and currency issues. His 1994 book, *The Great Canadian Disinflation*, co-authored with David Laidler, won the Canadian Economics Association's

Doug Purvis Memorial Prize for excellence in writing on Canadian economic policy, and his 2001 *C.D. Howe Institute Commentary*, "Will the Baby Boomers Bust the Health Budget? Demographic Changes and Health-Care Financing Reform," won the Policy Research Secretariat's Outstanding Research Contribution Award.

Mr. Robson is a familiar commentator on economic issues in the media. He also serves as Canadian Liaison Officer to the British-North American Committee, and serves on the executive and boards of several education-related and public affairs organizations. He lectured on public finance and public policy at the University of Toronto from 2000 to 2003. Before joining the C.D. Howe Institute in 1988, he held positions as an economist with Wood Gundy Inc. and the federal Department of Energy, Mines and Resources.

PART I

Introduction and Overview

1 *Canadian Monetary Policy and Its Background since the Early 1990s*

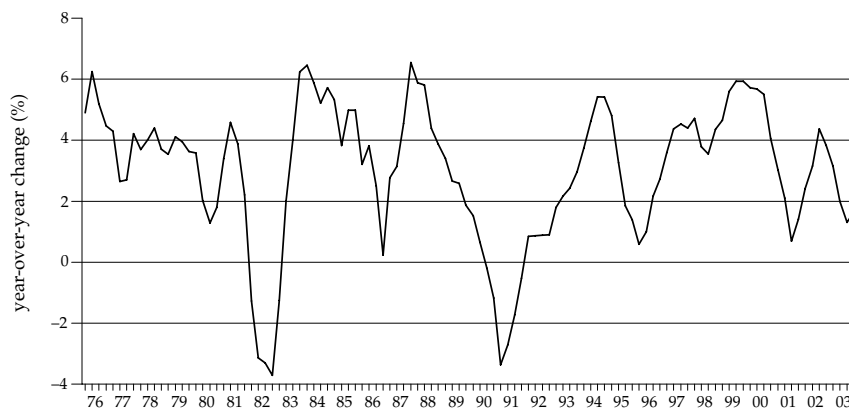
At the beginning of a book on Canadian monetary policy, readers might like reassurance that the subject merits their attention. Does monetary policy matter? If it does, how does it matter? A short outline of Canadian economic experience since the early 1990s can, we think, easily demonstrate the power of monetary policy to influence not only the short-term course of spending, output, and employment in the Canadian economy as a whole, but also the longer-term path of prices and, indeed, of the country's overall prosperity.

A Brief Macroeconomic History

For the Canadian economy, the 1990s began badly yet ended well. Canada, like much of the rest of the developed world, prospered during the late 1980s. In 1990, however, the country entered a recession that, by some measures, was the worst since the 1930s.

Output, Employment, and Inflation

After a lengthy period of growing prosperity, spending and output contracted sharply in 1990, with a peak-to-trough decline in activity

Figure 1: Growth of Real GDP, Canada, 1976–2003

Source: Statistics Canada, CANSIM database, table 380-0002.

as measured by real gross domestic product (GDP) of some 3 percent. The economy began to grow again in 1991, though only tentatively, and the recovery gave way before long to renewed weakness; only after 1996 did the expansion begin to look and feel secure. (See Figure 1.)

The unemployment rate — the proportion of Canadians in the workforce but unable to find work — jumped from less than 8 percent to more than 11 percent between 1990 and 1992 and did not return to single digits until late 1994; only in 1999 did the unemployment rate regain the levels of the late 1980s. Rates of labour force participation and employment — the proportion of Canadians of labour force age who were, respectively, in the workforce and actually employed — were even slower to return to their pre-recession levels. In the wake of impressive job gains from 1997 to early 2003, however, those rates hit new highs, and the unemployment rate fell to the 7 percent range, a level not seen for a sustained period since the early 1970s. Only after early 2003 did new softness in the economy curb job growth and induce a mild increase in the unemployment rate. (See Figure 2.)

Inflation, as measured by the year-over-year change in the consumer price index (CPI), moved up in the late 1980s and spiked at

Figure 2: Rates of Employment, Participation, and Unemployment, Canada, 1976–2003

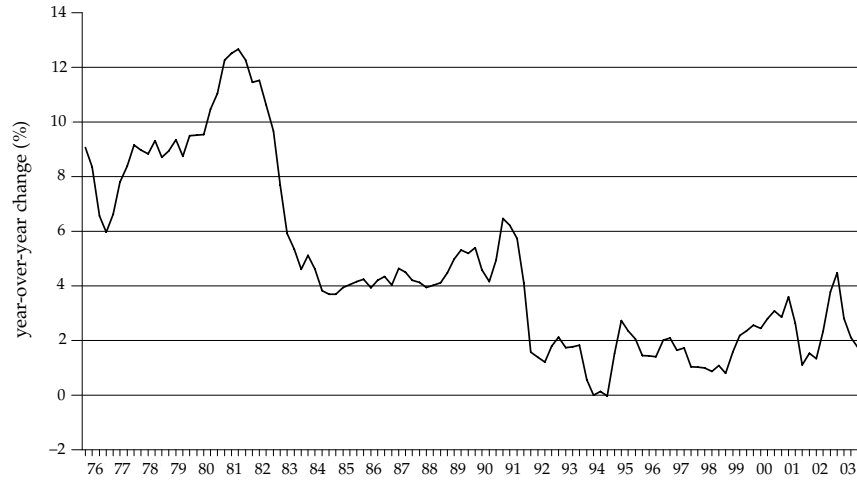


Source: Statistics Canada, CANSIM database, table 282-0087.

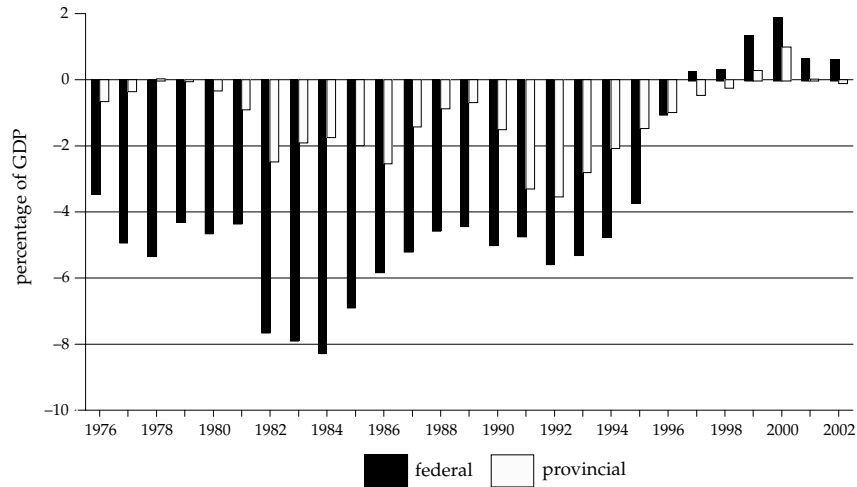
a rate above 6 percent at the beginning of 1991 with the introduction of the goods and services tax (GST) (Figure 3). Inflation then fell precipitously a year later to a little under 2 percent, due mainly to the recession but also to the impact of the introduction of the GST on the price level's dropping out of the 12-month measure of its rate of change after a year. Year-over-year inflation would remain low for the balance of the decade, not exceeding 3 percent again, even in a single month, until late 2000.

Public Finances

The state of Canada's public finances also changed dramatically in the 1990s and early 2000s. During the relatively prosperous second half of the 1980s, federal and provincial budget deficits were so large (see Figure 4) that even healthy growth in nominal incomes and expenditures did not reduce the ratio of public debt to GDP (Figure 5). The fiscal situation worsened sharply under the influence of the early 1990s' recession, and it was only in the mid-1990s — with the landmark federal budget of 1995 marking the key turning point — that retrenchment put fiscal policy on a sustainable

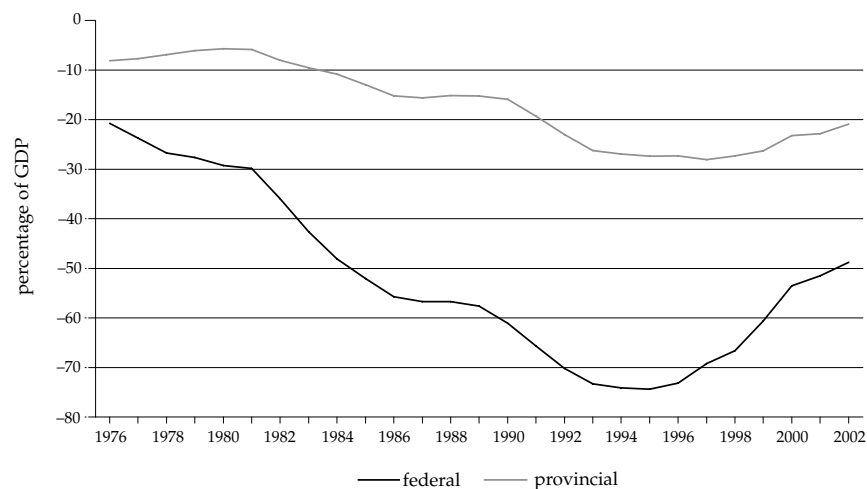
Figure 3: Consumer Price Inflation, Canada, 1976–2003

Source: Statistics Canada, CANSIM database, table 326-0001.

Figure 4: Federal and Provincial Budget Balances, 1976–2002

Sources: Canada, Department of Finance, Fiscal Reference Tables; provincial budgets.

Figure 5: Federal and Provincial Government Net Assets, 1976–2002



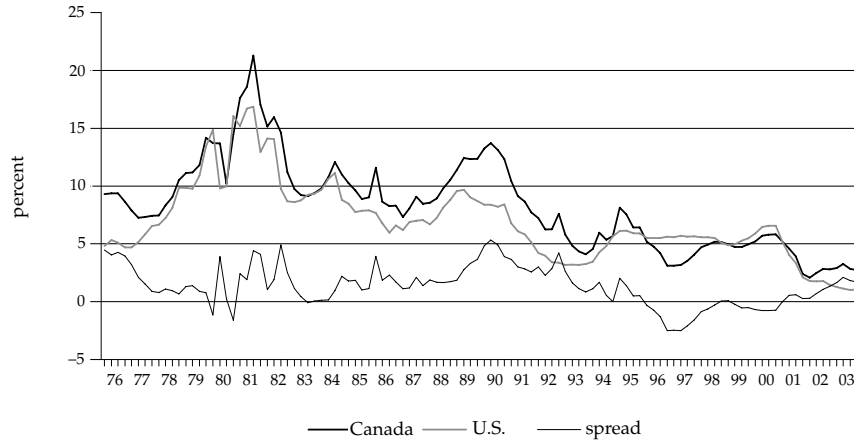
Sources: Canada, Department of Finance, Fiscal Reference Tables; provincial budgets.

track. The ratio of public debt to GDP shrank during the second half of the 1990s almost as rapidly as it had grown ten years earlier, and it continued to fall in the early 2000s.

Interest Rates and the Exchange Rate

Interest rates bear witness to the bad economic times that prevailed at the beginning of the 1990s and to the substantial improvement after 1995. A large positive differential between Canadian and U.S. short-term interest rates in 1990 and 1991, associated with much tighter Canadian monetary policy, was reversed by the second half of the 1990s by the combined effects of lower Canadian inflation and the improving fiscal situation (Figure 6). The return of a small positive differential after the turn of the millennium had more to do with relatively stronger real growth in the Canadian economy at that time than with any revival of fears about inflation in Canada. Ten-year government bond rates (Figure 7) show a similar, though less dramatic, narrowing and, for a while, reversal of Canadian-

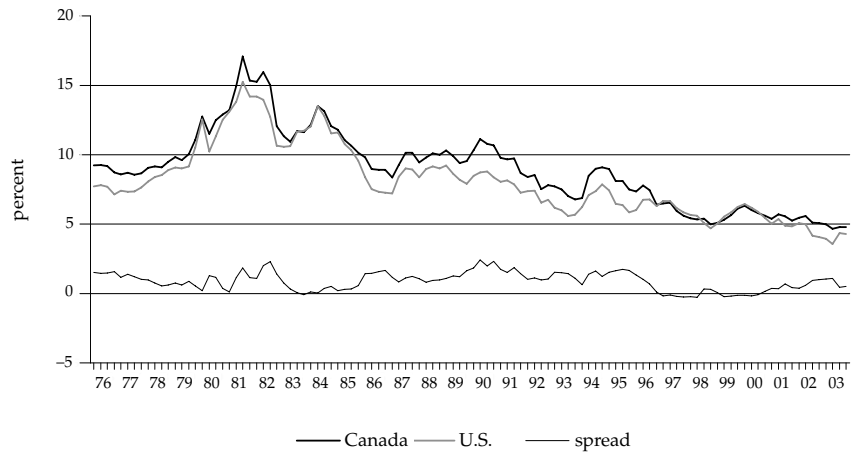
**Figure 6: One-Month Interest Rates,
Canada and the United States, 1976–2003**



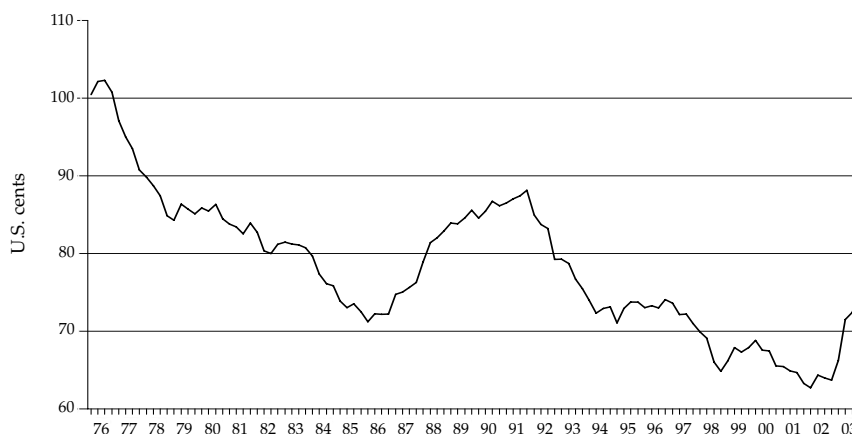
Note: U.S. yields are adjusted to a 365-day basis.

Sources: Bank of Canada; United States Federal Reserve.

**Figure 7: Ten-Year Interest Rates,
Canada and the United States, 1976–2003**



Sources: Bank of Canada; United States Federal Reserve (Canadian ten-year bond rates prior to mid-1982 are estimated from the synthetic yield for bonds with maturities of ten years and longer).

Figure 8: Canadian-U.S. Dollar Exchange Rate, 1976–2003

Source: Bank of Canada.

U.S. spreads in the late 1990s. Figures 6 and 7 also show the effects of the Asian and Russian monetary crises in 1997 and 1998 and the accompanying flight of investors into the safe haven of U.S. government securities, as well as the return to stability by the end of the decade.

The only widely discussed variable that inspired as much concern at the end of the 1990s as it did at the beginning was the Canadian-U.S. dollar exchange rate. In the early 1990s, many commentators thought the exchange rate too high for comfort; as the decade ended, many thought it too low. The Canadian dollar appreciated from a level of around US\$0.75 in the mid-1980s (it actually briefly dipped below US\$0.70 in 1985) to a peak of US\$0.89 in October 1991 (Figure 8), when the adverse effects of its appreciation on the competitive position of Canadian producers of tradable goods became a matter of acute concern. The exchange rate began to decline in 1992, and hit a new low of just over US\$0.63 in late summer 1998, before stabilizing around US\$0.66. In the early 2000s, the dollar reached another new low of just over US\$0.62, prompting debate about the extent of and reasons for the currency's undervaluation that was just as intense as the debate in the early 1990s about its

overvaluation. The rise in the exchange rate in 2002 and 2003, which restored it to the levels of the mid-1980s, did little to quell that debate. Instead, the focus of discussion shifted to general questions about the effects of exchange rate movements on the economy.

Explaining the Situation in 1990

At the beginning of the 1990s, the Canadian economy was in rough shape.¹ There were several reasons for this situation.

The Legacy of the 1980s

First, by 1990, Canada's fiscal situation had been deteriorating for 15 years or more. The slowdown in productivity growth in the early 1970s, the long-term nature of which did not become apparent until the 1980s, had rendered hopelessly optimistic the assumptions then underlying federal and provincial fiscal planning. These assumptions were deeply embedded, not only in the thinking of government officials, but also in what the general public believed government could provide and at what cost.

Second, after 1990 the implementation of the Canada-U.S. Free Trade Agreement (FTA) subjected many sectors of the Canadian economy to adjustment costs that, even without other disruptions, would have caused dislocations and, in all likelihood, a period of slower overall growth in output and employment. This adjustment was made harder by a commodity price boom in the late 1908s that put upward pressure on the Canadian-U.S. dollar exchange rate (Figure 9).

The single most important influence, however, on the economy, on the exchange rate, on inflation, and, therefore, on government budgets in the early 1990s was monetary policy. The 1980s had begun with a severe recession, as the Bank of Canada, already faced with double-digit domestic inflation, reacted to the impact of a severe U.S. monetary contraction on the Canadian-U.S. dollar exchange

1 Laidler and Robson (1993) deal with this period in considerable detail.

Figure 9: Prices of Canadian Commodity Exports, 1976–2003

Source: Statistics Canada, CANSIM database, table 176-0001.

rate with an abrupt increase in short-term interest rates. This episode brought to a spectacular end the Bank's previous policy of gradualism, which had sought, with little success, to bring inflation down by gradually reducing the target for growth in a narrow measure of the money stock — net M1.² Having abandoned money growth targeting, however, the Bank did not replace it with a new policy, and in the 1980s the Bank's policy framework became eclectic and hard to read. With hindsight, a growing emphasis on price stability as a policy goal is discernable in the Bank's statements as the 1980s progressed. Not, however, until Governor John Crow's Eric W. Hanson Memorial Lecture in January 1988 — in which he explicitly declared that the re-establishment and maintenance of

2 Net M1 — cash and chequing accounts, adjusted for payments in transit — is a narrow measure of money that has proved over time to be a useful leading indicator of economic activity and appears to play a role in the transmission of monetary impulses to the economy. We explore its properties in Chapter 3. Courchene (1981) and Howitt (1986) discuss money growth targeting and its abandonment in some detail.

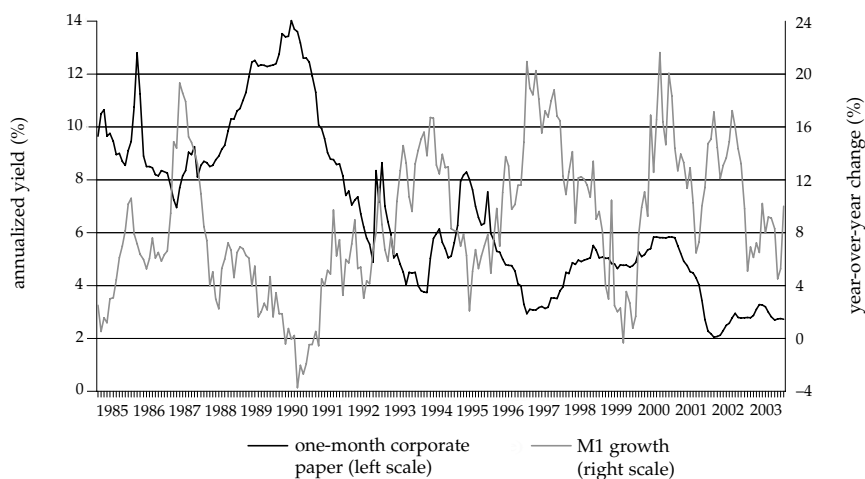
price stability would henceforth be the central goal of monetary policy (Crow 1988) — did this goal attract widespread attention.

Tighter Monetary Policy

The Hanson lecture became a common reference point during the years that followed. In one sense, its prominence was not surprising — widely watched indicators of monetary policy such as short-term interest rates, as well as less widely watched indicators such as M1, showed clear evidence of tightening over the course of 1989 (Figure 10). At the same time, however, the Hanson lecture did not define a new monetary policy regime for Canada. Governor Crow made clear that the Bank saw the then-current inflation rate as unacceptably high, but he did not define “price stability” or describe the means to attain it or establish a timetable for doing so. For many, though not all, observers, the Hanson lecture appeared more a statement of determination to prevent further increases in inflation than a signal to break decisively with the past.

At the beginning of 1990, monetary policy became seriously contractionary. Paradoxically, the proximate cause of the squeeze was an attempt by the Bank of Canada to loosen the stance of policy. To many financial market participants — especially against a backdrop of rising long-term interest rates abroad — a brief downward move in short-term interest rates in early January 1990 indicated, not that the Bank thought its policy had been tight enough to put inflation on a downward course, but that its resolve to bring inflation down was weakening. A run on the currency sent the Canadian-U.S. dollar exchange rate down more than 2 U.S. cents in a couple of weeks and close to 4 cents by the end of the month. The Bank tightened in response, hiking the key Bank Rate — the rate of interest at which it provides overdraft facilities to the banking system — above 13 percent and holding it close to that level through the summer. As Figure 10 illustrates, narrow money growth — an indicator that played only a minor role in the Bank’s assessment of the economy but that was signalling the economic downturn to come — also turned sharply negative after this episode.

Figure 10: Short-Term Interest Rates and the Growth of M1, Canada, 1985–2003



Note: Observations for M1 growth are effectively centred six months earlier than they appear.

Source: Bank of Canada.

The Monetary Policy Regime in the 1990s

In 1990, the Canadian economy operated with a flexible exchange rate — indeed, it still does. The alternative, a fixed exchange rate, is a policy goal in its own right; monetary policy devoted to maintaining a specific price for the currency in the foreign exchange market cannot simultaneously aim at any other target. A flexible exchange rate, by contrast, is not a policy goal as such; it simply leaves the monetary authority free to choose among other policy goals.³ In early 1990, therefore, there was no firm goal for monetary policy. The Bank of Canada had abandoned M1-growth targeting in 1982 and had been unable to find a suitable aggregate to replace it; “price stability,” as the term was used in the Hanson lecture, was no replacement. The firm establishment of a policy goal cast in terms

³ Some goals are, of course, more appropriate for monetary policy than others, a subject we take up in the next major section.

of price-level behaviour needed defining in quantitative terms and required a timetable for its achievement.

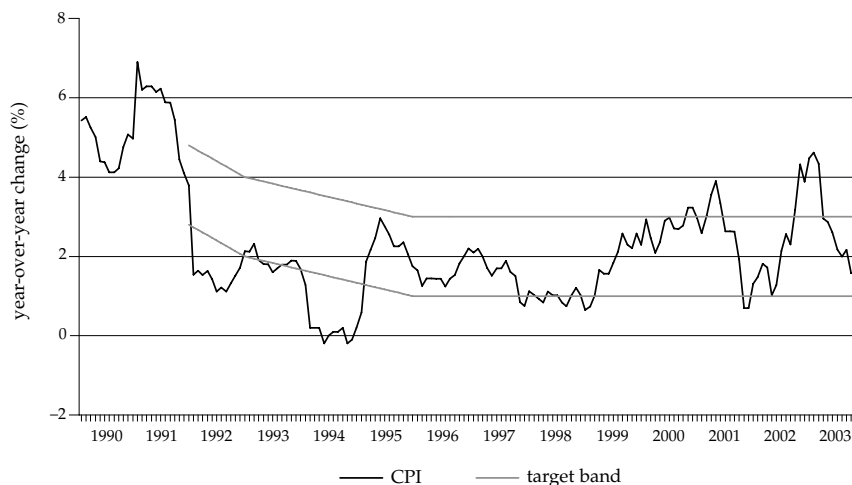
Inflation Targets

These deficiencies were addressed at the time of the 1991 budget by the joint announcement of “inflation reduction targets” by the finance minister and the Bank of Canada, which made Canada the second country, after New Zealand, to adopt such measures. The targets called for inflation, measured by the year-over-year change in the CPI, to fall gradually to 2 percent by the end of 1995. A permissible error band of plus or minus one percentage point around the central target acknowledged monetary policy’s less-than-precise control over short-run fluctuations in inflation. The announcement also envisioned, albeit with no precise quantitative commitment, a further reduction in year-over-year CPI inflation to a rate “clearly below 2 percent” at some point in the future (see Bank of Canada 1991, 5). By the first quarter of 1992, the year-over-year measure of CPI inflation, by then no longer influenced by the introduction of the GST, was already below the bottom of the target range. From then until the first quarter of 1995, year-over-year inflation — further influenced for a 12-month period by a sizeable cut in cigarette excise taxes early in 1994 — averaged 1.2 percent, and for 29 of those 37 months was below the bottom of the target band (Figure 11).

Along with its economically painful consequences, the recession that caused this sharp disinflation contributed to the routing of Kim Campbell’s Progressive Conservative government by the Liberals in the federal election of late 1993. Although the inflation targets themselves were not an explicit issue in the campaign, the overall tightness of monetary policy was a matter of contention, and the election coincided closely with the end the seven-year term of Bank of Canada Governor John Crow, who was personally identified in the public’s eye with monetary stringency in pursuit of the Bank’s “price stability” goal.

The doubts these circumstances cast on the future of Canadian monetary policy were, however, swiftly resolved. Although Crow

Figure 11: Consumer Price Inflation and the Target Band, Canada, 1990–2003



Sources: Bank of Canada; Statistics Canada, CANSIM database, table 326-0001.

was not reappointed to a second term, his successor — the Bank's senior deputy governor, Gordon Thiessen — had participated in crafting the inflation targets and was known as a strong supporter. A joint statement from the new finance minister, Paul Martin, and newly appointed Governor Thiessen affirmed that much of the existing monetary policy regime would remain in place, the important amendment being the replacement of the tentative goal of a further reduction to "clearly below 2 percent" after 1995 with a commitment to maintain the 2 percent target, with its 1-to-3 percent band, until 1998. In the event, the 2 percent target, with its plus or minus one percentage point band, was extended for a further three years in 1998. Its further extension for five years in 2001 occasioned very little debate, although a further modification laid more stress on keeping inflation in the centre of the target range at 2 percent than had been the case earlier.⁴ At about this time, too, the term "low

⁴ See Bank of Canada (1993-94). For the announcement of the renewal of targets in 1998, see Bank of Canada (1998b). A detailed discussion of the modifications made to the regime in 2001 is given in Bank of Canada (2001).

inflation” began to replace “price stability” to describe the fundamental goal of monetary policy.

How much the 1993 changes to the inflation-targeting regime and the absence of further major changes in 1998 and 2001 matter is something we discuss below. For this introductory history, the important facts are, first, that the political underpinnings of a regime that targeted low inflation became bipartisan in 1993 and, second, that by 1998 inflation targets seemed to have become not merely uncontroversial but almost routine, and hence highly credible among the public.

The Role of the Exchange Rate

The introduction of inflation targets, however, did not herald an abrupt change in Bank of Canada procedures. The Bank kept at least one wary eye on the exchange rate for the rest of the decade. More than once, a downward move in the Canadian-U.S. dollar exchange rate that the Bank thought incompatible with either the fact or the credibility of continued low inflation provoked a tightening beyond what indicators of the domestic economy would justify. As we discuss later, persistent softness in the economy and undershooting of the inflation targets in the early to mid-1990s seem attributable to the Bank’s concerns about the exchange rate.

From 1991 onwards, however, the fact that inflation targets were in place promoted a shift of policy focus toward the inflation rate and away from the exchange rate. Concern about the Canadian dollar’s external value in policymaking circles and measures prompted by exchange-rate movements seem to have become less frequent as the decade progressed.

The Evolution of Monetary Policy Debates

Inflation targets provided the Bank of Canada with a clear monetary policy goal for the first time in a decade. Even so, although most people dislike inflation and many economists make a cogent

case that it is harmful, initial support for the targets was not widespread, and many who favoured them did so with reservations.⁵

Questioning the Feasibility of Low Inflation

There were doubts about the feasibility of the goal of low inflation itself. Inflation had run consistently higher than 3 percent for more than 20 years when the targets were announced, and only a minority of Canadians had actually experienced inflation within the newly set limits during their adult lives. Since the early 1970s, low — let alone falling — inflation had been associated with a depressed real economy, an association to which the early 1990s added another painful example. Furthermore, Canadian inflation had tended to outrun US inflation since the 1960s, yet the new regime heralded a domestically determined inflation rate that would likely often be less than the rate prevailing south of the border.

By 1990, academic economists were beginning to reject older ideas that there was a tradeoff between inflation and unemployment that policymakers could exploit and that inflation arose from domestic “cost-push” factors or seeped in from abroad.⁶ These ideas nevertheless lingered among the public at large and continued to motivate doubts about the feasibility of a low inflation target, especially one to be achieved over anything less than a very long period of time. Only experience that contradicted the misgivings these theories caused could put them to rest, and they played a role in policy debates until well into the 1990s.

5 See, for example, Robson (1991) and Laidler (1991). The discussions of the pros and cons of aiming for low inflation in Lipsey (1990) and York (1990) show how contentious this issue was at the turn of the decade.

6 Though mainly of historical interest now, Bosworth and Lawrence (1982) illustrates the incorporation of “cost-push” ideas into what was then a mainstream framework. Nelson (2004) documents the dominant role played by these ideas in Canadian policy in the 1970s and early 1980s. He suggests that the severe recession, associated with tight money, that occurred in the early 1980s caused their influence on the actual conduct of policy to wane faster in Canada than it did in Australia and New Zealand.

The Monetary-Fiscal Mix

In its early years, opponents of the inflation control regime pointed to its inconsistency with the need to promote economic expansion to help fiscal policy get onto a sustainable course. Not only had chronic deficits pushed up the combined debt of the federal and provincial governments to close to 100 percent of GDP by 1990, but the maturity structure of Ottawa's debt was tilted heavily toward the short end, making a monetary policy induced slow-down especially troublesome to the fiscal balance.

Supporters of inflation targets met this case with two arguments. First, they suggested that success in controlling inflation would reduce inflation expectations, so that Bank of Canada policy ought to be characterized as seeking low inflation and low nominal interest rates, not low inflation and high nominal interest rates. Second, they argued that inflation had helped mask fiscal problems and that a low inflation environment would bolster governments' evidently weak resolve to address them.⁷

Low inflation did indeed bring low interest rates in its wake, and, importantly, the budgets of the mid-1990s eventually put fiscal policy on a more sustainable path. By the time the inflation targets came up for renewal and reassessment in 1998, the empirical basis for many earlier objections to the new regime had disappeared. The focus of debate during the run-up to this decision was not whether to renew the targets, but at what level to set them.⁸

7 In the early 1990s, Pierre Fortin (for example, 1991, 1996) was a strong advocate of combining a tighter fiscal stance with more accommodative monetary policy. We argued (Laidler and Robson 1993), however, that tight monetary policy was likely to be helpful in persuading those responsible to pay more attention to the problems imbalanced budgets created.

8 See particularly the contributions of Fortin (1997); Howitt (1997); and Parkin (1997) to this debate.

Adjustment to Free Trade

A second focus of discontent with inflation targets was the coincidence of disinflation with the implementation of the FTA. For producers of tradable goods, especially in sectors where the FTA had reduced tariff protection, the currency appreciation that accompanied the tightening came at a most inopportune time, intensifying adjustment pressure they would have faced in any case. Many observers feared that even a temporary loss of competitiveness resulting from the higher dollar, along with general economic and fiscal distress, might shift investment south of the border and launch Canada into the free trade area with a long-lasting handicap.

With the passage of time, however, these concerns abated. The high dollar, though unhelpful for the competitive position of Canadian businesses as far as operating costs were concerned, had the salutary effect of making imported capital equipment less expensive. Businesses that re-tooled during this period enhanced the competitiveness of their products when the dollar subsided again. More fundamentally, the resumption of growth later in the decade and the development of new and sometimes unexpected areas of comparative advantage for Canadian exporters made the discomfort of the high dollar look more like a temporary setback than a permanent liability for Canadian industry.

Low Inflation, the Labour Market, and the Exchange Rate Regime

There was also debate about the nature of the inflation targets themselves. At one extreme, some economists, such as Parkin (1997), argued for restating the targets in terms of the price level, rather than the inflation rate, to prevent "base drift." Others, such as Fortin (1997), who worried that labour market frictions dictated a permanently higher level of unemployment at a 2 percent inflation rate than at, say, 4 percent, accepted targets specified in terms of the inflation rate, but wanted a higher range. Exchanges about these

issues generated some academic heat, but the general public found little excitement in them, and the joint announcement in 1998 by the Bank of Canada and the finance minister of the renewal of existing arrangements for a further three years went almost unnoticed.

By 1998, then, seven years after a rough launch into a skeptical environment, inflation targeting was evidently working. And with government debt no longer rising relative to the level of output and threatening future “monetization,” the targets were also becoming increasingly credible.

In the late 1990s, however, further developments prompted new doubts about the monetary regime. First, the Asian crisis of 1997 triggered a wave of international financial instability that culminated in Russia’s default in August 1998 and the near-collapse of the New York-based Long-Term Capital Management “hedge fund” in September 1998. The resulting flight to quality in international capital markets drove up the U.S. dollar against other currencies, pushing the Canadian dollar to a then-record low just above US\$0.63. With the Canadian dollar’s temporary surge in value in the late 1980s and 1990s well in the past, this drop appeared to many as the latest stage in a long-term decline that seemed to indicate fundamental problems with the Canadian economy. A particular focus of concern was an apparently widening gap between U.S. and Canadian productivity levels and the possibility that the exchange rate not only was reflecting, but also contributing to, that gap. Then, in January 1999 came the launch of the euro, the new currency of a European Monetary Union. As the launch date approached, the currencies of the Union’s future members, notwithstanding the effects of the Russian crisis, remained strong against those of North America. It was natural to wonder whether North America might have something to learn from Europe about monetary arrangements.

These two influences lent impetus to vigorously stated and widely publicized arguments that Canada should abandon its flexible exchange rate for some sort of fixed rate arrangement against the U.S. dollar. Advocates of a fixed rate suggested such ideas as a pegged Canadian-U.S. dollar exchange rate, the creation of a currency

board based on the U.S. dollar, adoption of the U.S. dollar as Canada's national currency, or even a full North American Monetary Union on the European model. Most advocates of a fixed rate seemed to agree that exchange rate flexibility in general, and the Canadian dollar's long-term depreciation more particularly, were undermining Canadian productivity and living standards.⁹ And, since inflation targets are not compatible with a fixed exchange rate of any kind, these arguments explicitly or implicitly rejected inflation targets as an inferior regime.

Current Debates

At the time of writing, there is still a good deal of life in some of these debates. There are, for example, questions related to the virtues of current inflation targets. Some observers wonder whether inflation targets, or any other price-level objectives, are practical for a central bank in an era when technological innovations threaten to undermine traditional elements of monetary control. Others do not question the ability of the central bank to control inflation, but would prefer that inflation targets were set at some other level or expressed over a different timeframe — perhaps long enough that they resemble targets for the price level itself.

In a second category are disputes over the desirability of some alternative regime, in which the external value of the currency would be the policy goal. Key subjects of disagreement here are the nature and direction of the links between exchange rate behaviour and domestic productivity performance, and the extent to which the prices of Canada's commodity exports do, and should be allowed to, affect the exchange rate. The critical questions here bear on how the Canadian economy would adjust to economic swings

⁹ See Courchene and Harris (1999) and Grubel (1999), whose contributions launched a debate on the topic of a North American Monetary Union. Both papers canvassed the idea that Canada's floating exchange rate regime hampered domestic productivity.

and commodity price movements if the Canadian dollar were not free to float.

Finally, the political processes that underlie monetary policy are at issue. Are inflation targets set in terms of the CPI's annual rate of change a reasonable compromise between an indicator for monetary policy that citizens can readily interpret and one that economists and central bankers would see as a sensible way to monitor the effects of central bank actions? Does the assertion that Canada requires a flexible exchange rate to maintain political control of its own monetary policy reflect an outmoded desire to maintain national sovereignty in an increasingly globalized economy? Or does it simply respect the principle that those who make policy should be accountable to those on whose behalf they act?

Outline of the Rest of the Book

In this brief history, we hope we have demonstrated, not just that monetary policy matters, but that Canadian monetary policy evolved over the past decade in ways that affect Canadians in their day-to-day lives. In the pages that follow, we take a closer look at the role of the Bank of Canada in the economy, the changes in both the goals and tactics of Canadian monetary policy since the early 1990s, and the outstanding controversies that Canadians will likely address in the years to come.

Part II of this book begins, in Chapter 2, with a discussion of central banking in general, and its development in Canada in particular. Chapter 3 then looks at the economics of monetary policy: what it can and cannot do, and how changes in the stance of the central bank work their way through the economy. Chapter 4 discusses some key political economy questions: how monetary policy interacts with fiscal policy, and the nature of democratic control over the central bank.

Part III then takes a detailed look at the experience of the past decade. Chapter 5 describes the conduct of monetary policy in the context of key developments in the international and domestic

economies. Chapter 6 details the framework for monetary policy in Canada as well as the major changes in the Bank of Canada's operating procedures that have been implemented since the early 1990s.

Part IV draws some conclusions from recent Canadian experience and then looks ahead. Chapter 7 summarizes the lessons from Canada's experience with low inflation, and documents the uncertainties surrounding the behaviour of the exchange rate and its impact on the economy. Chapter 8 elaborates the arguments for and against alternatives to current monetary policy arrangements, canvassing such radical options as the disappearance of the Canadian dollar as an independent currency, and less dramatic adjustments to the inflation-targeting regime itself. Chapter 9 brings the study to an end with a brief discussion of the some general lessons of recent experience and some speculation about directions for Canada's monetary arrangements in the years ahead.

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Two Percent Target **Canadian Monetary Policy Since 1991**

This book deserves the attention of everyone who is concerned about stable prices in Canada and elsewhere. It tells the story of Canada's hard-won battle for price stability and the institutions and policy mechanisms that achieved it. Its compelling analysis leads relentlessly to the conclusion that Canadians have much to praise in the way monetary policy has worked, but plenty to fear about how it will go wrong if we lose sight of its limit and proper goals. Canadian central banking has provided a lesson of immense value for Canadians and others about the ingredients of a successful monetary policy and this book makes that experience highly accessible.

*Michael Parkin
Professor of Economics,
University of Western Ontario*

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*Andrew Spence
Portfolio Manager, Emerging Markets
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Canada's monetary policy is sometimes heavy lifting and always a work in progress. Laidler and Robson have once again produced a comprehensive study of the work done — this time over the past decade — and *Two Percent Target* should increase understanding of the important issues.

*John Crow
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Their 1994 study *The Great Canadian Disinflation* won the Canadian Economics Association's Doug Purvis Prize for excellence in economic policy writing.

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