C.D. Howe Institute
Institut C.D. Howe

Backgrounder

February 13, 1997

The Bank of Canada and the Economy:
Has the Referee Put Away the Whistle?

by

David E.W. Laidler

and

William B.P. Robson

Central banks, like referees, largely escape notice when they perform well. When inflation is stable and low enough for most people to ignore and when output and jobs are growing steadily, a central bank becomes part of the background, rather than a prominent participant in the game.

During the past year, the Bank of Canada has started looking like that kind of referee. A brief look at recent developments on the monetary scene, however, suggests that this welcome fade into obscurity may reverse sharply over the course of the next year or so unless the Bank makes a timely effort to keep control of the game.

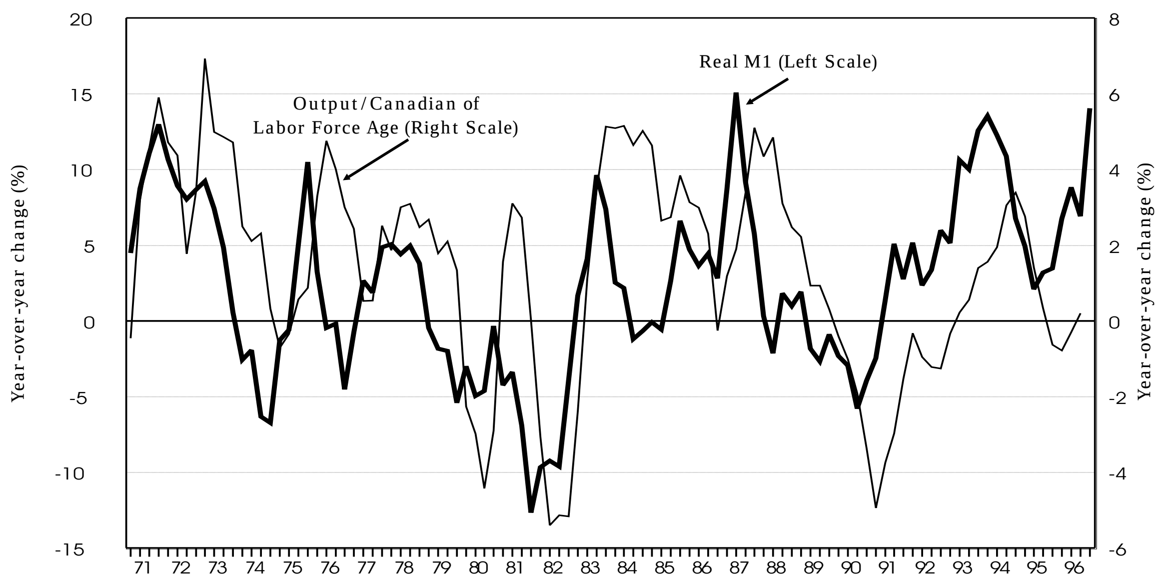
Setting the Pace through Money Growth

Urging the bank to keep its whistle handy may seem premature. But monetary policy works with well-known lags. On average, it takes six months or more for changes in money growth, as measured by M1 (cash and chequing accounts), to influence output and employment growth. (This relationship is shown in Figure 1, which compares year-over-year increases in inflation-adjusted M1 and output per Canadian of labor-force age). It then takes another year or so for the effects on inflation to materialize. (See Figure 2, which compares two-year growth rates in inflation-adjusted M1 to annual changes in inflation rates.[1])

These lags mean that the Canadian economy's current low inflation and recent pickup in spending owe a lot to the monetary policy that was in place well before last fall. They also mean that more recent policy will have consequences for output and employment during this spring and summer and for inflation next year.

During the second half of 1995 and the first half of 1996, M1 grew by some 7 percent. Money growth at that rate — or even somewhat faster, since demand for non-interest-bearing M1 rises when falling interest rates make alternatives such as savings accounts less attractive — would be compatible with a sustained and inflation-free expansion, which the Canadian economy, with substantial slack and high unemployment, has badly needed. In fall 1996, however, M1 accelerated sharply. After recording a blistering 36 percent annualized growth rate in the fourth quarter, M1 finished the year 17 percent above its level 12 months earlier.

Figure 1: ***Growth in Money and Output***



Seventeen-percent-plus money growth will do more than nurture a healthy and sustainable expansion. At that rate of growth, any increase in demand for M1 sparked by lower interest rates would shortly be met, and then far exceeded. Continued money growth in the high double-digits threatens to catapult Canadians back into the boom-bust cycle all too familiar from recent decades. The Bank may soon need to take remedial action — however awkward it may be during the run-up to a federal election — to keep the game from getting out of hand.

Monitoring the Game

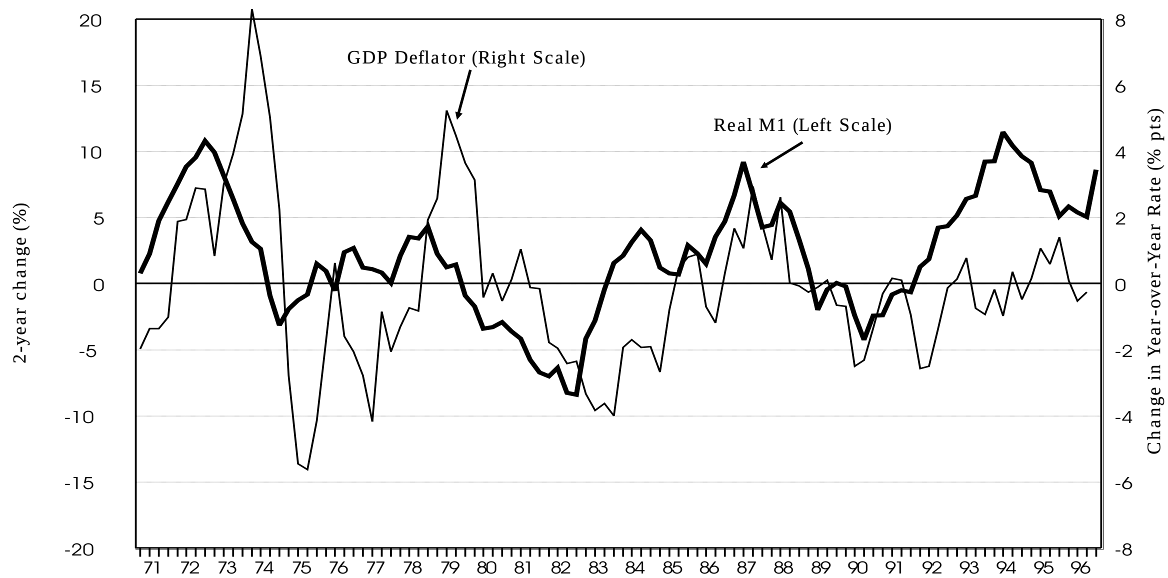
Why has the Bank been a prominent player in the economy, rather than a background referee, so often in recent years? One reason is that reining in the rise in inflation underway in the late 1980s was inevitably painful. Another reason, however, is that the Bank tends to use untrustworthy indicators — short-term interest rates and the exchange rate (now formally combined in the "Monetary Conditions Index") — to steer the economy, giving relatively little attention to money growth.

On the face of it, a drop in short-term interest rates or the dollar (a drop in the Monetary Conditions Index) may appear stimulative for the economy. But this is not necessarily so. Falling short-term interest rates will do little for the economy if consumer and business confidence — and therefore the interest rates at which Canadians are prepared to borrow — are falling faster. And a dollar that is declining because investors are fleeing fiscal or secession-related risks is a sign of looming economic weakness, not strength. Under these circumstances, flagging money growth can provide a valuable countersignal.

Exactly this situation arose several times in the turbulent economic and political environment of the early 1990s. In mid-1990, again in 1991, and once more in late 1994 and early 1995, a weakening dollar prompted a rise in short-term interest rates. Each time, sluggish growth or even declines in M1 warned that monetary policy was too tight. The Bank failed to react until, about six months later, reduced output and job growth — and a renewed spate of adverse publicity — confirmed the warning that slow money growth had given earlier.

Through 1996, the economic and political environment, both at home and abroad, was more tranquil. Short-term interest rates and the dollar were better behaved. M1 growth picked up to a rate sufficient to support a vigorously expanding economy with little risk of resurgent inflation down the road. Despite the odd attack from critics who seem less opposed to the game the Bank was calling than to the sport itself, the Bank began to fade from view.

Figure 2: *Growth in Money and Changes in Inflation*



A Boisterous Period in the Making

Since then, economic circumstances have continued to improve, and consumers and businesses have gained confidence. Spending is on the rise, the housing market is active and output is accelerating. Although the flow of new job-seekers into the labor market is keeping the unemployment rate high, even employment, which usually responds relatively slowly respond to monetary policy, has risen at a 2% annual rate since last September. A more buoyant economy and reduced anxiety about government debts and Quebec secession have made Canada more attractive to domestic and foreign savers, supporting the dollar.

To the extent that monetary policy can take credit for this improvement, it is the policy that was in place in the first two or three quarters of 1996. Over the past few months, however, monetary policy has taken a new turn that threatens the Bank's new-found and welcome obscurity.

Now, the Bank's emphasis on interest and exchange rates, rather than money growth, to steer the economy threatens to bring it back into unwelcome prominence. It may be on the verge of making an early-1990s-style mistake in reverse. As confidence rises, Canadians' willingness to borrow and spend at a given level of interest rates rises too. A dollar boosted by buoyant exports and an attractive environment for investment prefigures a strengthening economy.

Although the Bank's index says that monetary conditions now are roughly the same as they were last July, Canada's money supply tells a very different story. The recent explosive growth in M1 suggests that economic news through the first half of this year will be dominated by a surging economy, as recent indicators of strengthening spending, and output are followed by more spectacular gains. A more exciting game will, at first, distract attention from the referee. Yet as the game grows more boisterous — and it will if the referee continues to ignore the warning signs — the effort required to regain control will rise too.

Suppose that, over the coming year, the Bank brings M1 growth back to an annual rate of, say, 6 or 7 percent, raising short-term interest rates in line with Canadians' growing willingness to borrow and allowing increased demand for Canadian assets to push the dollar up as well. That pattern of money growth would accommodate a healthy expansion — real growth of, say, 4 percent-plus annually — with no significant resurgence of inflation and would bring unemployment steadily down.

Suppose, alternatively, that the Bank continues to treat market-generated upticks in interest rates or the dollar as signs of monetary tightening and resists them, allowing double-digit M1 growth to persist. Today's healthy pickup will become an unsustainable surge, with the speed of the expansion creating bottlenecks even before full employment is reached. The Bank's credibility as an inflation fighter may slow, but will not prevent, the acceleration of prices that will follow. When the Bank finally blows the whistle, interest rates and the exchange rate will jump sharply, not rise modestly. The economy will slump, not continue expanding smoothly.

Worse, today's happy fiscal outlook will turn abruptly sour. Current optimistic projections for continued deficit reduction require low inflation and interest rates, steadily growing tax revenues, and modest spending on unemployment benefits and other income supports. Another boom-bust cycle will put these improvements at risk. And the Bank of Canada will be back in the headlines again — perhaps in the middle of an election campaign, or perhaps shortly after, when it is negotiating a new set of inflation targets with the incoming government.

A Whistle in Time...

By and large, the Bank of Canada has been a good referee over the past year or so. It has at last nurtured a healthy expansion, and inflation remains low. Until recently, Canada's money supply was growing at a rate that promised continued growth without inflation through the end of the decade. The monetary explosion that began late last year threatens that record.

This is not a call for the referee to stop the game. Rapid money growth for a short period of time is no cause for panic. It should not, however, be ignored. To get money growth back on track and stop an increasingly energetic game from deteriorating into a bench-clearing brawl, the Bank needs to allow interest rates and the exchange rate to move up in line with Canadians' increased confidence and willingness to spend. If it does so, Canadians will be able, for the rest of the 1990s, to take their eyes off the referee and enjoy the game.

Notes

1 Figure 2 uses two-year changes in M1 so that the span of measurement for money growth corresponds to that used for changes in inflation (which are calculated by comparing year-over-year rates with their year-earlier counterparts).

Backgrounder © is an occasional publication of the C.D. Howe Institute. Its purpose is to comment briefly on policy issues of immediate concern to Canadians.

As with all C.D. Howe Institute publications, the views expressed here are those of the authors and do not necessarily reflect the opinions of the Institute's members or Board of Directors. David Laidler and William Robson, the authors of this issue, are Professor of Economics at the University of Western Ontario and an Adjunct Scholar of the Institute, and a Senior Policy Analyst at the Institute, respectively.

Copies of *Backgrounder* are available free of charge from the C.D. Howe Institute: 125 Adelaide Street East, Toronto, Ontario M5C 1L7 (tel.: 416-865-1904; fax: 416-865-1866).