70 Years of Central Banking in Canada

Remarks by David Dodge, Governor of the Bank of Canada, to the Canadian Economics Association

The Bank of Canada sponsored a special seminar, "70 Years of Central Banking in Canada," at the Canadian Economics Association meeting in May 2005 to celebrate the 70th anniversary of the Bank's founding. Four distinguished panellists, Angela Redish, David Laidler, John Chant, and John Helliwell—all former special advisers to the Bank—offered their reflections on the development of monetary policy during the past 70 years. Their presentations are reproduced in this issue of the Review, *beginning with the Governor's introductory remarks (below).**

—John Murray, Guest Editor

It gives me great pleasure to be here today with you, and to chair this special conference session celebrating the 70th anniversary of the Bank of Canada.

The Bank opened its doors on 11 March 1935, at the height of the Great Depression, and immediately faced enormous challenges. In meeting those challenges, the new Bank of Canada drew on the experience of other, established central banks. It received valuable guidance in functions such as the issuance of bank notes,managing foreign exchange reserves, and promoting financial stability.

However, such guidance did not prove to be much of an advantage in what has become the main function of the Bank of Canada—monetary policy. Up to the time that the Bank was founded, monetary policy had been subject to the tight discipline of the gold standard—a topic that Angela Redish has explored in her work. That discipline severely limited the authorities' room to manoeuvre.

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The notion that countries, acting through their central banks, might actually try to stabilize macroeconomic activity within their borders is a relatively new one. As a consequence, over the past 70 years, the Bank of Canada and other central banks have had to learn by doing—by experimenting and gradually refining the art and science of monetary policy implementation. We have received a great deal of help in this effort from the academic community, including the people here today. But it has not been an easy exercise—nor is it finished. Monetary policy is still very much a work in progress.

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* Although all of the authors provide references for additional reading, readers may also consult the following for historical details and context relating to the article by John Helliwell: D. McQueen, "Economic Research at the Bank of Canada: 1935–65," *Canadian Business Economics* 5 (2–3): 89–95 (1997); and P. Duguay and D. Longworth, "Macroeconomic Models and Policy-Making at the Bank of Canada," in *Empirical Models and Policy-Making: Interaction and Institutions*, ed. M. Morgan (New York: Routledge, 2000). The former is reproduced on the Bank's website (www.bankofcanada.ca).

The Evolution of Monetary Policy

Let me now briefly review some of the significant changes in monetary policy that have taken place over the past 70 years. The Preamble to the Bank of Canada Act states that the Bank should:

> 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 . . . promote the economic and financial welfare of Canada.

Seventy years later, this is still an accurate description of our goal. However, the Act does not provide any practical guidance as to how this objective should be pursued.

Through the late 1930s and the early post-war period, the main concern of the central bank was to try to eliminate, and then to avoid a return to, the deflation and high unemployment of the Depression years. The government shared this preoccupation, as evidenced by the 1945 federal White Paper on Employment and Income.

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Things started to change in the late 1950s and early 1960s, when economists led authorities to believe that there was a permanent trade-off between a little bit more inflation and a little bit less unemployment. All authorities had to do, it was believed, was pick their preferred point on a downward-sloping Phillips curve. But the bitter inflationary experiences of the 1970s and a belated recognition that the Phillips curve might be vertical in the longer run—if not slightly upward sloping—eventually led to an increased focus on price stability as the goal for monetary policy. We began to appreciate what Olivier Blanchard calls the "divine coincidence"—that is, the realization that aggregate demand-supply equilibrium and price stability are complementary objectives. We've realized that a low, stable, and predictable inflation rate is probably the best contribution a central bank can make to the economic welfare of the nation.

Since inflation was viewed as being "everywhere and always a monetary phenomenon," monetary aggregates were used as intermediate targets. But, eventually, they proved to be an ineffective anchor. As Gerald Bouey said, we didn't abandon monetary aggregates, they abandoned us. And so at the beginning of the 1990s, in the search for a new policy anchor, central banks started to focus directly on inflation, either through implicit or explicit inflation targets.

Monetary Policy Transmission and Policy Effectiveness

The instruments that we have used for the transmission of monetary policy have also changed over the years. In the first 35 years of the Bank's existence, we relied on a "belt and braces" approach to policy execution, in the belief that credit was fungible and that every possible financial avenue had to be covered.

The result was a complex mix of primary and secondary liquidity requirements, interest rate ceilings, quantitative limits, outright restrictions and prohibitions, foreign exchange market intervention, and—when all else failed—a healthy dose of moral suasion. Attempts to describe the conduct of monetary policy turned into a bewildering stream of arcane details that left listeners confused or—it was sometimes hoped—in awe of the economic alchemists who plied this mysterious craft.

This started to change in the 1960s, particularly following the Royal Commission on Banking and Finance in 1964, chaired by Chief Justice of Ontario Dana Porter. It would be hard to overestimate the impact of this analysis, and the sea change in official thinking that was initiated by the Porter Commission.

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The Commission's revolutionary analysis threw out the old reliance on extensive control over the financial system. As a result, Canadian officials were among the first to understand that reserve requirements and various other controls are actually inimical to the efficient operation of the financial system. The government gradually abandoned these controls in its regulation of financial institutions, and so did the Bank in its implementation of monetary policy. Today, the Bank simply announces its target overnight rate, and the market does the rest—a form of virtual, yet effective, control, back-stopped by the Bank's ability to borrow and lend near-infinite amounts of liquidity. After decades of research, and trial and error, we have reduced the conduct of monetary policy to its essential elements—perhaps a form of alchemy, after all!

From there, the next logical step was to make the conduct of monetary policy more transparent and accountable. In the past, central banking had often been cloaked in deliberate secrecy, relying on the element of surprise for its presumed effectiveness. Governance and accountability were not considered important. Communications and reporting were limited to an annual report and a few public addresses. Now, following on the work of John Chant—albeit with a significant lag—we have a clear, highly transparent paradigm for the conduct of monetary policy, and the Bank can be held accountable for its performance. Effective communication is an essential part of that transparency.

Monetary Policy and a Flexible Exchange Rate

Finally, let me talk about the role of the exchange rate in monetary policy. Canada moved to a flexible exchange rate in 1950 and again in 1970—well before most other countries. Although this gave Canada monetary policy independence, a flexible exchange rate alone does not provide a "coherent monetary order," as David Laidler has noted. The monetary policy framework still requires a nominal anchor to help guide decisions and expectations.

As I've said before, the Bank searched for that anchor throughout the 1970s and the 1980s. The outcome of that search was our eventual adoption of inflation targets in 1991. And this anchor has exceeded our most optimistic expectations.

Looking Ahead

This isn't to say that we have reached the end of monetary policy history. The Bank of Canada and other central banks are constantly looking for improvements. The inflation-targeting framework that the Bank and the government put in place 14 years ago has performed well. It is up for renewal in 2006, and we are now in the process of assessing both its past performance and possible refinements for the future.

As in the past, we are drawing on the work of researchers both outside and inside the Bank. A long tradition of successful modelling and analysis underlies our work, going back to people such as John Helliwell, who put the Bank on the frontier of macro-modelling in the late 1960s with initiatives like RDX. This research and external networking continues and was evident in the conference that the Bank hosted last month on "Issues in Inflation Targeting."

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As we move forward and add to the Bank's proud history, it is always useful to look back. Special occasions, such as this 70th anniversary, are valuable opportunities to reflect on the work of those who have preceded us.

I look forward to the presentations of our four distinguished panellists—John Chant, John Helliwell, David Laidler, and Angela Redish—all of whom have served as special advisers to the Bank. I want to thank them for the contribution they made while at the Bank, and for their continued efforts in advancing the practice of monetary policy in Canada. They will each speak for about 15 minutes. After that, I will open up the proceedings for questions and comments.