The Case for Price Stability, Then and Now: A Retrospective Note on John W. Crow's 1988 Eric J. Hanson Memorial Lecture

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Abstract: John Crow's 1988 Hanson Lecture argued for making price stability the goal of Canada's monetary policy, but in the early 1990s, political and economic circumstances led policy makers to settle for a 2 percent inflation target instead. The recently instituted review of the Inflation Control Program has put price stability on the policy menu again, and the current relevance of Crow's 1988 case is assessed in the light of the past 20 years' experience.

Key Words: Price stability, Inflation targeting, Bank of Canada, Monetary policy

JEL Classifications: E42, E58, E61.

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I

Bank of Canada Governor John W. Crow's January 1988 Eric J. Hanson Memorial Lecture (Crow 1988), presented a comprehensive, if in many respects conventional for its time, overview of "The Work of Canadian Monetary Policy". It dealt extensively with such already much discussed matters as the roles played by monetary aggregates, interest rates, the exchange rate and inflation expectations in policy's transmission mechanism, the interaction of monetary and fiscal policy, and so on. But, with respect to the goals of policy, Crow struck one note with unusual emphasis and changed the direction of subsequent debate in Canada. He proposed that "Monetary policy should be conducted so as to achieve a pace of monetary expansion that promotes stability in the value of money. This means pursuing a policy aimed at achieving and maintaining stable prices" (1988, p. 4)[1]

By 1991, Crow's price stability goal seemed to be on its way to realization with simultaneous announcements in February of that year by the Bank of Canada and the Minister of Finance (in his budget speech) of a formal and gradualist inflation *reduction* program, that was ultimately to lead to just such a state of affairs. This was not to be, however. Though today's inflation *control* program, with its two per-cent target, evolved directly from this 1991 announcement, it delivers low inflation, not price stability. But, as it happens, this program is currently under serious review, and on its own twentieth birthday in 2011, it might even be modified in the direction of Crow's original aspirations. In these notes, I shall discuss, in turn, why these were disappointed in the 1990s, and whether the arguments he advanced to support them in 1988 retain any relevance for current discussions.

II

The 1988 Hanson Lecture was not the first occasion on which price stability was proposed as a policy goal in Bank of Canada statements. The phrase had appeared in earlier speeches from time to time in the 1980s, even under the governorship of Gerald Bouey, but never before had it been accorded such pride of place. Though it is nowadays uncontroversial to suggest that monetary policy is appropriately aimed at a *single* target variable, and a nominal one at that - the price level or its rate of change, or perhaps under a very different regime to that now in place, the exchange rate - opinions were not so clear-cut in the 1980s. At that time, monetary policy was still widely regarded as a means of stabilizing the cycle, trading off inflation against unemployment as it did so, at least in the short run. It was usually expected to do this in co-operation with fiscal policy, moreover, and perhaps with the occasional support of more direct interventions in wage and price setting processes as well.

The very idea that monetary policy should focus single-mindedly on the price level was thus radical in and of itself, let alone Crow's more specific proposal that the Bank should go it alone in aiming at that variable's stability. Also, the fact that inflation had, by 1988, been consistently above 5 per cent for about fifteen years, and had twice moved into double digits, only added to the air of unreality that many attributed to this element of his lecture, an

[1]All page references given here to Crow 1988 refer to the 1988 Department of Economics, University of Alberta version, full details of which are given in the bibliography

impression further re-enforced by its failure either to define price stability, or to lay out any time-table for its achievement.

So matters remained, as far as major policy pronouncements were concerned, until February 1991, when the Department of Finance and the Bank of Canada jointly announced that monetary policy would henceforth be conducted so as to put inflation, as measured by the year on year percentage change in the Consumer Price Index - then running at close to 5 per cent but about to get an upward push from the introduction of the GST - on a slowly declining time path towards 2 per cent by 1995; and they also promised that, beyond this date, there would be further progress towards price stability.[2] This latter state of affairs would involve "a rate of increase in consumer prices that is clearly below 2 per cent", but beyond that, its precise nature was left open, pending further research.

Though this 1991 program at the time looked like an orderly next step in the implementation of a carefully thought through agenda that had begun around the time of the Hanson lecture, we now know that there was an element of opportunism to its introduction. The Bank of Canada seems to have had an eye firmly on its longer term implications for monetary policy, and to have taken the commitment to ultimate price stability very seriously, but the Department of Finance's main concern in 1991 seems to have been the more immediate one of making it clear to those involved in bargaining about wages that any increases aimed at compensating for the effects on consumer prices of the above-mentioned introduction of the GST would not be accommodated by monetary policy.[3] The short-term expediency that marked the program at its outset did not, under the best of circumstances, bode well for its durability, and, more ominously, the times were not providing the best of circumstances, either political or economic.

Governor Crow's seven year term of office was to expire in early 1994, and, as it happened, October 1993 saw an election in which economic policies were major points of contention. The Liberal party that it brought to power had promised to renegotiate the NAFTA and abolish the GST, the two principal economic policy achievements of its predecessor. Furthermore, though the Liberals had not made the inflation reduction program itself an explicit election issue, it was nevertheless the political property of a Conservative Minister of Finance who had announced it in a budget speech, and hence was fair game for change. When the new Minister of Finance in due course apparently insisted (as was his right) that the achievement of price stability after 1995 be deferred into a future sufficiently distant as to be indefinite, Crow withdrew his candidacy for re-appointment. Evidently his commitment to price stability

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[2]Specifically, the target for 1992 was 3 per cent, for the twelve months preceding July 1994, 2.5 per cent, and for 1995 2 per cent.

[3]On this episode, See Crow (2002, Chapter 8)

remained as strong as it had been in 1988, and, equally evidently, this term meant to him something very different from, and inferior to, a quasi-permanent 2 per cent inflation target.[4]

Even among those who (like this author) had sympathy with the 1988 Hanson Lecture's views on monetary policy's appropriate goals, and had cautiously welcomed the 1991 program, not everyone took the changes made in 1993 as seriously as did Crow, probably out of relief that so much of the program in question had, after all, survived the change of government. This outcome had been by no means certain before the event, because the Bank of Canada's "high interest rate, low inflation" policies - as the media routinely characterized them - were extraordinarily unpopular in the early 1990s. Being widely regarded, moreover, as stemming from an obsession with inflation to the exclusion of all else on the part of Governor Crow, their unpopularity tended to spill over to the idea of inflation targeting itself, to the point of threatening its very survival in any form.

Now, given monetary policy's undoubted role in bringing on the recession of 1990-91, widespread suspicion about its low inflation and price stability goals among the electorate was entirely understandable, but what was (and perhaps still is) often missed about this episode was that the measures which did most of the damage were implemented well before, and quite independently of, the 1991 introduction of the inflation reduction program. Furthermore, they were not so much the result of the Bank of Canada having already begun to devote monetary policy single-mindedly to reducing inflation, as of efforts on its part - seriously overdone, in my view, both then and now - to influence the exchange rate. These efforts stemmed from ideas left over from earlier policy regimes and had already done great damage in precipitating a previous even more severe recession in 1981-2 when the Bank raised short-term interest rates well into double digits in order to prop up the dollar, and, less dramatically, in the later 1980s too, when those rates had been held down to prevent it appreciating. But the ideas in question had nevertheless received considerable respectful attention in the Hanson Lecture, where their basic incompatibility with the single minded pursuit of price stability went unrecognized.

Be that as it may, as early as the end of 1989, monetary policy already appeared to have embarked upon a gradualist program of reducing inflation, and, consistent with such a program, the stance of policy was slightly eased at the beginning of 1990 as the real economy seemed to be slowing. Financial markets did not share in this interpretation of events, however, and a sudden (four cents in as many weeks) fall in the exchange rate ensued, accompanied by a sharp rise in longer term interest rates. According to the doctrines about the exchange rate's role in monetary policy set out in the Hanson lecture, any weakening of the currency that could not obviously be attributed to real factors was to be interpreted as relaxing monetary conditions and hence as requiring offsetting action on short-term interest rates. Crucially too, those same doctrines recommended vigilance against any signs of extrapolative expectations in the exchange

[4]Crow's own account of this episode (Crow 2002, pp. 206-7) is discreet, but it does, I think permit this conclusion. All in all the attitude of the new Government to monetary policy at the time of its election gives an impression of confusion, and perhaps not just about monetary policy. The reader will recall that the 1994 budget was directionless. Note that fiscal policy changed radically in 1995, and that pledges to reopen the NAFTA and do away with the GST were eventually abandoned as well.

market that might drive the rate down to an extent sufficient to exert independent upward pressure on domestic prices, thus threatening an unstable spiral that might, in extreme circumstances, prove hard for the Bank of Canada to control.[5]

Both ideas were set out in the Hanson Lecture, and invoked again by Crow in his introduction to the Bank's 1990 *Annual Report* to justify the sharp tightening of monetary policy that was its immediate response to the exchange rate's steep decline, and then had been sustained for long enough into the summer to precipitate a severe recession.[6] This recession, in its turn helped reduce inflation from just over 6 per cent in January1991, when the GST was introduced, to less than 2 per cent by January 1992, when that tax's effects came out of the year on year inflation calculation: all this in the course of the very year in which monetary policy had been given the formal goal of reducing inflation gradually to 2 per cent over a three year period!

There is space here only to mention the many other factors that conspired for two or three years thereafter to keep monetary policy almost always tighter than was needed to achieve its gradualist goals of 1991 - at home, the failure of the Charlottetown Accord (itself a response to the 1990 failure of the Meech Lake Agreement) and the subsequent near success of the Quebec referendum on sovereignty, and abroad the EMS and Tequila crises - and also only to note the contribution made by that tightness to finally bringing to a head in 1995 a fiscal problem that had been festering since the mid-1970s, and about which Crow had already expressed concern in (1988, p. 7).[7] Suffice it to assert also that what now appears surprising about the first half of the 1990s is not that the central pillar of the monetary policy agenda set out by John Crow in 1988 disappeared under the political and economic pressures of the period - some of them admittedly self-inflicted by the Bank - but that enough of it nevertheless survived to make it possible now to ask whether price stability is a policy goal worth putting in place in 2011.

III

Whatever may have been the case in the early 1990s, there is nothing improvised about the way in which monetary policy is now implemented in Canada. Since then its tools and conduct have been much refined, as have the Bank of Canada's communication strategies, in ways too complex and numerous to delineate here, but which have surely made major contributions to the Bank's success in delivering inflation that has averaged almost exactly 2 per cent since 1995 when this finally became its target value, and to establishing among the public at large the ongoing credibility of the Bank's commitment to this goal. Furthermore, despite the sluggishness of the economy's recovery in the early 1990s, Canada is now in its seventeenth year of continuous real expansion. On the fiscal front, moreover, a virtuous circle of low interest rates and budget surpluses has replaced the vicious circle of earlier years, to the point at which the major risk in this area now is that the public's newly found liking for fiscal surpluses and low

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[5]See Laidler and Robson (1994, Ch. 7) for an essentially contemporary account of this episode. The Hansen Lecture's discussion of the role of the exchange rate in the monetary policy nexus occurs in Crow (1988, pp. 15-20).

[6]See Laidler and Robson (1994, pp. 102-103)

[7] Pierre Fortin (1996) gives a thorough account of the early 1990s experience that is highly critical of the Bank's policies

taxes will force pro-cyclical contractions in government spending when the real economy next goes into recession, as sooner or later it surely will. These would not only tend to amplify the downturn in question, but could also damage the microeconomic efficiency of those parts of the public sector where they were imposed.

As to the exchange rate, when it came under pressure in 1998 as a side effect of the Asian Crisis and Russia's default, measures resembling, albeit as a pale shadow, those of early 1990 - a market intervention accompanied by an interest rate increase - were tried to support it. When these failed, however, they were not persisted with. In particular, and in sharp contrast to1990, the interest rate increase of August 1998 was quickly unwound before it could induce much domestic disinflation. The lessons that monetary policy can target domestic inflation or the exchange rate, but not both, and that letting the exchange rate adjust itself to circumstances, including the domestic inflation rate, is not after all a likely recipe for imported economic disaster, seem to have been finally learned in 1998, and there have been no interventions since then. Furthermore, the presumption that underlay policy making in the early 1990s, namely that exchange rate movements normally require an interest rate offset, was also slowly given up in the 1990s; though not totally, of course, for information about the rate's behaviour and the factors driving it as they impinge upon the outlook for inflation still influence the design of policy even today.[8]

In short, Canada’s current monetary order is both coherent and successful, but, as already noted, the inflation targeting policy that lies at its centre is now under review.[9] Low inflation is not price stability, after all, and perhaps it is still possible to do better. It will be helpful to the further discussion of this matter first of all to repair an already noted omission in Crow’s lecture, by defining the idea of price stability in precise quantitative terms.

Given that the phrase "price stability" plainly means that prices on average should neither rise nor fall over time, and given that there is an upward bias of something under one percentage point in the way the CPI, the Bank of Canada's chosen target price index, currently measures inflation, but given also that working in round numbers contributes to monetary policy’s transparency, it is hard to see how the quantification of a price stability target in Canada could, at the present juncture, involve anything other than a measured inflation rate of one per cent. Furthermore, given that occasional overshoots and undershoots of such a target are inevitable, the requirement that prices on average should remain stable over time should also surely imply a commitment to return them to the appropriate time path after such an event, rather than to allow bygones to be bygones. In short, to implement John Crow’s 1998 policy goal in 2011 the Bank of Canada would have to give up its 2 per cent inflation target, and aim instead at keeping the Consumer Price Index close to a time path that rises by 1 per cent per annum. This is not the

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[8]The policy experience underlying the developments discussed here is surveyed in Laidler and Robson (2004). Even today, there is room for disagreement about how much attention should be paid to exchange rate movements in the actual execution of monetary policy, witness recent discussion about the extent to which interest rates should be used to offset the currency's appreciation to the region of par and even above.

[9]See Bank of Canada (2006) for details of this review, and its raison d’etre.

right occasion to express and then defend a firm opinion about whether or not this would be worth doing, but it is appropriate to assess how much weight can be given now, in the light of experience, to the arguments that Crow advanced in favour of a price stability target in 1988.

At that time, the idea of simply learning to live with inflation at its then prevailing and apparently deeply entrenched rate of 4 or 5 percent, rather than incur the costs of reducing it by any significant amount, was popular, and Crow used this at a foil against which to deploy his own proposal First of all, he argued, such an alternative goal would not be sustainable: those who were willing to tolerate inflation at rate of 4 per cent, would very likely be willing to tolerate 5, so any upward disturbance to the status quo would go uncorrected. And if 5 was tolerable, why not 6 in the event of another disturbance? Tolerance for positive inflation would thus inevitably breed tolerance for rising, or at least fluctuating, inflation, and the monetary system would always lack firm direction under a policy regime founded on it. Price stability, on the other hand, had about it a degree of authority that would encourage efforts to restore it in the event of any disturbance, and hence could anchor the monetary system.[10]

To many in Crow's late 1980s audience, this would have been recognizably an application of arguments that had been current in the 1950s and ‘60s about the dangers of putting up with what had then been called “creeping” inflation. To those same listeners, the experience of the two previous decades must also have seemed to provide considerable empirical support to his views, and to their corollary that, when it came to inflation, zero might after all be something of a magic number.

But two more decades have now passed, and if, in Canada, they have demonstrated one thing about monetary policy beyond reasonable doubt, it is surely that a target for a low positive inflation rate (albeit 2 rather than 4 per cent) can be set and sustained for a protracted time period. And the further facts that, at current count, twenty three other countries also now target low but positive inflation rates - Canada was only the second, after New Zealand, to try this - and that the only ones to have given up such policies so far - Finland and Spain - did so in order to adopt the Euro as their domestic currency, only serve to undermine this element of Crow's case further. Price stability might still be the right goal - though only the ECB is currently committed to it, albeit in a very anaemic version - but only if it promises to produce better economic results than any stable inflation (or deflation) alternative, and not because it alone is viable and sustainable.[11]

In 1988, Crow thought that price stability would also pass this second test, advancing an early version of the argument that price stability would be conducive to better productivity

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[10]See Crow (1988, pp. 5-6). The idea of living with inflation derived from the view that the transitional costs of reducing it were not likely to be outweighed by any longer term gains. This “cost-benefit approach to monetary planning” owed much to the work of Edmund Phelps. See in particular Phelps (1972), whose subtitle is quoted here.

[11]The European Central Bank, which did not exist in 1988, currently operates under an explicit price stability mandate given to it in the Maastricht Treaty, and quantifies this in a way not very different from that adopted in Canada’s original 1991 inflation control program, namely as an inflation rate “below, but close to, 2 per cent”.

performance because, with it in place, the clarity of the information and incentives that the structure of relative prices, and changes therein, transmitted to economic agents would be enhanced. In due course, such arguments would be extended, notably by Peter Howitt (1990), to pay specific attention to matters like the interaction of inflation with an only partially indexed tax system, and also to include the possibility that, in leading to investment inefficiencies through such a route, inflation probably reduced not just the level, but also the rate of growth of productivity. The experience of the preceding two decades in western economies, Canada included, seemed to provide ample anecdotal evidence of such effects, as indeed did the baleful experiences of high and hyper-inflations, both recent and not so recent, in many other places.

These arguments played a central role in the debates of the 1990s about the virtues or otherwise of Canada's two per cent inflation target, though they were never without their critics - for example Fortin (1996), Christopher Ragan (1998) - because they implied that productivity gains from reducing inflation would be available, albeit on a shrinking scale, all the way down to zero, and that these might be large enough to more than offset any costs incurred in reducing the inflation rate over some meaningful range. For this reason, Canada's overall rather disappointing experience with productivity growth since the early 1990s is relevant to today's policy choices.

As lower inflation became embedded in the economy in the 1990s, it was associated with greater labour peace, lower interest rates, more stable and liquid capital markets, particularly at the longer terms that are particularly important for investment decisions, not to mention a considerable reduction in the overall volatility of the real economy. All of this was very much for the better, making economic life a little more tranquil and easier to cope with for the majority of Canadians, but it does not seem to have paid any notable material dividends. Although the economy's productivity performance did improve a little in the 1990s, particularly during the first half of the decade, most of this improvement was almost surely the result of the rationalization of production in the manufacturing sector prompted by the NAFTA. Once this effect is allowed for, there seems to be little or nothing left over to be attributed to lower inflation, making it hard to avoid the conclusion, that, no matter how damaging hyper - and even merely high - inflation undoubtedly is, modern economies, Canada included, are able to function well enough so long as it remains in low single digits.[12] And this in turn makes it difficult to claim that a reorientation of monetary policy from a 2 per cent inflation target to price stability is likely to lead to any noticeable gains in output or its rate of growth.

Now the foregoing points do not actively argue against making price stability the goal of monetary policy, but they surely imply that the case in favour of adopting such a goal, once low inflation is already well established, is weaker than one might have thought, and that any decision taken for 2011 will therefore have to hinge on other considerations. One of these will surely be whether downward stickiness in the level of money wages, such as was postulated by Akerlof, Dickens and Perry (1996), is sufficiently widespread and persistent as to cause price stability, or even merely lower-than-current inflation, to generate a permanently higher

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[12]Laidler and Robson (2004 pp. 139-155) elaborate this assessment, and give references to an extensive literature on the questions involved.

unemployment rate than we have recently experienced. Another will be the extent of any transitional costs to be incurred in moving from two per cent inflation to price stability. The current two per cent inflation target is widely agreed to be extremely credible, and if this is because the Bank of Canada is now trusted by the public at large to mean what it says and deliver what it promises, then an announcement of any impending policy change on its part should be enough to set adjustment to it in motion and keep transitional costs low; but if the current regime's apparent credibility simply reflects the behaviour of agents who have by now adapted to two per cent inflation without really understanding it, then change will be altogether more difficult. We need a thorough and up-to-date review of these questions before any policy decision is made.

And then there are the distributional effects of inflation on those unable to adapt to it. These were serious in the 1970s and 1980s, particularly with respect to the sticky nominal incomes of an older generation whose earlier years had already been scarred by depression and world war – two of the latter in some cases - and it is surprising that Crow did not mention them in his Hanson Lecture. Even so, such effects are surely less of an issue in today's 2 per cent inflation environment, but they are still there, and the baby-boom generation that will be particularly subject to them in its retirement might just be numerous enough, and therefore carry enough political weight, to make them a more important focus of debate this time around. If this conjecture proves accurate, then perhaps the battle for price stability might even be won on the basis of arguments that were not even deployed when it was first begun in 1988.

IV

This note has reflected briefly on the relevance of a lecture given twenty years ago both for what happened in its immediate wake, and for a policy review that is currently in progress. I hope that my readers will first of all agree that, even though subsequent experience did not treat all of its ideas kindly, John Crow's Hanson lecture still provides much food for current thought. But I hope also that they will not overlook the more important fact that, whatever the outcome of the current review, this country's monetary policy regime will, in one way or another, almost surely continue to be aimed at the behaviour of the price level. It will thus also continue to conform to one aspect of that lecture's central message, which, though it may be a commonplace now, was anything but that in 1988.

Today – setting aside the occasional pleas that are still made on behalf of a fixed exchange rate, or a North American monetary union - we are mainly arguing about whether we should target the time path of the price level or its rate of change, and at 1 per cent or 2 - perhaps someone will suggest 3 - and these matters are utterly trivial when compared to those at stake twenty years ago. Crow's specific price stability agenda may not have won the day, and whether it ever will remains an open question, but the broader idea underlying it, namely that monetary policy needed to be refocused single-mindedly on setting and achieving a goal for the behaviour of the price level, did catch on, in the process changing the course of the Canadian debate, and in due course the policy regime too. John Crow therefore deserves more credit than he has yet received as an important architect of the monetary stability that Canada now enjoys.

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