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What I propose to do on this panel today is to talk about stabilization policy and policy cooperation from the viewpoint of an industrial country that has a floating exchange rate and both an explicit inflation target for monetary policy and a clear objective for fiscal policy. While my perspective has been particularly influenced by my time as deputy minister of finance and now as governor of Canada's central bank, the broad outlines of my conclusions are widely shared, not only in those two institutions, but in Canadian academic and public policy circles as well. Moreover, I believe that our experience and the lessons that can be drawn from it are applicable to all open economies with flexible exchange rates.

In the 1990s, the Bank of Canada and the government of Canada reached a series of joint agreements on inflation-control targets. As well, the government established a framework that greatly reduces the probability of running a fiscal deficit and, thus, puts the debt-to-GDP ratio on a clear downward track.

Initially, the credibility of these policies was not high; so, it was essential to demonstrate clearly our resolve to achieve greater fiscal prudence and lower inflation until credibility was gained. Thus, it was sometimes necessary to override the automatic stabilizers of fiscal policy

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in order to establish credibility. And for monetary policy, it meant that we could not always implement the easing warranted by our inflation targets. But as the targets were achieved, the public's trust that the authorities were going to do what they said they would do increased. That trust is tremendously important.

Now that the credibility of both monetary and fiscal policies is firmly established, the stabilizers are able to do their job.

I would like to begin by considering stabilization policy, then say a few words on policy cooperation.[1]

I. STABILIZATION POLICY

Monetary policy and stabilization

In aiming to achieve a 2 percent inflation target over an eighteen- to twenty-four-month horizon, Canadian monetary policy plays an important role in stabilizing the economy in response to demand and supply shocks.

When there are shifts in demand, the direction of changes in our policy interest rate is quite clear. Suppose that the economy is operating at its production potential and that inflation is at the 2 percent target. A downward shift in demand would create excess supply in the economy, putting downward pressure on inflation. To bring inflation back to 2 percent over a period of eighteen to twenty-four months, the Bank of Canada would lower its target for the overnight interest rate. Through its effect on market interest rates and the exchange rate, this action would increase the level of output in the economy, moving it back toward production potential. Inflation would, therefore, return to the target shortly after the excess supply disappeared from the economy. An upward shift in demand would, of course, generate symmetric responses.

While the theory is clear about the appropriate response to demand shocks, the magnitude and persistence of shocks—and, hence, the size and timing of interest rate adjustments—are always difficult to judge. This is where the art of monetary policymaking comes into play.

It is even more difficult, of course, to gauge the appropriate monetary policy response to supply shocks, which take the form of higher (or lower) inflation than expected for a given level of demand. The bank's framework for inflation targeting allows temporary supply shocks to be largely ignored, as long as they do not feed into inflation expectations. The credibility that has been established means that they typically no longer do so. Consider price surprises coming from the most volatile components of the consumer price index—components such as fruits and vegetables or fuel oil and natural gas. As our operating guide, we use a measure of core inflation that excludes these components. This gives us, and economic observers, some confidence that we are looking at something close to the underlying trend of inflation. Thus, our interest rate response to price shocks that are perceived to be temporary can be minimal. As a result, there will be little effect on output. In other words, monetary policy does not turn temporary supply shocks into something that is destabilizing for aggregate output.

A more difficult situation occurs when persistent increases or decreases in prices coming from the most volatile components of the consumer price index threaten to keep the total index away from the target for a significant period. Credibility helps here too, but the bank must be particularly cautious that these movements in inflation do not feed into inflation expectations.

Supply shocks that take the form of a change in the level or growth rate of potential output are often hard to recognize. Here, however, the key is for the central bank to return the trend of inflation to the target if it has moved away. Since the trend of inflation relative to the target is the best indicator of where demand is relative to potential output, this will be consistent with moving demand back into line with the new path of potential output over the medium term.

Fiscal policy and automatic stabilization

In Canada, the main automatic fiscal stabilizers are various types of tax revenues, as well as employment insurance payouts. Some of these fiscal stabilizers work almost immediately—for example, personal income tax deducted by the employer. Others, such as employment insurance payments, work with a fairly short lag.

Comparing and contrasting automatic fiscal and monetary stabilizers

Automatic fiscal stabilizers are very effective in dampening an output cycle. But they offset only part of the change in output. In contrast, monetary policy can fully offset a change in output, but it takes time to work, with the full impact on output normally felt only after twelve to eighteen months.

Discretionary stabilization policy

While the *automatic* or quasi-automatic stabilization provided by monetary and fiscal policies is very desirable, the question remains as to whether there is a role for something further—a *discretionary* stabilization policy.

In the case of monetary policy, the nature of the response is the more or less automatic one described earlier. As I implied then, judgment is key to the process. That is particularly true in times of great uncertainty, such as last autumn. But a clear inflation target means that, in principle, the discretionary choice for monetary policymakers is limited relative to that of the fiscal authorities.[2]

The arguments for and against discretionary fiscal policy as an important element in macroeconomic stabilization in an *open* economy tend to revolve primarily around lags and around the effectiveness of short-run fiscal policy relative to monetary policy.

If the timing were close to perfect, fiscal policy measures that lasted for two or three quarters could, *in principle* and under ideal circumstances, shorten the time it takes to move output back to its desired level. Thus, in principle, discretionary fiscal policy is a useful tool. But, as a practitioner, I can tell you that the great problem here is that temporary measures are both difficult to initiate quickly when the need arises and extraordinarily difficult to stop once the need is past.

Thus, as a practical matter not a philosophical one, there are some severe limitations to the use of discretionary fiscal policy as a stabilizer.[3, 4]

My views about this have been reinforced by the way the business cycle in Canada has developed over the last eighteen months or so. In early 2001, we were expecting that the slowdown in both the U.S. and Canadian economies would be modest. In Canada, an earlierannounced tax cut was fortuitously coming into effect. It was not until the middle of last summer that it became evident that the Canadian economy was undergoing a more pronounced slowdown than we had expected. Between January and August 2001, we had lowered our policy interest rate by 175 basis points. Even the most ardent supporters of discretionary fiscal policy would not have thought about doing anything major until August. With the horrific events of September 11, economic forecasters marked down their forecasts for 2001 and 2002 significantly. We, like other major central banks, accelerated the pace at which we were cutting interest rates—from September through January 2002, we lowered our policy interest rate by a further 200 basis points.

Fortunately, the Canadian government added only a small amount to spending in its budget announcements in late 2001, and that consisted mainly of necessary spending for security and border issues. I say "fortunately" because, based on the national accounts published at the end of May 2002, growth in the Canadian economy actually rebounded in the fourth quarter of 2001 and accelerated to about 6 percent in the first quarter of this year.

Thus, with the benefit of hindsight, it is evident that there was more underlying strength in the economy than we expected. Combined with the large amount of monetary stimulus that was applied, this meant that the economy could recover rapidly. Therefore, added fiscal stimulus was not necessary to get the economy going. And the monetary stimulus provided is proving much easier to turn around. Since mid-April, we have raised our policy rate by 75 basis points. To be sure, other uncertainties have arisen and will continue to arise in the future. Our best judgment about these uncertain factors will continue to be taken into account. But, overall, this episode is clearly showing that monetary policy actions can be used more flexibly than fiscal policy actions.

I would stress that discretionary fiscal policy can also get governments into trouble if it leads them to neglect their long-run fiscal anchor—particularly since discretionary action is more likely to be associated with an easing in policy than a tightening. This neglect would risk eroding fiscal credibility—the trust that the public has that the fiscal targets will be met.

II. POLICY COOPERATION AND STABILIZATION

Now, let me turn to the issue of policy cooperation and policy coordination.

Our inflation targets are joint targets. They are not just the bank's targets—they are the targets of the government of Canada as well.

Our view is that, essentially, "coordination" came through the joint agreement on inflation targets. With clear agreement on the medium-term policy objectives and with a shared understanding of the policy framework, there is no need for coordination on the setting of interest rates and fiscal policy instruments.

The economic literature on policy coordination tends to be about situations where the fiscal and monetary authorities have one or more of the following: very different views of economic welfare,[5] inconsistent policy objectives, policy that is totally discretionary, or a tendency to get involved in game-like behavior with one another. None of these applies in Canada—and none should apply anywhere.

Given our policy framework, when the government changes fiscal policy, it needs to think of how these changes will affect inflation and, consequently, interest rates. Similarly, the Bank of Canada needs to consider how changes in fiscal policy will affect demand and inflation and, thus, its setting of interest rates. Therefore, it is to the mutual benefit of both parties to *cooperate* in sharing information and analysis as they adjust their policy settings.

Cooperation between the bank and the federal Department of Finance occurs on a number of levels. I have frequent discussions with the minister and deputy minister. And there are meetings at the staff level to share, for example, information from economic forecasts, surveys, and contacts with various groups and organizations. One of the key reasons for our regular discussions has been to ensure that each institution understands the details of the framework within which the other one is pursuing its objectives and how this framework is being implemented with respect to current economic surprises. The bank also keeps in close touch with provincial fiscal authorities.

Thus far, I have not said anything about the appropriate *mix* of monetary and fiscal policies when talking about coordination and cooperation. Quite simply, with explicit frameworks in place for monetary and fiscal policies, the whole issue of policy mix becomes moot. The fiscal and monetary authorities are both adjusting their policy instruments to attain their respective objectives. There is no other mix of interest rates and fiscal thrust that the authorities will perceive as consistent with meeting the monetary and fiscal objectives.

III. CONCLUDING THOUGHTS

Clear monetary and fiscal objectives, combined with clear accountability for meeting those objectives, provide the background for policy cooperation and stabilization in Canada. The monetary and fiscal policy frameworks have created an environment where cooperation in the form of sharing information and analysis is most effective. Fiscal and monetary credibility is high. In other words, economic agents trust that the monetary authorities and the fiscal authorities will maintain these frameworks.

With trust in place and with expectations well-anchored, the automatic fiscal stabilizers can be allowed to operate fully, and monetary policy actions can be directed to achieving the inflation targets. In addition, when major shocks occur, with trust in place, there can be a temporary overshoot or undershoot of the fiscal or monetary targets without unhinging confidence in the framework or in expectations that the targets will be met over time.

I believe that Canada's experience and the lessons we have learned about having clear policy objectives and supportive, transparent policy frameworks have broad applicability in open economies with a flexible exchange rate.

ENDNOTES

[1] The interaction of fiscal and monetary policies is covered more fully in Dodge (2002).

[2] Some commentators have described inflation targeting as "constrained discretion," in the sense that there is a clear objective and a medium-term framework but no precise rule for varying the policy interest rate (Bernanke and others, 1999). That is, there are many possible paths back to equilibrium. At the Bank of Canada, we have decided that the best way to implement inflation targeting is to have an acceptable tradeoff between the variance of inflation around its target and the variance of output around its production potential. Thus, we have chosen an eighteen- to twenty-four-month horizon for achieving the inflation target. We take into account all the relevant information, but we have no simple rule for setting interest rates.

[3] This is also the view of Cecchetti (2002) and Taylor (2000). For an opposing view, see Seidman (2001). Much earlier, Boulding (1969) summarized an academic session on recent experiences in the use of fiscal policy with a poem including the following lines, "… Policy may follow Fillip's Law—Too little and too late, too much too soon. ..."

[4] For the Canadian federal government, the limitation of discretionary fiscal policy as a stabilizer is compounded by the fact that Canadian provincial governments taken together represent a larger share of the economy than the federal government does, and their spending structure (which includes more spending on capital than the federal government) better lends itself to discretionary spending for stabilization purposes.

[5] That is, their "loss functions" are very different.

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