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Pitfalls and Opportunities for the Conduct of Monetary Policy in a World of High-Frequency Data

Pierre Siklos

Discussion

Lloyd Atkinson

My comments focus on the role of high-frequency data in formulating monetary policy and the potential for their misinterpretation by the public.

Two stylized facts are particularly relevant. First, monetary policy involves long and variable lags. Second, in order to understand inflation, one must understand the structural relationships that underpin the economy. High-frequency data can contain useful information, but it does impose the difficult task of separating short-term fluctuations—noise—from the true underlying economic trend.

One source of policy misinterpretation stems from the insistence of central bankers on using indicators that are not unambiguous. The monetary conditions index (MCI) is one example. Although the Bank of Canada is now highlighting the MCI's role as an indicator rather than as an operating target, and although the Bank is now permitting it to vary over a much wider range, the MCI is still subject to misinterpretation and misuse by those outside the Bank. The MCI can be a powerful tool for those who understand the world economy and Canada's connection to it. However, there is a tendency for market participants to perform a mechanical calculation of the MCI and anticipate monetary policy changes based on a simple number, rather than considering it in its proper context. As such, the MCI can be more dangerous than useful to the central bank. For example, the MCI that is appropriate for a given global situation will generally be inappropriate if that situation changes. Thus, the Asian crisis, which promises slower growth outside Canada's borders, should elicit, other things being equal, an easier MCI. This is not well understood in the financial community.

Speculation on how the Bank of Canada will respond to the current weakness in the Canadian dollar provides another example of how high-frequency data can be misused. There have been reports of a statistical convergence in Canadian and U.S. inflation rates. If inflation is similar in the two countries, one would think that nominal interest rates should be roughly similar and, hence, the Bank should bring Canadian rates in line with those in the United States (and in so doing, defend the Canadian dollar). However, my calculations indicate that the underlying structural rate of inflation is 100 to 150 basis points lower in Canada. This justifies the Bank's current policy of lower nominal interest rates, particularly given the evidence that the dollar's depreciation is linked to fundamental factors such as the decline in commodity prices and the crisis in Asia.