The Role and Objectives of Canadian Monetary policy

Paul Beaudry, Vancouver School of Economics, UBC

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Introduction

- Partial list of Issues we were asked to address
  - Objective: Price Stability or Broader?
  - Should the BoC consider a dual mandate?
  - Are there viable alternatives to inflation targeting and market determined flexible exchange rates?
  - In addition to financial vulnerabilities, are there other situations where the BoC may want to alter its inflation targeting horizon?

Start with First: Price stability and the value of money

- The goal of price stability is most often associated with the goal of maintaining a stable and predictable purchasing value for the Canadian currency.
- In practice, it may not matter much which price indice we choose for such a purpose. In the medium term they may behave similarly.
- However, there is one dimension on which is appears to matters considerably: domestic prices or in terms of the price of goods abroad.
- That is, the value of the Can $, in terms of purchasing power in other countries varies considerably.

Price stability and the value of money

- So my comments will focus on why it may be desirable to re-examine issues related to exchange rate movements before the next renewal
- This is an issue that many may prefer not to touch for many reasons.
- However, it may be a good "neutral" time to discuss it, as the dollar is not far from PPP (allow us to discuss variability, versus particular outcome)

Should the BoC worry about (real) exchange rate movements?

- Reasons not to include in objectives
  1. It is best to keep a simple target: inflation
  2. It may be counterproductive to do anything about it
  3. Conditional on domestic price stability, using purchasing power abroad may be irrelevant metric for evaluating the value of the currency
  4. The exchange rate movements may be mainly "good" movements (helping adjustment). EX: respect to changes in energy prices.
- These may all be good reasons, but I think it is at least worth re-exploring some issue more closely (as relates to growth and productivity).

Why real exchange rate movements may be good to re-explored prior to 2021

- A few well know facts
  1. The real exchange rate movements between Can/US are large and very persistent.
  2. The variability has been especially high under inflation targeting and changed. Example: correlation with commodity prices was was -.56 74-91, versus .81 91-16.
  3. The standard mechanism of pass through is very weak for many/most goods.(Demand switching effects often small)
  4. Many models have trouble explaining explaining exchange rate movements, so many of our models are not great guides for discussing policy on this dimension.

Reasons why the BoC could want to reduce low frequency real exchange movements volatility

- Before discussing further, want to clarify that it is medium run/lower frequency movements in the real exchange rate that may deserve focus
- These are not day-to-day changes, week-to-week or month-to-month
- But instead changes over years.

Reasons why the BoC could want to reduce low frequency real exchange movements volatility

- While the exchange rate movements may often help dampen the effect of outside forces, such as energy prices in energy exporting regions
- In other regions, because of limited pass through, this creates mainly high variability in profits (not changes in current demand)
- What is the effect of such variability?
  1. Could discourage certain types of firms, especially those with long horizons, to implement and develop in Canada.
  2. Could create a hysteresis effect after an appreciation, which isn't reversed by a similar sized depreciation
  3. May reduce investments in long lasting capital
- Since one of the biggest challenge facing the Canadian economy is improving productivity and growth, reducing low frequency real e variability could be important for well being of Canadians. (which would need to traded off against any short run benefits)

So what to do?

- Even if the current variability of the exchange rate has costs, can (or should) the BoC do something about it?
- Case against
    1. This complicates the communication of monetary objectives
    2. Could reduce the effectiveness of the inflation targeting on domestic price stability
    3. The currency market is extremely difficult to influence

Case for considering

- Elements in a case for considering
    1. The issue should not be about short term stability
    2. Issue should be, in the medium run sense, is having a goal for the REAL exchange rate (PPP type) desirable, that is, could it be effectively added as monetary policy objective over a medium run horizon.
    3. This may involve threatening temporary deviations from inflation target
    4. Conjecture: Maybe the market would react well to such a communicated anchor: simply by statement.
    5. Especially, given credibility, the currency could stabilize in the medium run with little actual actions by the BoC

Returning to initial questions

- Should our inflation targeting regime have broader objectives?
- I don't know
- Our inflation targeting regime has been very successful on many fronts
- However, before 2021, seems reasonable to ask whether any type of medium run real exchange rates goals may be desirable– and compatible– within inflation targeting regime .
- May be easiest to discuss such a situation when the exchange rate is close to PPP

How could it be explored

- Some examples

1. Need to try to document both better cost and benefits of current real exchange variability.
2. Example: Is oil production in Canada substantially less sensitive to changes in the price of oil than in Texas
3. Ex: Interview firms that left Canada when $ was high, but have not returned afterward. Why? Hysteresis?
4. Look at whether low frequency movement real exchange rate tend to be especially important in inflation targeting regimes. Could this be causing coordination problems because of a missing anchor.

Last word

- Being optimistic, adding a medium run target for the real exchange rate could turn out not to create much tradeoff.
- Inflation stabilization under inflation targeting mainly arose from clear communication. It created an anchor, with little tradeoff.
- Maybe the same could happen for the exchange rate?