Bank of Canada Workshop Summary

Monetary Policy Framework Issues: Toward the 2021 Inflation-Target Renewal

Ottawa, ON, September 14, 2017

Almost 50 experts—academics, journalists, other central bankers and policy-makers—joined Governor Stephen S. Poloz, Senior Deputy Governor Carolyn A. Wilkins, members of the Bank's Governing Council and Bank economists on September 14 for a lively and provocative discussion about issues related to monetary policy frameworks. The day-long workshop, held at the Bank, brought out wide-ranging views on the goals of monetary policy, the effectiveness of monetary policy tools, the role of transparency and communications, and lessons learned from other central banks.

The workshop will help shape the Bank's broader research agenda, including issues that may be relevant for the 2021 renewal of the agreement on the inflation-control target with the Government of Canada. As Deputy Governor Lawrence Schembri explained in his opening remarks, the Bank's existing framework has served Canada well, but it is always worth looking at whether it could be improved.

This is especially so in the wake of meaningful economic developments in recent years, such as the decline in the "neutral" policy interest rate (which limits the scope for monetary policy to counter economic weakness), the decline in potential output growth—especially in advanced economies—driven by demographic trends and lower labour productivity growth, and the elevated level of indebtedness in both the private and public sectors (which raises questions about the optimal mix of monetary and fiscal policy and macroprudential policy measures).

The conference was webcast and tweeted live, and questions and comments from the public, via social media, were encouraged. What follows is a summary of the workshop and the key arguments and themes discussed.

Panel 1—The Role and Objectives of Canadian Monetary Policy

The first speaker, Professor Stephen Gordon of Laval University in Québec, argued strongly for Canada's parliamentarians and the wider public to be much more engaged during the 2021 inflation-targeting renewal process than in the past. Gordon called the 2016 renewal process "a missed opportunity" to broaden the discussion about monetary policy objectives beyond policy-makers, economists and niche policy analysts. He argued that while the Bank has independence to implement the mandate laid out in its agreement with the government, the substance is a political decision and thus warrants vigorous debate in a public arena. Parliamentary hearings would underscore the point that whether and how to change the framework is a political decision, Gordon said. In addition, hearings would give economists an opportunity to explain and refute unorthodox views that have long been discredited by the economic community but may be gaining traction among certain segments of the public.

Gordon (and later speakers) noted that little public or political attention was paid to the process for the several years culminating in the 2016 renewal, even as the post-crisis period raised questions about whether a modified framework may be necessary.

Former Bank of Canada Deputy Governor John Murray, who now teaches economics at Queen's University, argued against raising Canada's inflation target from the current 2 per cent because—among other reasons—there is insufficient evidence that the perceived benefits outweigh the potential costs, while there is evidence that unconventional policies such as quantitative easing (QE) provide scope for additional monetary easing at the "effective lower bound" (ELB). Meanwhile, Murray dismissed concerns that it could be too difficult to communicate a switch to price-level targeting or to targeting nominal GDP, and suggested the Bank's research agenda should focus on revisiting the merits of those ideas.

Murray also noted that monetary policy "can't do it all" and advocated against the idea of using policy to lean against income inequality. In his view, income inequality is primarily a fiscal policy issue. He pointed to data showing that, after taxes and transfer payments, the Gini coefficient for Canada—a measure of inequality—has not increased to the same degree as it has for the United States, arguing that commentary about US income inequality may be colouring Canadian attitudes. Murray argued that the key criteria for a desirable monetary policy framework should include: feasibility, comparative advantage, consistency, simplicity, clarity and predictability.

Paul Beaudry, an economics professor at the University of British Columbia's Vancouver School of Economics and a former recipient of a Bank of Canada Fellowship, said the Bank should study whether targeting a "stable, medium-run real (i.e., after inflation) exchange rate" could contribute to better price stability and economic outcomes. Doing so, he said, might make firms more willing to invest in Canada because they could plan more effectively. It could also counter the notion in financial markets that the Canadian dollar is a "commodity currency" that will typically move in tandem with global prices for commodities such as oil.

The final "wrap-up" speaker—Martin Eichenbaum, Charles Moskos Professor of Economics and co-director of the Center for International Macroeconomics at Northwestern University—warned against changing the Bank's framework to, for example, price-level or nominal GDP targeting, without coordinating such a shift with the US Federal Reserve. Canada's economy and currency are too closely tied to that of the United States to bring in such a change unilaterally without Canada sacrificing some of the benefits of its current flexible exchange rate and monetary policy framework—namely, very stable domestic inflation—he said. Moreover, the greater frequency with which central banks are likely to find themselves at or near the ELB—given that the neutral rate of interest is lower than before the global financial crisis—calls for Bank policy-makers to coordinate with counterparts in other jurisdictions on "consistent" strategies for dealing with this "new world," Eichenbaum argued.

During the audience question-and-answer session, Don Drummond of Queen's University School of Policy Studies argued that the focus of the current policy framework on hitting the 2 per cent inflation target may be too rigid. Drummond argued that the Bank should put more emphasis on the 1 to 3 per cent target range, as opposed to doing things to "artificially" bring inflation up to the 2 per cent midpoint when economic performance is otherwise fine.

In response to a question via Twitter about whether it would be worth exploring the merits of moving to a "dual mandate" similar to that of the Fed—i.e., price stability and "maximum" (or full) employment—panellists tended to agree that this is a somewhat moot point for Canada because the Bank's inflation-targeting framework has been effective in stabilizing employment, despite not being formally mandated to do so.

As well, Murray commented that he would not favour Beaudry's proposal to look at targeting a stable, medium-run real exchange rate because the real exchange rate seems to move in response to fundamentals over time as it is. Beaudry responded that while this is true, there are still questions about whether it moves in the right direction and at the right speed. He also questioned Eichenbaum's assertion that the Bank would need to coordinate any new framework with the Fed or face greater inflation volatility.

Panel 2—The Scope and Effectiveness of Monetary Policy Tools

Steve Ambler, Professor of Economics at l'Université du Québec à Montréal and a member of the C.D. Howe Institute's Monetary Policy Council, was the first of several speakers to contend that the Bank should provide more regular forward guidance about the likely path for short-term interest rates. Forward guidance, such as the Bank's "conditional commitment" during the financial crisis to keep the policy rate unchanged for a year as long as the outlook for inflation didn't change, is a tool the Bank has argued should only be used in exceptional cases because it diminishes incentives for market participants to follow economic data and inhibits two-way trading.

Ambler argued this "guidance" should come in the form of conditional interest rate forecasts. He also contended that there's not enough evidence that negative interest rates increase spending sufficiently to offset the potential unintended consequences for the economy and financial system, so QE remains the most promising tool for managing ELB episodes. Central banks could make QE more credible and effective by combining it with price-level targeting, he argued. This would remove the fears of hyperinflation sometimes associated with QE, he said, since symmetric targeting of the price level would imply that the central bank would work to ensure that above-target prices resulting from QE were followed by below-target prices in the future.

Michelle Alexopoulos, Professor of Economics at the University of Toronto, argued that some form of conditional forward guidance can be a viable tool in both conventional and unconventional times. This is because consistent guidance about the likely rate path reduces confusion in markets and, hence, limits the risk of contagion, provided the Bank is clear about when deviations could occur. She added that, to increase the effectiveness of forward guidance over time, there is scope for more research on how markets interpret central bankers' messaging, and noted that artificial intelligence, or "AI", and machine learning techniques could be very useful in this regard.

Jean-François Perrault, Senior Vice President and Chief Economist at the Bank of Nova Scotia, argued that the Bank and the Finance Department should explore the merits of closer coordination on meeting the Bank's inflation objectives, particularly when lower potential growth and lower neutral interest rates highlight the limits to monetary policy. In the future, a more explicit commitment by the government to hold itself responsible for helping the Bank meet its inflation-targeting objectives may make sense, he suggested.

The final speaker, Dartmouth University's Andrew Levin, argued that the Bank's Governing Council, which makes policy decisions by consensus, should consider adopting a more Fed-like approach. Specifically, Levin suggested that the Bank "think hard" about moving to a policy committee type of system (practised by many central banks around the world) where policy-makers cast individual votes at policy meetings. He argued that making them individually accountable for decisions is a good way to limit group-think. Levin also noted that central banks must take care to present a wide range of alternative scenarios, much like weather forecasters, as a way of maintaining credibility when the base-case view turns out to be wrong.

During the audience question-and-answer session, David Macdonald of the Canadian Centre for Policy Alternatives asked whether inflation targeting while at the ELB should incorporate specific measures to encourage wage growth, perhaps in “partnership” with federal and provincial governments.

Levin responded that a key feature of inflation targeting is that, when inflation is too low, the measures a central bank takes to lift inflation and keep inflation expectations anchored promote demand-strengthening activity, which feeds through into nominal wage growth.

Alexopoulos argued that the Bank ought to be “somewhat cautious” about engaging more closely with governments in an official capacity because it could create an impression that the Bank is subject to political influence, and sow uncertainty in financial markets. She also warned that major changes to the policy framework—even if carefully communicated—could confuse and lead to “perverse effects” in terms of investment and hiring, as people wonder whether similarly stark changes might become more commonplace.

Finn Poschmann, president and chief executive officer at the Atlantic Provinces Economic Council in Halifax, warned the Bank against providing too much information about what policy-makers believe could happen in the future, arguing that credibility may suffer when forecasts are wrong. Alexopoulos agreed, but still stressed the importance of regular, clear communication, especially while at or near the ELB. It is in those moments when the public and markets are paying closest attention, she said, making it crucial to avoid misinterpretation.

Perrault also argued for caution on the issue of being more transparent with forecasts, saying part of the problem is that market participants think forecasting is easier and more precise than it is. Levin reinforced his earlier point about the importance of presenting a range of alternative scenarios, and to publicly discuss contingency plans for each.

Panel 3— Monetary Policy Transparency and Communication

Turning more squarely to transparency and communication issues, journalist and Senior Fellow at the Centre for International Governance Innovation (CIGI), Kevin Carmichael, started the third panel by highlighting initiatives the Bank has taken to better explain its thinking to the public, such as through the statement it issues at the opening of the press conference following the release of the Bank’s quarterly *Monetary Policy Report* (MPR). That statement describes the main points of deliberation that Governing Council grappled with before reaching its decision. However, after some uncertainty in markets about whether the Bank would raise the policy rate at its September 6 decision, Carmichael urged the Bank to do more both to make its communication more consistent and to keep it on market participants’ radars.

Carmichael laid out two steps the Bank could take toward this end. First, he argued, the Bank should hold a press conference and issue a statement about its deliberations after each of its eight interest rate decisions every year, instead of only after the quarterly MPR. Second, he proposed that the Bank's Deputy Governors deliver more public speeches which, he argued, would keep market participants engaged, debating—and, importantly, absorbing—the Bank's views.

Pierre Siklos, Professor of Economics at Wilfrid Laurier University (and also a CIGI Senior Fellow) spoke next. He argued that central bankers may underappreciate the distinction between transparency and clarity—in the sense that more transparency, if not managed effectively, can sow greater confusion. Also, he pointed out that while credibility is very high for the Bank, it is nonetheless fragile in the post-crisis world. The Bank could counter this fragility with more emphasis on the ranges of disagreement and confidence intervals around its forecasts for inflation and real GDP growth, he said, rather than focusing on "point forecasts," which imply a false degree of certainty.

Michael Ehrmann, a former Bank of Canada Chief of Economic and Financial Research who is now at the European Central Bank (ECB), presented survey data showing that academic economists are more convinced than policy-makers that forward guidance is a useful policy tool. The same survey showed that academics favour data-based, or "state-contingent," guidance, while practitioners are more evenly spread over a range of types of guidance but, if anything, prefer "purely qualitative" guidance that offers the most flexibility.

Ehrmann argued that forward guidance has more impact if it is combined with an asset-purchase program such as QE. State-contingent forward guidance is, on balance, the most effective for shaping market expectations and preserves market responsiveness. This is because it is consistent with the central bank's uncertainty about how long the guidance will be in effect. State-contingent guidance needs to be based on reliable, real-time data and be relatively clear and simple to communicate, he added, suggesting that the Bank should further research the pros and cons of basing any future forward guidance on its measures for underlying inflation.

The final speaker, former Riksbank Deputy Governor Lars Svensson (now at the Stockholm School of Economics) argued that policy-makers should publish forecasts for the expected interest rate path, saying that failing to do so is akin to "hiding the most important information" about policy decisions. Moreover, Svensson argued, all central banks should publish minutes of their proceedings and should justify their choice of rate path by showing how alternative paths would yield less-desirable economic outcomes. He noted that his proposals are very different from what the Bank currently reveals about its policy decisions.

During the audience question-and-answer session, Levin asked panellists what they thought about Svensson's idea of publishing alternative rate paths: specifically, whether they thought the public and markets would be able to digest all the information without confusion or without interpreting the various scenarios as promises.

Siklos commented that the key point is to show a willingness to adjust views about the future as new information comes in, and to clearly explain why that could happen. For example, he pointed to the Bank of Canada's 2009–10 "conditional commitment", arguing that then-Governor Mark Carney was able to drop the commitment without roiling markets because the Bank had very clearly communicated the policy as conditional.

Ehrmann then asked Svensson about an earlier comment, when he said central banks should aim for private sector expectations for interest rates to align with the base-case rate path.

Ehrmann said he would worry about this indicating that market participants are slavishly following the central bank and interpreting the forecast as too much of a promise. Svensson responded that evidence from several countries indicates that forecasts for the rate path typically reflect a “battle” between markets and the central bank. The key is to repeat constantly that it is a forecast, not a promise, and that it will change as information changes, he argued.

Panel 4—Lessons from Other Central Banks

The first speaker, Nadine Baudot-Trajtenberg, Deputy Governor of the Bank of Israel, described her experience practising flexible inflation targeting in a small, open economy. She focused on Israeli central bank policy over the past three years, when the country has seen solid growth, rising wages and house prices, and a strong currency, while inflation has not just been below target, but mostly in negative territory.

The Israeli experience shows that protracted periods of below-target inflation don’t automatically mean a loss of credibility or of control over inflation expectations, she said. This can occur, she argued, if policy-makers clearly communicate their willingness to be patient while using a variety of targeted tools to demonstrate they are being proactive in maintaining a broader (i.e., longer-term) environment of price stability. In Israel’s case, such tools have included near-zero interest rates, non-conditional forward guidance and currency intervention. Israel’s experience also suggests that changing the inflation target is not necessary without “strong evidence” that it is no longer at the right level, including evidence from significant weakness in real economic activity. And while monetary policy must take financial conditions such as long-term rates and exchange rates into account, central banks also need to remain forward-looking, clearly and regularly communicating their views about contradictory data and holding firm against “flavour of the day” pressures, she said.

Athanasios Orphanides, a former Governor of the Central Bank of Cyprus and member of the ECB’s Governing Council, pushed back against calls from earlier panellists for the Bank to publish a forecast for the interest rate path, saying such a step should be considered only when at or near the ELB. Orphanides, now at the Massachusetts Institute of Technology’s Sloan School of Management, argued that clearly articulating a systematic and predictable policy strategy is more important for good communication than publishing a rate path or other types of forward guidance. As an example, he suggested the Bank had explained its data-dependent reaction function well enough for market participants to see that a September hike was likely after the surprise of 4.5 per cent annualized GDP growth for the second quarter. He argued that a published rate forecast could have been too rigidly interpreted to properly absorb such news.

Also, while the Bank’s 2 per cent inflation target and the symmetrical approach the Bank takes to meeting it “could not be clearer,” the ECB’s inflation objectives are much more open to interpretation and thus prone to “harmful discretion” and even political pressures, he argued. To improve communication, he proposed that the Bank be more descriptive in the MPR about the degree of growth or inflation surprises that could push policy-makers to move interest rates in response.

Both Orphanides and the next speaker, Stephen Williamson—Stephen A. Jarislowsky Chair in Central Banking at the University of Western Ontario and former Vice President at the Federal

Reserve Bank of St. Louis—argued that there is insufficient evidence for the Bank to make significant changes to the current inflation-targeting regime.

Williamson argued that the Fed's post-crisis forward guidance was "a bust" because it kept changing. He suggested that this was in part due to the Fed's policy committee system, in which the wording of guidance can be more about certain voting members trying to "bind" their colleagues to a position than about speaking clearly to the public.

The final speaker, former Bank of England Deputy Governor Paul Tucker (now at Harvard University's John F. Kennedy School of Government) said that reviewing the Bank's framework and tools is wise even if big changes are unnecessary. This is because the Bank will probably face another recession with the policy rate still "fairly close" to zero and, in any case, it will likely take a long time to bring inflation sustainably back to the target in the current global environment.

In terms of improving the Bank's framework, Tucker recommended being more precise about the criteria the Bank might use for leaning against financial imbalances, and perhaps bolstering mechanisms through which it could formally recommend that regulators take macroprudential steps in lieu of using Bank policy. But he recommended against a shift to targeting a level for prices or nominal GDP unless there is strong conviction and evidence that the current inflation-targeting framework would be insufficient in a future crisis.

The audience question-and-answer session included discussion in response to a Twitter question about the best ways to solicit input from the public about central bank mandates, given that discussions around policy objectives and tools can be highly technical.

Tucker responded that the Bank of England's best forum for communicating with the public about its monetary policy considerations is through testimony before the House of Commons Treasury Select Committee. He also stressed the importance of communicating in an accessible way and striving to ensure that certain messaging in speeches gets picked up by media. At the same time, he questioned how useful Twitter or Internet blogs can be in communicating subtle, slow-moving themes or arguments.

Citing programs at the Fed, such as Fed Econ Ed (which aims to educate the public about personal finance and the economy) and visits to educational institutions of all levels, Williamson stressed the importance of sending officials or staff out to explain policy to the public. Similarly, Orphanides argued that central banks need to do more to broaden the level of public education and economic and financial literacy. Once the public is more economically and financially literate, he said, it will be easier to have a more inclusive discussion about preferences for central-bank objectives.

Closing Remarks

Immediately following the fourth panel and audience Q&A, Senior Deputy Governor Carolyn A. Wilkins, who is overseeing the research work at the Bank leading up to the 2021 renewal, delivered concluding remarks.

She began by reiterating that the bar for making significant changes to the Bank's well-functioning inflation-targeting regime remains high.

However, picking up on themes voiced by the day's panel speakers and audience members, SDG Wilkins said it will likely be worthwhile to study the costs and benefits of making greater use of the "flexibility" that comes with flexible inflation targeting. For example, it is important to research the potential impact on inflation expectations of taking longer to meet the inflation target on a more regular basis. Similarly, she said, it is worth looking at the costs and benefits of putting less emphasis on hitting the midpoint of the 1 to 3 per cent target band. As well, more research is needed on how inflation expectations are formed, she said.

She reminded that the Bank introduced inflation targeting at a time when inflation truly was "the dragon to slay," noting that with low and stable inflation in recent years, a different framework may be better suited to current and future realities. Central banks also have a better sense since the crisis that strict adherence to monetary policy rules can contribute to a buildup in financial imbalances. Plus, the lower neutral interest rate, issues around the effectiveness of monetary policy at the ELB, and supply shocks such as what may be happening as the economy becomes more digital all make it harder or less wise to focus on hitting 2 per cent inflation. The Bank may look at whether credibility built up over the past 25 years could help smooth the transition to a new regime, such as price-level or nominal GDP targeting, she said.

Given the issues discussed above that illustrate the limits to what monetary policy can achieve on its own, Wilkins added the Bank's voice to the debate about whether there is scope for greater coordination between monetary policy-makers and fiscal/macroprudential authorities. She argued that it is important to think about the "optimal mix," noting that monetary policy is "neutral in the long run" — not designed to fix structural problems in the economy. Questions about the role of fiscal and structural policies in helping to achieve inflation objectives and, over time, in raising the neutral interest rate could grow in importance, she said.

The diverse views brought to this workshop, and to other discussions in the coming months and years, will be instrumental in helping the Bank hone its research questions for the 2021 renewal, Wilkins said: "Today's discussion was immensely helpful in defining points of disagreement in a way that will allow us to move forward."