BANK OF CANADA
BANQUE DU CANADA

Closing remarks[1] by Carolyn A. Wilkins
Senior Deputy Governor of the Bank of Canada
For the workshop "Monetary Policy Framework Issues: Toward the 2021 Inflation-Target Renewal"
Ottawa, Ontario
September 14, 2017

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

Introduction

This has been a lively and constructive day. I am not surprised many of us agree that inflation targeting has been, on balance, a successful foundational element of solid and sustainable economic growth—not only in Canada, but around the world.

At the same time, few of us in this room would say that the inflation-targeting regime is perfect, or that we would be wasting our time to seriously consider alternatives.

The beauty of Canada's regime is that we renew the agreement on the inflation-control target with the federal government every five years. This gives us a mandate to step back, get out of the day-to-day frame of mind and think about fundamental issues. Is inflation targeting as we know it still the best thing the Bank of Canada can do to support the economic and financial well-being of Canadians?

We invited you, experts from Canada and abroad, to put diverse points of view on the table and start a conversation. On that metric alone, this workshop has clearly been a success.

[1] The remarks have been edited for clarity for readers who may not have attended the workshop.

I will not attempt to summarize everything that we talked about today. I do want to highlight three broad issues that came up, because they are particularly important to pursue further:

- The choice of the monetary policy framework
- How monetary policy should dovetail with other policies, notably macroprudential and fiscal policy
- The appropriate form and degree of transparency and communication for central banks

1. Issues Related to the Choice of Monetary Policy Framework

When we started this morning, many could not resist the temptation to take a walk down memory lane. This is understandable, since some of the people in the room may still have been in school in 1981, when inflation in Canada peaked at just about 13 per cent. Clearly, the dragon to slay in the 1980s was inflation. Many of us were dedicated to finding a better monetary policy framework or improving the one we had. Governor Poloz was one of those people, but there are many others that we are fortunate enough to have with us today as well.

When we settled on inflation targeting, I can tell you that no one was 100 per cent sure it would work. We worried about, among other things, the uncertainty surrounding the strength and timing of the transmission mechanism. While today we know the power of credibility and expectations, that was also a source of worry at the time. So there was some element of a leap of faith in the analysis that had been done. This leap was easier to take because there was a clear sense that something was broken and needed to be fixed.

I did not get the sense today that anybody believes there is presently a similar dragon to slay. But I did hear several concerns that have gained in importance since the financial crisis:

- Inflation targeting, especially strict inflation targeting, can contribute to a buildup of financial imbalances.
- The low neutral interest rate we have today may make a 2 per cent target difficult to achieve.
- Supply shocks, such as those we may be experiencing with the digital economy, could make it more difficult or unwise to try to achieve a 2 per cent target at all costs.

Some of the alternatives discussed today were aimed at addressing one or more of these concerns, and I think that many of the ideas are worth pursuing in our research program.

The first idea is related to the flexibility of our current inflation-targeting regime. Although we haven't changed the target over the last 25 years, we did introduce greater flexibility in the framework for how fast we should aim to return inflation to target. We thought this flexibility might be particularly useful in circumstances where returning inflation more slowly could help support financial stability—recognizing that financial stability is part of our risk-management approach.

Right now, the important question is: what are the costs and benefits of making greater use of this flexibility, particularly when it comes to anchoring expectations? Similarly, what are the costs and benefits of putting less emphasis on the midpoint of the 1 to 3 per cent target range? These are interesting research questions.

A second idea that was put on the table relates to alternative frameworks that could reduce the chances of hitting the effective lower bound. One alternative discussed was to change the level of the inflation target; another was to switch to price-level targeting (PLT). We heard many pros and cons for each.

One of the dominating worries, especially with PLT, relates the effectiveness of the regime if it proved to be too complex for people to understand. Those worries are real. And, since the bar to make a change is very high, we need more research on how inflation expectations are actually formed. Research in this area would help make the debate more productive. We should also ask ourselves whether we can leverage the credibility we have built up over the past 25 years to make the transition to a new regime smoother.

Some believe that a digital currency issued by a central bank could help address issues related to the lower bound of on nominal interest rates by making it easier to implement a policy of negative nominal rates. In theory, this makes sense, but I wonder how much of the issue about the effective lower bound would go away in practice if we had a central bank digital currency. That is an open question for research, and the answer depends on how much power there is in negative nominal interest rates. Other complex issues related to central-bank-issued digital currencies that merit study also came up today, such as who should have access to the central bank balance sheet. Of course, the Bank will continue looking at these questions.

We also talked about the idea of broadening the mandate to include a real-economy objective—what is known as a dual mandate—or some version of nominal income targeting. These approaches could be useful when the so-called divine coincidence—low and stable inflation occurring in tandem with low and stable unemployment—doesn't hold. Even there, it's not simple, because the regimes could create tensions related to the independence of the central bank.

But there may be other benefits associated with such approaches that should be studied further. Think of how disinflationary effects of positive supply shocks can lead to low interest rates that could reinforce financial imbalances under strict inflation targeting. We have seen such a shock with inexpensive imports from China in the 2000s. Targeting nominal GDP might help in those cases. Since nominal GDP growth is the sum of inflation and real GDP growth, weaker inflation that is offset by stronger economic activity would leave nominal GDP growth at the target.

Choosing the right framework is serious business. I was happy to hear people's views on the considerations that should guide our research. Clearly, we want a framework that stabilizes the economy without worsening inequality and that performs well when the neutral rate of interest is low.

2. Issues Related to Policy Coordination

This brings me to the second set of issues. A low neutral interest rate raises the question of the optimal policy mix. There has been much research on the effectiveness of fiscal policy at the effective lower bound. We heard a great deal today about how important macroprudential and microprudential policies are to guard against excessive credit growth and the buildup of financial imbalances, well before we start thinking about using monetary policy. It is difficult to disagree with that.

This line of research is an important building block to a more fundamental issue that was raised today—the optimal mix of monetary, macroprudential and fiscal policies to get the economy back to its potential. I am taking an expansive view of fiscal policy to include countercyclical policies, automatic stabilizers and structural policies.

Different mixes of policy may be able to achieve the same macro outcomes in the short to medium term, but the outcomes could differ in some important respects over a longer horizon: whether indebtedness builds up in the private or public sectors, or whether the distribution of income and wealth widens or narrows. It can matter when the time comes to choose between unconventional monetary policy measures, such as quantitative easing (QE), and fiscal policy measures.

The optimal mix of fiscal and monetary policy was a hot topic in economic journals in the 1970s and ‘80s. Interest tapered off because we thought we had the problem solved. The consensus was that you had a monetary anchor with inflation targeting, which meant that the monetary authority could simply take fiscal policy as a given. And that may work very well in normal times, but several factors discussed today support doing more research in this area.

The first factor, which I already mentioned, is the low neutral rate and the limits of monetary policy in the face of negative shocks. We can discuss whether the neutral rate of interest will rise or fall in the future, but it is clear that it is currently lower than it was before.

The power of negative interest rates, QE and other unconventional policies is still being debated, as we saw today, and so questions around an increasing need for fiscal stabilization may become more important. The same is true for structural government policies to raise the rate of potential growth of the economy. As several people correctly observed today, monetary policy—which is neutral in the long run—cannot fix structural problems.

The issue of the optimal policy mix is made more pressing by the reality that “low for long” and unconventional monetary policies may give rise to vulnerabilities in the financial system because they work through credit. This point was made several times today.

It seems to me that the debate around the role of monetary policy in leaning against financial imbalances can only move forward through a better understanding of the effectiveness of macroprudential policies. What we need to know is how macroprudential policies interact with monetary policy and how authorities with different mandates can coordinate effectively.

Policy coordination in real time raises governance issues for policy-makers who have clear and independent mandates. How can we support this clarity of mandates as we explore policy-mix options? One way would be to focus research on the coordination of framework design, rather than on the coordination of responses to cyclical shocks. Complementary frameworks could deliver better outcomes while maintaining the central bank's instrument independence.

Most economists would recognize that we need better models to answer the questions I just raised. There has been important progress over the years, but more is needed. Better modelling of the linkages between the real economy and the financial sector will be crucial. Understanding how expectations are formed will be just as important, as will be measuring the importance of heterogeneity in household incomes, wealth and the size of businesses.

3. Issues Related to Transparency and Communications

The third set of issues, and one that permeated the workshop, relates to transparency and communications.

We all agree that central banks must be clear and transparent. Indeed, communication in and of itself has become a policy tool for many central banks. The debate today was around the form and the degree of this transparency. We heard some very strong and helpful advice in that area. Some advised central banks to publish the path for their policy interest rates or to at least give regular conditional forward guidance on interest rates. Others recommended that central banks should repeat their messages more often and provide more information on their reading of the economy. Still others cautioned that too much information could cloud the incentives of market participants to do their own analysis.

We saw survey evidence today that showed academics tend to favour more transparency than practitioners. The discussion helped to shed light on where the points of disagreement may be most important. First, there is no consensus on the gravity of the problem to begin with. It would be useful to know whether increasing transparency along the lines discussed today would improve outcomes for inflation, output, jobs and other variables that matter to us.

There is also disagreement on how much clarity can be achieved by more transparency about the potential future path of interest rates in an environment that is constantly evolving. Practitioners know their forecasts will not always be right and that they will have to adapt as new information comes in. To be sure, economic models can help analyze the effects of developments, but they cannot do away with uncertainty. One question here is how well market participants would understand the conditional nature of forward guidance.

The last point of divergence relates to the trade-off between the benefit of additional clarity and the cost of the information you lose from markets when you telegraph your expected actions in advance.

We are constantly seeking new ways to innovate in our communications, and this workshop gave us a great deal to think about.

The Way Forward

We have heard today from you, experts from many countries and fields of expertise, about what you think are the key monetary policy framework issues. You have given us many good ideas to consider on the best way to fulfill our mandate to support the economic and financial well-being of Canada.

There are many tough questions related to the framework itself, policy coordination and transparency. I want to thank those who participated in person and those who watched the webcast. I also want to thank Larry Schembri for organizing this workshop.

We will use this workshop and other discussions to articulate our research agenda, and we will get started this fall. From there, we will be able to narrow down the questions that are pertinent for the inflation-target renewal in 2021. We are not going to rush this because we want to keep it broad for now. You will be able to see our progress over time because we will post the research we do on our website.

Now that we’ve reached out to you, you might be wondering how you can contribute in a constructive way. Stay connected; do research and analysis on the issues, if that is your thing; and send us comments on our work.

We are doing our homework, and we are listening.