What Monetary Policy Framework in 2021?

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Recessions* are short, recoveries are long

Dive into recession	Duration of recovery
1953Q2-1954Q2	3 years
1981Q2-1982Q4	5 years
1990Q1-1991Q1	7 years
2008Q3-2009Q2	5 years

*** These are Canada's last four «category 4» recessions according to the classification by Philip Cross and Philippe Bergevin (C.D. Howe *Commentary No. 366*, 2012).**

Collaborative actions for reopening

- **Extraordinary set of collaborative actions by Ottawa, the provinces and the Bank**
- **The Bank has played its role of lender of last resort**
- **Policy rate has been lowered from 1.75% to 0.25%**
- **Will be kept “very low for a long time”**
- **The Bank is involved in a large asset purchase program**

The decline in interest rates coming out of last four recessions

	Decline in interest rates (pp)	
Trough date	Overnight	5-10-year GC bonds
June 1980	-10.4	-2.9
October 1982	-12.7	-7.4
April 1992	-8.7	-4.4
May 2009	-4.3	-2.3
Average of last four	-9.0	-4.2
April 2020	-1.5	-0,8

Source: Statistics Canada (CANSIM 1010-0122); Philip Cross and Philippe Bergevin (2012).

Conventional monetary stimulus is limited

- **Since 2007, the policy rate has been 1% or less 75% of the time**
- **It has never exceeded 1.75%**
- **The policy interest rate can be stimulative only within the narrow band [0.25%, 2.5%]**

Raise the inflation target?

- One way of getting more stimulus when needed would be to raise the inflation target, say, to 4%
- The benefit/cost ratio of this move is very favourable
- In the 1980s, inflation was very stable at 4.4% with no tendency of slipping upwards
- However, it could prove difficult to lift inflation to 4%
- And moreover, it would be a political nonstarter

How much further stimulation now?

- **According to the *MPR* central scenario, output could be 6.5% (150 billion dollars) short of potential in 2021**
- **If $\mu = 1.25$ and $\tau = 0.4$, say, then $\Delta G = (1/\mu - \tau)*\Delta Y = (1/1.25 – 0.4)*150 = 60$ billion dollars could close the gap**
- **Low interest rates would help finance resulting deficits**
- **Federal-provincial coordination would be essential**
- **But by how much public spending could be increased on short notice would remain a challenge**

Medium term: alternative monetary policy frameworks compared by ToTEM

<u>Six</u> frameworks are compared and contrasted:

- **IT = current inflation targeting scheme**
- **AIT = average inflation targeting with 2-to-3-year window**
- **PLT = price level targeting with long history dependence**
- **DM = inflation-unemployment dual mandate**
- **NGDPLT = nominal GDP level targeting**
- **NGDPGT = nominal GDP growth targeting**

What is ToTEM about and what does it do?

- **ToTEM is a large-scale open economy DSGE model of the Canadian economy**
- **It shies away from the extreme assumption of system-based expectations**
- **It can impose an occasionally-effective lower bound (ELB) of 0.25% on the policy interest rate**
- **Variances of key variables over time are compared across the six monetary policy frameworks under study**

Simulations comparing IT, AIT and PLT

- **To me, the most relevant environment is the one assuming:**
  - **1) a fraction of firms and households are rule-of-thumb wage- and price-setters,**
  - **2) a 0.25% ELB is occasionally binding, and**
  - **3) unconventional monetary tools (UMP) are ineffective**

- **Optimal history dependence:**
  - **-- increases with extent of the ELB constraint, and**
  - **-- decreases with more rule-of-thumb expectations**

- **By and large, minimizing the variances of inflation and the output gap implies that AIT ≥ IT >> PLT**

What should we optimize really?

- **In the future, one could look at maximizing output instead of minimizing its variance around some filter-generated average trajectory (however "extended") that is then interpreted as potential output**

- **Should we take into account:**
  - **-- Blanchard-Summers hysteresis**
  - **-- Nakamura-Steinson plucking**
  - **-- Akerlof-Dickens Phillips curve convexity?**

Simulations comparing all six frameworks

- **DM, NGDPLT and NGDPGT are added to the list of frameworks to be compared**
- **My focus here is on the same relevant environment concerning rule-of-thumbers, ELB and UMP**
- **36 standard deviations for 6 key variables x 6 frameworks are calculated separately**
- **This time, IT, AIT and DM turn out to be the most robust of the frameworks**

Exclusion of the NGDP frameworks in Canada makes good sense

- **The NGDP frameworks pose insurmountable problems:**

1) the split between the price level and real CGP would generate confusion among the public

2) contrary to CPI data, GDP data lags and is often revised

3) divergence between export prices in GDP and import prices in CPI is frequent and often persistent

4) it would be hard to convince Central Canadians that interest rates need to be raised after a boost of incomes in Alberta generated by higher oil prices

Best to stick to flexible inflation targeting

- **The simulations suggest that the alternative frameworks do not offer gains large enough to replace the current IT regime**

- **I agree that it would be best to stick to a flexible IT framework operated independently by the central bank**

- **But the simulations also suggest that a somewhat more flexible approach could be welfare-improving:**
  - **1) by shifting temporarily to AIT in bad times, and**
  - **2) by putting more emphasis on unemployment as needed**

Desirable that the 2021 agreement clarify what the 2 x 2 macropolicy game is about

1) If the steady-state Phillips curve is convex, unemployment is <u>not</u> independent from inflation even in the long run

2) Coming out of a recession, with path dependence lurking, unemployment may be dangerously slow to return to equilibrium

3) With the squeeze on monetary policy and the smaller cost of debt service, there is a need to conform more affirmatively to the Tinbergenian prescription of close coordination between the two macro instruments for achieving the two macro targets

4) Canadians have a basic right to comprehend the macropolicy game

Merci/Thank you !