PROGRESS TOWARD 2021 CANADIAN MONETARY POLICY RENEWAL

SEPTEMBER 2020

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INTRODUCTION

Central banks have deployed a range of conventional and unconventional tools in their emergency responses to the COVID-19 pandemic and its economic disruptions. These extraordinary measures have also refreshed discussions around the need for strong public engagement on the part of monetary authorities. As Bank of Canada (BoC) Governor Tiff Macklem noted at the Jackson Hole Symposium in August 2020, "The imperative is to step boldly beyond market transparency and engage with the public to explain how our actions serve our economy-wide objectives."

Governor Macklem's call for "a deeper relationship between the central bank and its citizens" coincides with a routine re-assessment of monetary policy in Canada. The BoC is in the process of a multi-year review in advance of the renewal of its monetary policy framework in 2021. Culminating in an inflation-control agreement with the Government of Canada every five years, the renewal process adds credibility to the Bank's inflation objective and underpins its operational independence.[1] The BoC runs a research program in the years preceding each scheduled agreement to inform the terms for renewal.[2] As a milestone in its current program, the Bank held a virtual workshop on August 26, 2020, entitled "Towards the 2021 Renewal of the Monetary Policy Framework." Senior Deputy Governor Carolyn Wilkins described the event as an occasion to share and discuss the research progress made thus far, but also to solicit the feedback of attendees as part of the Bank's wider public outreach.[3]

Overview

Although the COVID-19 pandemic featured prominently, much of the workshop also reflected a course established prior to the crisis. Senior Deputy Governor Wilkins set out the agenda for the Bank's research program in November 2018, at which point she acknowledged the success of the existing monetary policy framework since its adoption in 1991. She noted that its flexible 2% target for Consumer Price Index (CPI) inflation, inside a 1 to 3% band and with a floating exchange rate, helped the BoC deliver price stability despite significant periodic shocks to the economy. Notwithstanding, Wilkins also referenced new challenges to the inflation targeting approach that have emerged since the global financial crisis. A lower neutral interest rate had left central banks with less "conventional firepower" to cut policy rates in a downturn, and created financial instability by motivating households and investors to accept excessive risk. Given these challenges, the BoC set out to conduct a side-by-side comparison of multiple alternative monetary policy frameworks for the first time since it adopted the 2% inflation target, weigh the strengths and weaknesses of each approach, and consider how the Bank's policy toolkit could support whichever framework prevailed in the 2021 renewal agreement.[4]

Nearly two years on, the BoC has made progress in its research program. In the virtual workshop, the Bank presented interim results from its comparative assessment, and also hosted separate panels on macroeconomic policy coordination and alternative monetary tools through the COVID-19 crisis. Some key themes were:

- The drawbacks of and necessary trade-offs involved with each of the alternative monetary frameworks, and the need for transparency around them;[5]

- The constraints of the Effective Lower Bound (ELB) and the need to re-examine fiscal-monetary interactions; and

- The mixed costs and benefits of unconventional central bank policies in the pandemic response.

SUMMARY OF THE WORKSHOP

In her opening remarks for the virtual workshop, Senior Deputy Governor Wilkins highlighted the three questions the BoC has sought to address in its research:

1. Is there another monetary policy framework that outperforms the existing inflation targeting approach and can be clearly articulated?

2. How can the Bank deploy its instruments in service of the agreed monetary policy framework, whichever one that might be?

3. In what ways can monetary policy interact with fiscal policy and other public policies to achieve price stability and sustainable growth?

Accordingly, the workshop included three distinct sessions, each addressing one of the guiding questions.

Session 1: Comparison of Alternative Monetary Policy Frameworks

In the first session of the workshop, Rhys R. Mendes, Managing Director of International Economic Analysis (INT) at the BoC, presented the interim results of the comparative assessment of alternative monetary policy frameworks, a product of independent staff research. This side-by-side evaluation, what the BoC refers to metaphorically as a "horse race," combines quantitative and qualitative methods to weigh the relative costs and benefits of different policy frameworks, including the Bank's existing flexible 2% inflation target. The researchers use economic models, laboratory experiments and public consultations to measure the performance of each framework across a series of criteria, from their benefits to macroeconomic stability to their distributional implications (see below for more). The final results of the horse race will help inform the 2021 monetary policy renewal agreement with the federal government. The six frameworks in the assessment are as follows:

Inflation Targeting (I-T):* The central bank sets a specific target for the single-year annual inflation rate, as measured by the CPI. The BoC has operated within an I-T framework since 1991.†

Average Inflation Targeting (AIT): The central bank sets a specific target for a multi-year average rate of inflation, as measured by the CPI.

Price-Level Targeting (PLT): The central bank sets a specific objective for the price-level (or cumulative average inflation), as a measure of all past CPI inflation rates.

Nominal GDP Level Targeting (NGDP Level): The central bank sets a specific target for nominal GDP.

Nominal GDP Growth Targeting (NGDP Growth): The central bank sets a specific target for the year-over-year rate of nominal GDP growth.

Dual Mandate (DM): The central bank adopts both a pre-determined inflation target as a means to achieve price stability, and a commitment to supporting employment. This approach resembles those of other monetary authorities like the United States Federal Reserve and the Reserve Bank of New Zealand.

The frameworks are distinguished by two underlying characteristics: *history dependence and the stabilization of specific real variables.* History dependence refers to the degree of commitment under a given framework to compensate for historical deviations from an inflation objective. Approaches like I-T, NGDP Growth and DM have low history dependence, in that a central bank operating under one of these frameworks is not bound to compensate for past under- or over-shoots in policy targets. Alternatively, AIT, PLT and NGDP Level involve

* The BoC uses the acronym "IT" as an equivalent in its comparative assessment.

† The BoC interim results did not include a discussion of an adjusted numerical target under the existing I-T framework. The Bank considered and ultimately ruled against an increase in the 2% inflation target as part of its 2016 review and renewal process. However, research continues into this alternative.

greater history dependence in that they correct for past deviations in order to reach a longer-term average inflationary, price-level or growth target. The stabilization of specific real variables applies to cases where a monetary framework incorporates objectives beyond inflationary targets. Frameworks like NGDP (Level/Growth) and DM involve explicit commitments to achieve targets in the real economy like GDP, growth and employment.

Analytical Methods and Assessment Criteria: The BoC weighs the different frameworks using three analytical methods, also referred to as "tracks" in accordance with the horse race metaphor. The Bank continues to run various economic modelling simulations to measure the relative performance of each framework. Laboratory experiments assess how the public would interpret and understand the different frameworks. And public consultations incorporate the feedback of various external stakeholders. The relative performance of each framework is then evaluated along five criteria:

- Macroeconomic stability (price stability and stability of the real economy)
- Financial stability
- Robustness (to different economic conditions and assumptions about private-sector behaviour)
- Distributional implications (in terms of wealth, inequality)
- Implications for the accountability, communications and credibility of the central bank

Key Results: As per the interim results of the study, no single alternative predominated in meeting the various assessment criteria, and there was insufficient evidence to rationalize a change to the BoC's existing I-T framework. Some models clearly excelled in specific cases: for example, the more history dependent option, AIT, was more effective than I-T at stabilizing inflation under ELB constraints. I-T, AIT and DM performed reasonably well across a range of metrics. However, when compared to the historical record, the observed differences in performance across the six frameworks were fairly marginal.

Panel Discussion: Following the opening presentation from Rhys Mendes, a panel of three external experts discussed the methodologies behind, and interim results from, the BoC's horse race. Joseph Gagnon of the Peterson Institute for International Economics (PIIE), Pierre Fortin of l'Université du Québec à Montréal, and Stephanie Schmitt-Grohé of Columbia University, each made individual presentations and fielded audience questions.

Session 2: Policy Cooperation & the COVID-19 Crisis

The second session featured a panel of two external experts that commented on macroeconomic policy coordination in light of the emergency responses to the COVID-19 pandemic. Ricardo Reis of the London School of Economics (LSE) explored how fiscal, monetary and macroprudential policies could interact as authorities confront four imminent challenges. Record-setting public debt levels, rising private debt defaults, increased digital banking linked to e-commerce, and the prospect of new inflation equilibria, all tend to increase the interactions across the three policy branches. Much like the global financial crisis, Reis projected that strong policy interactions between fiscal, monetary, and financial authorities will continue after COVID-19. These interactions and the constraints they impose will likely prevent the central bank from fully prioritizing inflation control. But Reis suggested that there is little added advantage in forsaking the existing I-T framework.

Martin Eichenbaum of Northwestern University defended the emergency central bank responses to COVID-19 as necessary given the unique features of the crisis, with its simultaneous supply and demand shocks and clear negative externalities linked to public health. Those unconventional actions risk amplifying the threat to central bank independence, however, as they may induce politicians to challenge monetary policy decisions that increase the burdens of higher public debt. Eichenbaum argued that assessments of the monetary policy framework will need to take fiscal policy into greater account after the pandemic. Among other commitments, he suggested that discussions of greater coordination should include clear pledges on the part of governments to provide more support (including asymmetric automatic stabilizers) where monetary policy reaches its effective limits. In any case, Eichenbaum concluded that the empirical conditions justifying the initial adoption of I-T by central banks have since shifted. Thus, he implies that a reconsideration of the existing framework is probably warranted.

Session 3: Alternative Monetary Policies & Lessons from the COVID-19 Crisis

The third and final session featured a panel of three external guests and weighed the costs, benefits, successes and failures of alternative monetary policies as deployed in response to COVID-19. Ed Devlin, formerly of PIMCO, observed how the unconventional measures deployed by the BoC have been largely successful at short-term crisis relief, providing vital liquidity and decreasing risk premia. However, these instruments also threaten unintended negative effects, like increases in moral hazard, capital misallocation, greater income inequality linked to asset inflation and inequities in access to financing between large and small companies. The alternative monetary policies are further limited in their ability to boost consumer/business confidence and directly affect CPI. Devlin surmised that unconventional tools as of yet unused by the BoC, like Yield Curve Control (YCC), negative interest rates, and equity purchases, are likely to inflict unintended costs that will outweigh any added benefits. He agreed that a revised model for the fiscal-monetary relationship is a necessity going forward.

Annette Vissing-Jørgensen of the University of California, Berkley, presented on the reaction of bond markets to COVID-19 and the fixed-income purchase programs of the U.S. Federal Reserve. Among its effects, this balance sheet expansion helped to prevent the economic fallout from triggering a financial crisis. However, Vissing-Jørgensen warned of increased moral hazard, undue support for zombie firms[‡] and poor credit issuance through the Fed's Main Street Lending Program.

Anil Kashyap of the University of Chicago traced two different interpretations of the economic logic behind alternative monetary policies. He presented a co-authored study, looking at the effects of unconventional tools on financial conditions across eight countries. Kashyap concluded by highlighting three unanswered questions related to COVID-19:

- How will the central bank explain the scope of the alternative monetary policies it deployed and the justifications for them?
- Have central banks created a "put" by either conditioning markets to expect monetary stabilization or politicians to demand monetary support for public spending?
- How will officials manage/restructure the high levels of corporate debt issued through the crisis?

‡ As defined by Banerjee and Hofmann (2018), *zombie firms* refer to companies "unable to cover debt servicing costs from current profits over an extended period." Refer to Ryan Banerjee and Boris Hofmann, "The Rise Of Zombie Firms: Causes And Consequences," BIS Quarterly Review (September 2018): 67, https://www.bis.org/publ/qtrpdf/r_qt1809g.pdf.

CONCLUSION

The BoC is set to complete its research program over the coming months. A report on the Bank's public consultations is also forthcoming. The Global Risk Institute will support our members across the financial sector as the review and renewal process continues, including with a webinar series on monetary policy commencing in the fall of 2020.

ENDNOTES

1. Refer to Carolyn A. Wilkins, "Choosing The Best Monetary Policy Framework For Canada," (speech transcript, McGill University, Max Bell School of Public Policy, Montreal, November 20, 2018), 1-2, https://www.bankofcanada.ca/wp-content/uploads/2018/11/remarks-201118.pdf.

2. Refer to Robert Amano, Thomas J. Carter and Lawrence L. Schembri, "Strengthening Inflation Targeting: Review And Renewal Processes In Canada And Other Advanced Jurisdictions," Bank of Canada/ Banque du Canada – Staff Discussion Paper/Document d'analyse du Personnel, last modified August 6, 2020, accessed September 3, 2020, 7-8, https://www.bankofcanada.ca/wp-content/uploads/2020/08/sdp2020-7.pdf.

3. Carolyn A. Wilkins, "Opening Remarks," (speech transcript, Bank of Canada Workshop: "Toward the 2021 Renewal of the Monetary Policy Framework," Ottawa, August 26, 2020), 2, https://www.bankofcanada.ca/wp-content/uploads/2020/08/remarks-2020-08-26.pdf.

4. Wilkins, "Choosing The Best Monetary Policy Framework For Canada," 2-11. Where Wilkins refers to new challenges to the inflation targeting approach, the speech transcript cites multiple external sources in support.

5. Wilkins specifically references tradeoffs and transparency in her final comments, refer to Carolyn A. Wilkins, "Closing Remarks," (speech transcript, Bank of Canada Workshop: "Toward the 2021 Renewal of the Monetary Policy Framework," Ottawa, August 26, 2020), 2, https://www.bankofcanada.ca/wp-content/uploads/2020/09/closing-remarks-2020-08-26.pdf.