Where are we headed?

Exploring the future of Canadian monetary policy

A SERIES OF PAPERS FROM A PANEL OF INDEPENDENT ECONOMISTS

These papers were written for and presented at *Choosing the Right Target: Real Options for the Bank of Canada's Mandate Renewal*, a conference held by the Max Bell School of Public Policy, September 22–25, 2020

McGill | MAX BELL SCHOOL of PUBLIC POLICY

SEPTEMBER 22–25, 2020

Choosing the Right Target: Real Options for the Bank of Canada's Mandate Renewal

A conference organized by Christopher Ragan and Stephen Gordon

With the Bank of Canada's mandate up for renewal in 2021, McGill University's Max Bell School of Public Policy held a four-day online conference from September 22-25, 2020. The conference was attended by over 100 policy professionals, students, academics, and monetary policy experts who had the chance to think about, exchange, and question what monetary policy in the post-pandemic era should look like. Recordings of the conference sessions can be accessed at:

https://www.mcgill.ca/maxbellschool/choosingtherighttarget

Table of Contents

Angela Redish

In 1934, the federal government passed legislation creating the Bank of Canada. The goals of the bank were summarized in the preamble:

> *"It is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation,to and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion."*

Remarkably, while the Act has been revised the preamble remains unchanged except for the substitution of "Canada" for "Dominion."[1]

Since 1991, the Bank has signed quinquennial agreements with the government that bound it to operationalize these broad goals by targeting the CPI inflation rate. Initially, the target was set at three percent but in December 1993 the target was reduced to a band of one to three percent and in 1995 it was more firmly set at the two percent midpoint of that band. Thus, for roughly thirty years the Bank has had an inflation target and that target has been CPI inflation of about two percent. Prior to the last several reviews the Bank has engaged in deep research programs to assess the optimality of this target, and this year in particular the Bank has encouraged external discussion of the appropriate mandate.

I began my review of the papers in the Conference looking forward to (at last) a new approach. After all, the Canadian economy has significantly changed since 1991: the neutral real rate of interest has declined (making the challenge of the effective

1 24-25 Geo V, c43.; R.S., 1985, c. B-2; most recently amended Jan 31 2020; https://laws-lois.justice.gc.ca/PDF/B-2.pdf

lower bound (ELB) more salient; inflation expectations are well anchored, the Phillips curve appears to have flattened, and digital currencies are entering the mainstream of discussion, if not economic activity. The discipline of economics has also changed: macro models are less reliant on representative agent models and able to develop and estimate, or calibrate, models with some heterogeneity in agents. Also, as shown by Professor Petersen's paper, experimental methods are being used to enhance our understanding of expectations' formation. Additionally, after a decade of international acceptance of inflation targeting as the optimal central bank policy, some central banks are adopting alternative goals: The Federal Reserve recently announced that it has an 'average inflation rate' target, while the Reserve Bank of New Zealand, the first central bank to adopt inflation targeting, has adopted a dual mandate, targeting both inflation and 'maximum sustainable employment'.

And yet, with caveats discussed in the final section, I came away disappointedly believing that the status quo remains the optimal approach. I will briefly discuss some of the factors that persuaded me against the proposals discussed at the conference and then raise some features of the status quo that I believe should be addressed within the inflation targeting approach.

I have little to add to the discussion of raising the inflation target, lowering the target or leaning against the wind, as in each case the presenter concluded in favour of the status quo. (In the metaphor that Professor Ragan used of our panel as a jury assessing the plaintiffs' cases, it seems that the plaintiffs abandoned their cases before we got to the deliberations.)

The case for raising the inflation target rests primarily on the premise that the gain of avoiding the ELB would exceed the costs of higher inflation. Neither is compellingly large – there are alternative policies that can avoid the ELB and menu costs are not high– however, the impact on central bank credibility and expectations formation raises the bar and leaves me in favour of the status quo. The keynote presentation by Professor Kocherlakota added an additional concern. He suggested that perhaps central banks are able to set a ceiling on inflation but would have difficulty raising the inflation rate. Announcing but failing to achieve a higher target would be particularly damning for central bank credibility.

Lowering the inflation target would have the opposite direct effects: it would become more likely that the interest rate would hit the ELB but inflation costs would be lowered. But, if it was not optimal to lower the inflation targets in earlier decades when the ELB was less likely to be a factor, it is hard to see that it would be optimal in the current environment.

'Leaning against the wind' refers to policy that incorporates financial stability goals into the objective functions of monetary policy. For example, if asset prices appear 'frothy', and markets are characterized by 'irrational exuberance' the central bank could tighten policy pre-emptively to forestall the impact of a bursting asset market bubble. Yet as Dr. Leduc pointed out, the devil is in the details here: 'frothiness' is notoriously hard to identify, and furthermore (as Professor Rouillard and others also noted) monetary policy is a one-size fits all policy. Macro prudential tools provide a more targeted toolkit for addressing the build up of asset market instability (though not quite surgical) and have been demonstrated to be effective.

The case for nominal GDP targeting has the intuitively appealing feature that it can theoretically stabilize the economy in the face of either aggregate demand or aggregate supply shocks, but the conference discussion highlighted a number of, to my mind, fatal challenges. Suppose that the goal is two per inflation and that it is expected that potential GDP will grow at a rate of two percent: The nominal GDP target would be four percent. But if after two years potential GDP is expected to grow at only one percent then the target would be reduced to three percent. Frequent changes to the target would be a challenge for any communication strategy, over and above the challenge, as Professor Ambler remarked, of explaining that the Bank's goal wasn't to set inflation but to set 'incomes'. The final straw is the frequency of data revisions for nominal GDP. While now-casting is showing promise in providing an instantaneous picture of the state of the economy, the frequent data revisions would provide yet a further communications challenge.

The dual mandate came closest to outperforming the status quo, and yet at the end I felt that it did not provide economic benefits relative to the current policy of flexible inflation targeting, that is, a policy of returning inflation to target over a two-year horizon but allowing the speed of the return to depend on the state of the economy. That said, flexible inflation targeting is not so different from a dual mandate, and indeed could arguably be seen as simply an opaque dual mandate policy.

While the monetary policy mandate of the Bank may remain unchanged, operational procedures can be modified, as the history of the last 30 years has shown. Three areas where the Bank could make changes to improve its effectiveness are (a) in the interaction between the fiscal and monetary authorities (b) assessing the impact of policy on the distribution of income and (c) working to improve financial literacy amongst the Canadian public.

The setting of the mandate of the Bank of Canada is a "joint commitment of the Government of Canada and the Bank of Canada to the inflation target". [from the 2016 announcement by Minister of Finance. The 'jointness' is important for the independence of the Bank as it provides broad oversight by the democratically elected government and enables the accountability of the institution. But a joint target inflation target provides an anchor for fiscal policy as well as for monetary policy. In the context of the current large stimulus package and consequent federal government deficit, the interaction between monetary and fiscal policy will become increasingly complex and how to ensure greater coordination between monetary and fiscal policy, while maintaining the appropriate degree of central bank independence will be a key challenge for the next five years.

Assessment of the appropriate mandate for the Bank includes research using macro models that evaluate the impact of alternative mandates on economic outcomes such as inflation stability, employment, the growth of income and its volatility. But the 'economic and financial welfare of the nation' is more than aggregate GDP, it includes income distribution. Monetary policy also affects income distribution – it does so through asset prices and employment rates. As noted above, economists have developed and estimate models with heterogeneity and I'd like to see issues of distributional impacts of monetary policy more in the forefront of discussion. Unanticipated inflation, varying employment trajectories, asset price movements all have very different impacts across the income distribution and just looking at the impact of monetary policy on the growth and volatility of aggregate GDP is an inadequate way to assess the mandate of the Bank of Canada.

At the risk of 'mission creep' from recommending an expansion of the functions of the Bank of Canada, and acknowledging the increase in public outreach by the Bank around this renewal of the mandate, the effectiveness of monetary policy could be enhanced by raising the level of financial literacy of Canadians. From the discussion of alternative mandates, it is clear that how Canadians form their expectations of the inflation rate is central to the choice of mandate. More generally, financial literacy plays a role in central bank credibility as, were the Bank to change its mandate, the change would be most efficient if its consequences were well understood by the Canadian public. Finally, as Jonker and Kosse (2020) note financial literacy can have the additional benefit of expanding financial inclusion. For all these reasons it would serve monetary policy well if the Bank were to invest resources in this area.

In summary, the two percent inflation target has served Canadians well and is well understood by the Canadian public. A change in mandate would only be justified if it were feasible and would bring gains to Canadians, but the papers presented here did not make a compelling case that such a change was on the table.

References

Nicole Jonker and Anneke Kosse, "The Interplay of Financial Education, Financial Literacy, Financial Inclusion and Financial Stability: Any Lessons for the Current Big Tech Era?" Bank of Canada Staff Working Paper 2020-32, August 13, 2020.

Jeremy Kronick and Francisco Villarreal, "Monetary Policy, Income Inequality, and Inflation – What's the Link?" C.D. Howe Institute E-brief 300, January 2020

David Andolfatto

Flexible Inflation Targeting in Canada

In February 1991, the Government of Canada and the Bank of Canada jointly determined a set of inflation targets as part of a strategy to reduce the long-run rate of inflation. This inflation-control agreement has been reviewed and renewed several times since then. The basic monetary policy framework has remained largely in place for decades now. In particular, the level of the inflation target and the width of the target band have remained unchanged since the mid-1990s.[1]

There were, however, two important modifications to the manner in which interest rate policy was conducted. First, the exchange rate received less attention over time, so that by the dawn of the new century, the monetary policy framework operated largely in the context of a flexible exchange rate regime. Second, following the 2006 review, the inflation-targeting regime became more "flexible" in the sense of granting policymakers the option to adjust the time horizon over which they expected inflation to return to target. According to Amano, Carter and Schembri (2020, pg. 9),

> "*To this day, judicious adjustments in the target horizon remain the main mechanism through which the Bank of Canada confronts short-run trade-offs between monetary policy's effects on prices and the real economy.*"

1 Laidler (2020) provides a useful review of how inflation-targeting evolved in Canada.

In adopting a flexible inflation-targeting policy, the Bank effectively moved itself closer toward a U.S. Federal Reserve type of dual mandate. Indeed, a broader mandate is consistent with the preamble of the Bank of Canada Act (1985) which instructs the central bank to provide a nominal anchor and to mitigate undesirable fluctuations in output and employment.

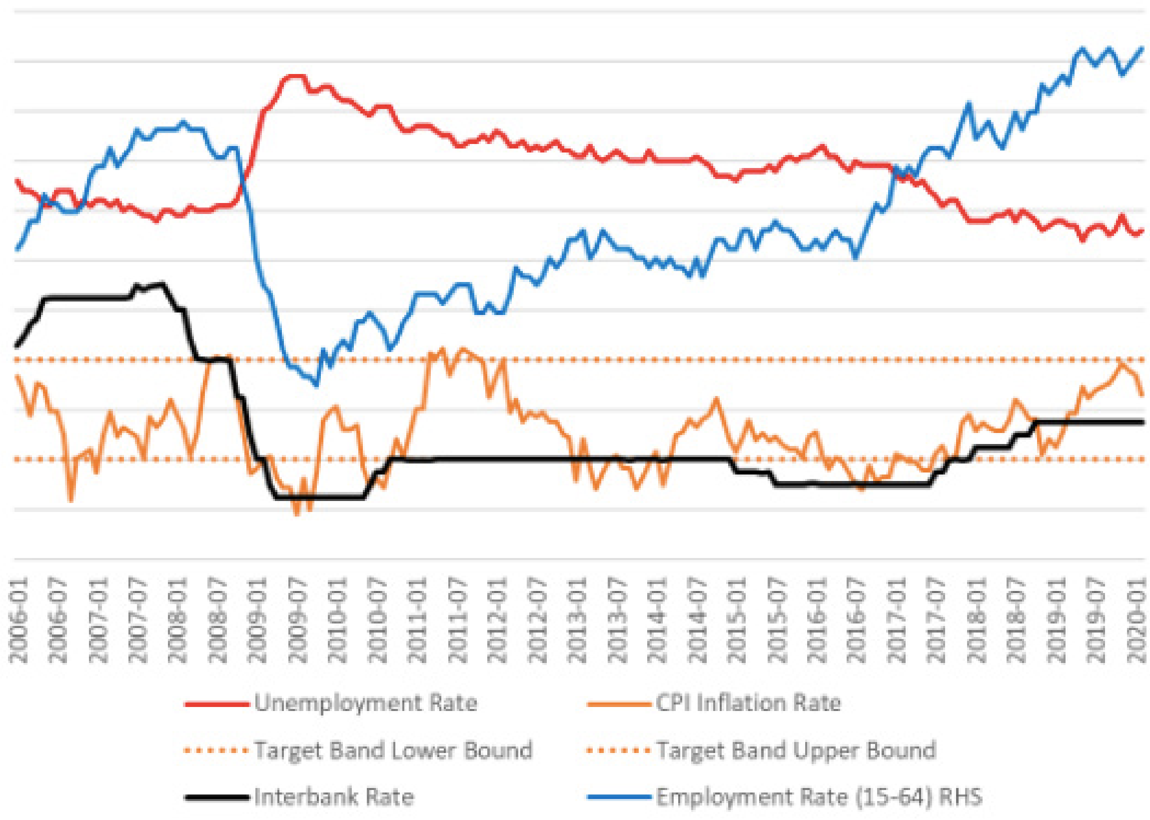
Recent Performance

Since the monetary policy framework today has remained in place more or less unchanged since 2006, it seems appropriate to evaluate its performance since then. Given that no major changes were adopted following the reviews in 2011 and 2016, it seems fair to say that the present framework is judged by the Bank and the Government to have performed reasonably well since then; at least, relative to what alternative frameworks might have delivered.

Of the six papers presented at the Max Bell conference, the one penned by Kostanyan and Laxton is perhaps the most critical of the Bank of Canada's policy in the decade following the Great Recession. Evidently, the Bank's focus on guiding inflation back to target (from below) kept policy tighter that it would have been had it instead placed more weight on its broader mandate. In particular, these authors suggest that a temporary overshoot of inflation would have facilitated a more rapid recovery in the labor market. In light of this view, they recommend a new monetary policy framework based on average inflation targeting and an explicit dual mandate. Ambler implicitly offers a similar criticism and a related prescription; namely, a monetary policy framework based on nominal GDP targeting.

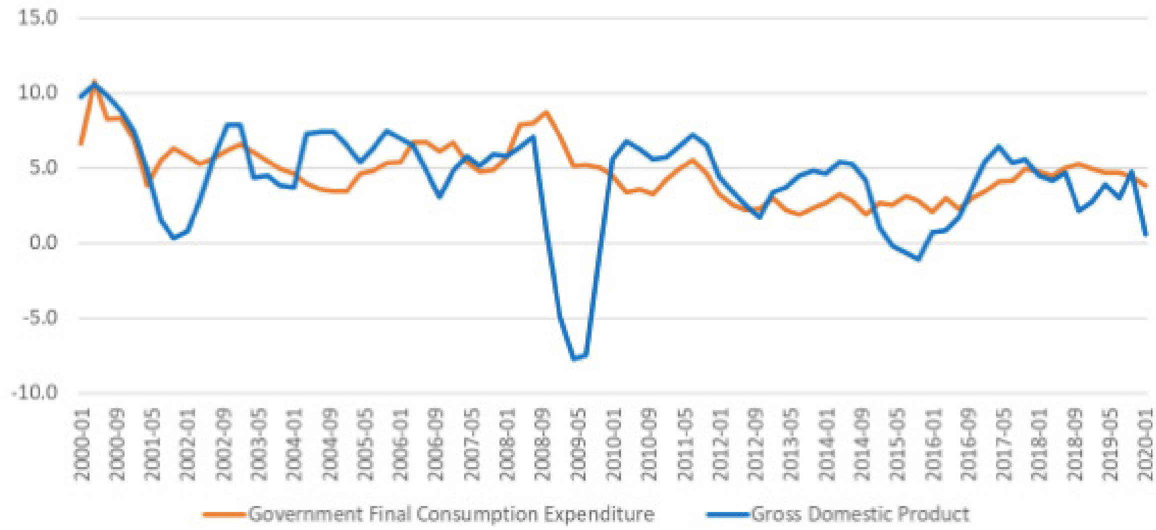
The data presented in Figure 1 seems consistent with the notion that policy, at least in retrospect, remained excessively tight through most of the recovery beginning in 2010. Over the period 2009:01-2017:12, CPI inflation averaged about 1.4 percent and spent much of its time near the lower part of the target band. The years 2013-14 seem particularly glaring: the policy rate remained elevated at 100 basis points, inflation was declining to levels below the lower bound of the target band, the prime-age employment rate was declining, and the unemployment rate remained elevated at seven percent.

Figure 1: Unemployment, Employment, Inflation, & Interest Rate
Canada, 2006:01 - 2020:02 (CPI inflation measured yoy)



Of course, care should be taken not to overstate the power of conventional monetary policy. We do not know for sure whether keeping the policy rate 25-100 basis points lower over this episode would have had a large quantitative effect on the labor market. Figure 2 suggests that the significant deceleration in the growth of federal government consumption spending over the period 2010-17 may have played a role as well. It is not clear that interest rate policy alone could have overcome this fiscal drag. Having said this, lower interest rates are not likely to have hurt labor market performance and may very well have helped it. It seems hard not to escape the conclusion that monetary policy could have been kept a little looser over this episode, at least, assuming financial stability concerns were adequately addressed.

Figure 2: GDP and Government Purchases
Canada, 2000:1 - 2020:1 (% growth yoy)



Kostanyan and Laxton suggest that the desired monetary and fiscal policy would have been forthcoming if a dual mandate was enshrined in law. Alexopoulos doubts whether this would have been the case and I share her skepticism on this score. In any case, as I mentioned above, the preamble in the Bank of Canada Act (1985) is reasonably interpreted as already providing the Bank with a dual mandate. Moreover, it seems clear that the Bank does pay attention to the real side of the economy. In the language of Taylor rules, perhaps all that is needed here is for more weight to be placed on the estimated output gap and less weight on the inflation gap. This is a change that could be implemented in the context of the current monetary policy framework.

Looking Ahead

A pressing issue for many policymakers concerns the role of conventional monetary policy as an economic stabilizer in a world in which the so-called neutral rate of interest remains low. In particular, how might policy respond to a negative aggregate demand shock when the Bank of Canada's policy rate is at or near its "effective" lower bound?

Happily, lender-of-last-resort operations are not hampered by the effective lower bound, and the willingness to provide the necessary support along this dimension seems not to be in question. But what is to be done in the event of a weakening in aggregate demand not associated bank-sector instability? The most direct way to support spending in this case is to provide cash transfers to households most in need of the money.[2] Of course, this type of program falls under the realm of fiscal policy. Both Kostanyan and Laxton, and Alexopoulos discuss the desirability of automatic fiscal stabilizers in this context.

Automatic stabilizers are determined government legislation and are normally triggered by economic circumstances. An increase in the unemployment rate, for example, automatically triggers an increase in unemployment insurance payments. In the context of a program of state-contingent transfer payments administered by the Bank of Canada, it would be advisable to have the policy designed jointly by the Bank and the Government, but to locate the trigger authority with the Minister of Finance. That is, there may be some merit in making the trigger discretionary, rather than automatic. Among other things, a program with this property is more likely to garner the necessary political support for the policy. And, in any case, it is the Government and not the Bank that should be held accountable for fiscal policy.

What might the Bank of Canada consider in the way of unconventional monetary policy? Forward guidance and large-scale asset purchases of government securities constitute weak tea in the opinion of many, myself included. Negative interest rate policy should, in theory at least, work to promote aggregate demand in the event of an aggregate demand shortfall. It seems clear that central banks could go deeply negative with their policy rates if they wanted to. The traditional argument of physical currency providing an effective lower bound is unpersuasive; see Andolfatto (2019a). Having said this, there may be reasons why deeply negative *deposit* rates could turn out to be counterproductive. This might be the case, for example, if banks were forced to hold large quantities of reserves at negative rates, were unable to pass these costs on to depositors, and if this, in turn, somehow

2 In Andolfatto (2020a), I discuss under what circumstances the use of time-dated money transfers should be employed.

impinged on their ability to lend.[3]

One option, not discussed at the conference, but something the Bank of Canada might want to consider, is negative *lending* rates. This is a policy that the European Central Bank already has in place; namely, in the form of its targeted longer-term refinancing operations (TLTROs). The basic idea is to offer banks long-term funding on attractive terms to support lending activity targeted at non-financial corporations and households. The TLTRO III operation is scheduled for June 2020-21 and sets lending rates as low as *negative* one percent.[4] It will be of some interest to monitor this program as it unfolds.[5]

What Happened to Inflation?

Inflation targeting in Canada was originally implemented as a way to bring inflation down and to keep it there. No one wants to repeat the painful disinflationary episodes the country experienced in 1982-83 and 1991-94 (Crow, 2002).

Since the 2008-09 financial crisis, however, many advanced economies have experienced significant disinflationary pressure. Much of this pressure is, in my view, being driven by the demand for safe sovereign debt--due in part to new regulatory requirements, its growing use in wholesale banking arrangements and, in times of crisis, as a flight-to-safety vehicle.

Because safe sovereign demand remains in high demand, the Bank of Canada need not be overly concerned about the prospect of persistently high

3 It seems reasonable to suppose that banks would pass the costs on to depositors if NIRP was viewed as a long-lasting phenomenon. While depositors with small-value accounts might be induced to hold cash, this is not a practical option for large-value depositors (e.g., corporate cash managers) and NIRP would just be absorbed as part of the cost of managing money.

4 See https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200430~fa46f38486.en.html

5 Desislava and García-Posada (2020) report the estimated impact of earlier TLTROs.

inflation, at least, for the time-being. In a sense, this makes conducting monetary policy easy since there is really little more to do apart from keeping monetary policy accommodative (assuming financial instability is not a concern). The ball is effectively in the government's court - and one can normally expect politicians to exploit fiscal space as it becomes available. To the extent this is true, it seems odd (to me, at least) for a central bank to go out of its way in such circumstances to promote inflation for the sake of hitting a target. Ideally, it seems better to step back and let fiscal policy do its job. In the meantime, the Bank might want to consider reinterpreting the inflation band as a "zone of indifference." The important part of the target band is the ceiling, not the target or the floor. A rapidly expanding federal debt is likely to manifest itself as higher inflation at some point.[6]

The recent phenomenon of "lowflation" has turned central bank attention away from formulating contingency plans to deal with inflationary pressure. Perhaps this is justified in the case of Canada since the inflation-control agreement is made in collaboration with the federal government.

Unlike Canada, the two percent inflation target in the United States was implemented unilaterally by the U.S. Federal Reserve in 2012. It is not entirely clear how a central bank can defend an inflation target in all contingencies without fiscal support (Andolfatto, 2019b). However unlikely it seems now, there is a possibility that U.S. fiscal policy ultimately manifests itself as a persistently high rate of U.S. inflation and that the Federal Reserve may have trouble reigning it in.

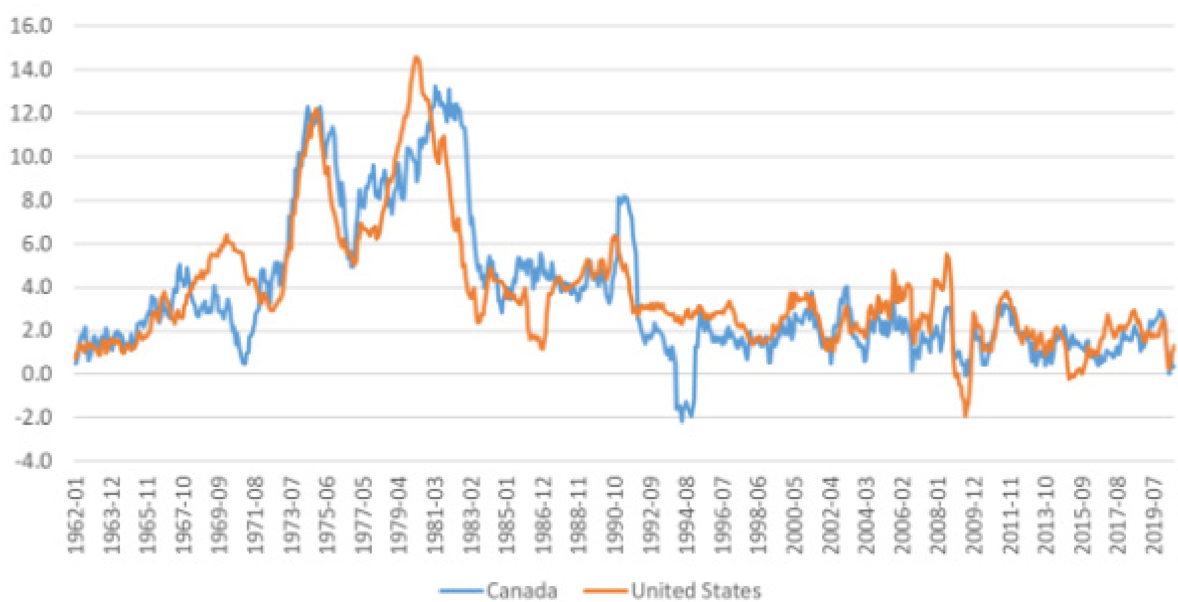
How might or should domestic policy respond to a persistently high rate of inflation in the United States? The high inflation in Canada in the 1970s was to a large extent imported from the United States through a concern for defending the exchange (Bouey, 1982, Howitt, 1986). The Bank of Canada's current policy framework is based on a flexible exchange rate policy. On the basis of this, one might expect that U.S. inflationary pressure would manifest itself primarily as an appreciating Canadian dollar. Depending on the size and speed of the phenomenon,

6 And if it does not, then the fiscal authority can safely continue to cut taxes and increase transfers. For more on the federal debt in Canada, see Andolfatto (2020b).

the Bank would be confronted with the usual set of concerns emanating from the most-affected sectors of the economy. How would the current flexible inflation-targeting regime hold up against such an event?

Interestingly, it seems that Canada has never (apart from a brief episode in the late 1960s) operated in a world where the rate of inflation across Canada and the United States diverged by a large amount over long periods of time; see Figure 3. To put things another way, the present flexible exchange rate regime has not been severely tested along this dimension. Is the current flexible inflation targeting regime well-equipped to deal with a sharp and persistent rise in U.S. inflation? Given the projected path of U.S. government budget deficits, the scenario is not outside the realm of possibility. But even if the event seems remote, it is the job of central bankers to formulate well-designed contingency plans in advance. As it is better to be prepared than to be surprised, this is a question that deserves some attention.

Figure 3: CPI Inflation
1962:01 - 2020:08



References

Amano, Robert, Thomas J. Carter and Lawrence L. Schembri (2020). “Strengthening Inflation Targeting: Review and Renewal Processes in Canada and Other Advanced Jurisdictions,” Staff Discussion Paper 2020-7, Bank of Canada.

Andolfatto, David (2015). “Arguments for and Against Liftoff.” http://andolfatto.blogspot.com/2015/08/arguments-for-and-against-lift-off.html

Andolfatto, David (2019a). “Is the ZLB an Economic or Legal Constraint?” http://andolfatto.blogspot.com/2019/03/is-zlb-economic-or-legal-constraint.html

Andolfatto, David (2019b). “Understanding Lowflation,” https://files.stlouisfed.org/files/htdocs/publications/review/2019/01/14/understanding-lowflation.pdf

Andolfatto, David (2020a). “Hot Money for a Cold Economy,” Federal Reserve Bank of St. Louis Working Paper. https://research.stlouisfed.org/wp/more/2020-019

Andolfatto, David (2020b). “Is Canada’s National Debt a Cause for Concern?” https://financesofthenation.ca/2020/10/28/is-canadas-federal-debt-a-cause-for-concern/

Bouey, Gerald (1982). “Monetary Policy--Finding a Place to Stand,’’ Per Jacobsson Lecture, Bank of Canada Review (September): 3-25.

Crow, John (2002). Making Money: An Insider’s Perspective on Finance, Politics, and Canada’s Central Bank, John Wiley & Sons Canada, Ltd.

Desislava, Andreeva C. and Miguel García-Posada (2020). “The impact of the ECB’s targeted long-term refinancing operations on banks’ lending policies: the role of competition,” European Central Bank Working Paper No. 2364.

Howitt, Peter (1986). Monetary Policy in Transition: A Study of Bank of Canada Policy, 1982-85. Toronto: C.D. Howe Institute.

Laidler, David (2020). "Interactions among Economic Ideas, Policies and Experience: the Establishment of Inflation Targeting in Canada, 1991-2001." Review of Economic Analysis, 12: 133-166.

Hon. Diane Bellemare

And the winner is...

With my title of Senator, one may have thought that I was an intruder in this conference, but I assure you I was in my element considering I studied economics at Western and McGill and taught economics for over 20 years at UQAM. Though, my positions on monetary policy may differ from others as my economic perspective has been shaped by my experience as a labour economist and as a parliamentarian.

More specifically, my work in managing active labour market programs in Quebec in the ’90s convinced me that in real life, monetary policy matters and it matters tremendously. Monetary policy affects the everyday life of many people as well as businesses. Its consequences may be long-lasting and may affect the income stream of individuals and businesses for many years after its implementation. It also affects productivity, the future potential of the economy and the distribution of income. Theorists may argue it is neutral in the long-run and this may be the case in some theoretical general equilibrium models. But as Keynes once said: In the long run we are all dead. As a parliamentarian, I would add it is the present that counts most.

That being said, let’s focus on the topic of the conference which is the future framework of monetary policy. I entered the conference with a strong preference for the dual mandate. After listening to all participants, I remain convinced that the dual mandate is the option for the 2021 agreement between the Bank of Canada and the Government of Canada. As demonstrated by the daily polls initiated by the organizers, I am not alone in this line of thought.

Let me explain my position.

Firstly, the dual mandate is the only option that takes into consideration the actual economic situation. It recognizes that monetary policy can participate actively in the recovery process of the Canadian economy following the big structural shocks created by the pandemic while keeping an eye on inflation.

Only a few participants addressed the issue of the pandemic and of the increase in uncertainties in Canada and in the world. The renewal of the five-year agreement will happen in a totally different economic environment then the first one which took place in 1991. It has been renewed seven times since then and has respected basically the same objective: Price stability.

Nowadays, inflation is not the problem it used to be in the past. Due to globalization, technological changes and many other factors, price increases have been relatively low on average since the '90s. Apart from the recent years before the pandemic where demographic factors such as aging produced labour shortages in some provinces and sectors, the main problem in Canada has often been unemployment. The crisis of employment is now back in the forefront of public policy debates and monetary policy must acknowledge this reality.

Consequently, if using the economic context as a criterion to choose among the six options presented in the conference, two options can be eliminated at once. Targeting a lower inflation rate does not address the problem of the day. On the contrary, as many agree, the risk of deflation outweighs the risk of inflation. Moreover, including the pursuit of financial stability within the monetary policy framework offers some interest but does not address the concerns of the day either. Besides, financial stability can be achieved through macroprudential policies.

Second, the dual mandate presents itself as the most credible option. The credibility criterion, which was widely discussed in the conference, enables one to pick the best option among the following: The status quo, the nominal GDP targeting, the increase in the target of inflation, and the dual mandate.

Let me elaborate.

Most of the participants agreed that monetary policy efficiency relies in part on its credibility and capacity to shape expectations. Not only should the Bank be credible in its policy, but Canadians need to understand the message as well.

Under the credibility test, the option of nominal GDP targeting should be discarded. Even though it incorporates issues relating to the economic situation including employment, it is somewhat difficult to explain and fails the credibility test.

The option to increase the inflation target also encompasses employment preoccupations, however, it also fails the credibility test. Indeed, how can one explain to the public that the economy needs more inflation while for so many years the Bank argued that the economy needs price stability. It is neither easy to argue nor to communicate.

What about the status quo? I am convinced that the status quo is not an option because it focuses only on inflation targeting while the main problem concerns growth and employment.

On the other hand, one may argue that due to inflation being below target, this option implies the need to stimulate the economy. I believe this argument encounters the same credibility concerns as increasing the inflation target. If the status quo implies stimulating inflation and coincidentally promoting growth and employment, then why not make it explicit through the dual mandate? Undoubtedly, it would make it easier to comprehend.

Having applied those two tests, the choice becomes obvious. It is time for Canada to adopt a new framework for its monetary policy and enlarge it to embrace not only price stability, but full employment or maximum employment as seen in countries such as the USA, Australia and New Zealand. In short, it is time to adopt the so-called dual mandate.

As Professor Pierre Fortin has often argued, the dual mandate adopted in the USA may explain why the American unemployment rate has often been lower than the Canadian one.

The dual mandate is a more credible choice for the coming decades, particularly when facing future challenges such as increased risks associated with climate change, technological changes and many other variables. It is also more credible and more equitable because it considers the concerns of those who have assets as well as those who do not and need a job for their livelihood.

Furthermore, I would argue that the dual mandate is more efficient. By taking employment into account, it could have positive indirect effects on productivity. As everyone knows, increases in productivity help to absorb supply costs increases.

If the dual mandate becomes the new framework, I would argue that the specific target of a two percent average inflation rate may not need to change. The period considered could be enlarged (to 18 or 24 months), especially when considering the Covid-19 factor which creates a lot of uncertainties and unpredictable events.

The full employment target is not as easily defined as the inflation target. However, it should not be understood as the so-called natural unemployment rate. I think that the availability of statistics on vacancies enables the Bank to use a large spectrum of information in order to appreciate the state of full employment. The Bank could utilize the concept once proposed by Beveridge and Keynes: full employment is achieved when the number of vacancies equate the number of unemployed. The Beveridge curve could offer an analytical tool to assess the different labour markets in Canada.

The dual mandate may demand more coordination between monetary and fiscal policies, but that is not an absolute constraint. Indeed, we can already observe that the Bank and the Department of Finance do collaborate.

Finally, let me say a few words on an issue dear to me and other parliamentarians which concerns the democratic deficit surrounding the process of choosing a monetary policy framework.

I agree that the central bank should enjoy independence in its operations, but the monetary policy framework could be defined through a more democratic process. A recent paper from the Bank of Canada[1] compared the practices of different countries in choosing their monetary policy framework. In Canada, the central bank proposes the mandate and the targets, does the research, proceeds to the evaluation of the results and relies on the decisions of the Governor and his team to operate the policy. Is this the best practice? I am not convinced.

Monetary policy is too important to be left to politicians. I agree. However, it is also too important to be left in the hands of the Governor and his team alone no matter how qualified they are. Government and Parliament must have a say in defining the mandate. Policy evaluation could be performed by independent research. The creation of a monetary policy committee, as proposed by Douglas Laxton who convincingly presented the case for the dual mandate, seems like a good idea. If such practices and a dual mandate were adopted, monetary policy would respects the essence of the Bank Act preamble and maximizes the Canadian welfare function.

1 Robert Amano, Thomas J. Carter and Lawrence L.Schembri, (2020), Strengthening Inflation Targeting: Review and Renewal Processes in Canada and Other Advanced Jurisdictions, Bank of Canada.

Kevin Carmichael

The University of British Columbia's Angela Redish, a distinguished historian of monetary systems and a former adviser at the Bank of Canada, is a voice that matters in Canadian economics.

So, when Redish states that she's "kind of disappointed" that we're once again drifting towards re-upping the Bank of Canada's grunge-era approach to monetary policy, it's worth taking note, as her peers surely did when she made the remark at the Max Bell School of Public Policy's "Choosing the Right Target" conference in September.

"We've had inflation targeting, two percent inflation targeting, for 25-plus years," Redish said. "Over those 25 years, there has been dramatic changes in the economy and the world and there's been changes in economics, too," she continued. "With all of those changes, I kind of expected the goal of monetary policy would change. And yet, the status quo for me ... is a very strong contender."

Chyrstia Freeland, the finance minister, must decide by the end of 2021 whether to stick with inflation-targeting or to order Macklem to try something else. It will be one of the most important decisions she makes, as it will determine how the Bank of Canada sets interest rates for the next five years.

Freeland's predecessor, Bill Morneau, opted to leave things alone when the central bank's mandate last came up for renewal in 2016, a decision that I and some others thought was taken after too little public debate. These twice-a-decade decisions are the one moment when politicians have an opportunity to influence monetary policy, as convention otherwise dictates that the Bank of Canada will be left alone to set policy how the governor and his or her advisers see fit. Last time, the Bank of Canada and the Finance Department had what was essentially a private conversation. That's not how a democracy is supposed to work.

The central bank is trying much harder to include the public ahead of the 2021 decision. Policy-makers have been working unusually hard ahead of next year's renewal, hosting a couple of conferences and devoting several speeches to the subject. They also are testing the current regime against a menu of alternatives similar to some of the options that attendees reviewed at the Max Bell conference.

To be sure, the benefits of a regime change must exceed the costs associated with switching to a new way of setting interest rates, including the disruption that would come with communicating a new process. The difficulty the Federal Reserve encountered while trying to explain its new “average-inflation” target no doubt got the attention of Canadian policy-makers. So, the bar for change will be high. The Bank of Canada’s “horse race” of policy options appears to have resulted in no clear leader, suggesting that Macklem will be tempted to recommend leaving well enough alone.

“The interim results suggest that the differences in performance among these frameworks is relatively small by historical standards,” Rhys Mendes, the central bank’s managing director, international economic analysis, said at a conference the Bank of Canada hosted on August 27. “Consequently, it’s not yet clear if any of the alternatives would offer expected gains large enough to justify shifting away from the proven and successful inflation-targeting framework.”

Mendes said that three policies had “performed well” in the Bank of Canada’s tests: the current regime of setting interest rates to keep the annual rate of growth of the Consumer Price Index (CPI) around two percent; a version of the Fed’s average-inflation target, which would make up for past misses in pursuit of a mean change in inflation over a period of time; and a dual mandate that pairs the existing inflation target with an employment goal.

Two of those three — the inflation target and the dual mandate — also stood out at the Max Bell conference. The others, for all their various merits, didn’t feel right in context of 2020.

A lower target might have been a worthy goal in the 1990s, but it seems out of place now, given that inflation has stayed low for more than a decade despite ultra-low interest rates. At the same time, a higher inflation target seems unnecessarily risky; there’s a reason former IMF chief economist Olivier Blanchard’s suggestion in 2010 that central banks should target inflation of four percent never gained traction.

Attempting to achieve a certain level of growth in nominal gross domestic product has an intuitive appeal, if, as the preamble to the Bank of Canada Act states, the central bank's mission is to "generally to promote the economic and financial welfare of Canada." But it could be an idea that is ahead of its time.

Inflation targeting works because the target — CPI — is a measure that is updated monthly and is fairly easy to understand. Nominal GDP has neither of those attributes, suggesting the central bank would struggle to communicate its intentions. The conference heard that new real-time statistical techniques would allow for more timely GDP estimates than are available currently; indeed, Statistics Canada appears to have had success predicting the path of GDP throughout the pandemic. Still, those methods will need more time before they win the confidence of the public. Nominal-GDP should remain in the mix for the 2026 mandate renewal, but not 2021. The public won't be ready for it.

Asset bubbles are a feature of contemporary monetary policy, as lower-for-longer interest rates have inflated housing costs, caused stock prices to skyrocket, and encouraged an unprecedented buildup of corporate debt. But is it the central bank's job to deflate them? Probably not, or at least not before more targeted measures such as borrowing restrictions and taxes have been tried.

The Fed should have been aware that the housing bubble that formed ahead of the 2008-09 financial crisis was national in scope, not a handful of local hotspots, and therefore warranted higher interest rates. But that was a unique phenomenon. Bubbles still tend to be local, and it would be mistake to accept suboptimal economic performance in order to calm home prices in a handful of cities.

Canada would benefit from a more proactive and transparent approach to financial regulation, a point the International Monetary Fund has made on many occasions. The Bank of Canada might even be best placed to take the lead on "macroprudential policy," regulation that is intended to manage supply and demand for specific assets. But that would require a political discussion that few in Ottawa view as a priority, as officials tend to voice satisfaction with the current approach. There's an element of complacency in that position, but even those who think Canada's regulatory system could be improved balk at the suggestion that the central bank should make up for any deficiencies by using interest rates to pop bubbles. The primary aim of monetary policy, specifically, must remain economic growth and price stability.

That leaves two viable options, at least based on what's on the menu offered by the Max Bell conference and the Bank of Canada's horserace: a dual mandate that would see policy-makers target both inflation and employment, and the status quo.

For years, a dual mandate was seen as a quirk of the U.S. political system, as Congress was the only political body that had saddled its central bank with the assignment of hitting two targets with a single instrument. Then in 2019, New Zealand's government added an employment objective to the Reserve Bank of New Zealand's marching orders. Questions about the practicality of a dual mandate remain, but a psychological barrier has been broken. New Zealand was the first country to try inflation targeting, followed by Canada; if they think a dual mandate can work, then maybe it can.

The risk with a dual mandate is that it could open a central bank to political pressure that could distract it from its main purpose: price stability. Yet there is an equally good argument that an emphasis on inflation creates a risk-averse culture that could keep central bankers from pushing for higher employment. Before the pandemic arrived, the Fed had successfully pushed past what it thought was full employment without triggering a burst of inflation, forcing policy-makers everywhere to take seriously the possibility that they hadn't been trying hard enough to lower the jobless rate.

This dilemma is why the status quo still looks so good after all of these years.

Ahead of the conference, Carolyn Wilkins, the Bank of Canada's senior deputy governor, told me in an interview that she was intrigued by the idea of "probing" current theoretical constraints on how low interest rates can go before they stoke runaway inflation. The current inflation-targeting regime would allow for that because the actual ceiling is three percent, the upper end of a one-percentage-point tolerance zone above and below the two percent target.

“It’s perfectly possible within our current framework that we could take into account some uncertainty about where that sweet spot was in the labour market before you got too much inflation pressure, and by being more patient you could draw more people back into the labour force,” Wilkins said. “We could incorporate that more explicitly in our mandate than we have right now.”

All that effort — the Bank of Canada, led by Wilkins, started work on its policy review in 2017 — for a tweak? That’s the way the wind was blowing near the end of 2020. There is indeed something disappointing about that given all that’s happened in the world over the last decade. But at least the public got a chance to participate this time, which should translate into greater confidence in monetary policy. That’s progress.

About the authors

Angela Redish

Professor of Economics, Vancouver School of Economics,
University of British Columbia

Angela received her PhD from the University of Western Ontario and has been a Professor of Economics in the Faculty of Arts at UBC since then. Her teaching and research have focused on the history of monetary and banking systems in Europe and North America. In 2000-2001, she served as Special Advisor at the Bank of Canada.

From 2001 to 2006 she was Head of the Department of Economics. From 2012 to 2015 she was Vice Provost and AVP at UBC and from 2015 to July 2017 she served as UBC's Provost and Vice President Academic pro tem. She is the immediate Past President of the Canadian Economics Association.

David Andolfatto

Professor of Economics, Department of Economics, Simon Fraser University
Vice President in the Research division of the Federal Reserve Bank of St. Louis

David Andolfatto is a Senior Vice President in the Research Department at the Federal Reserve Bank of St. Louis. He was a professor of economics at the University of Waterloo (1991-2000) and Simon Fraser University (2000-2009), before joining the Fed in July 2009. Mr. Andolfatto has published several articles in the profession's leading economic journals, including the American Economic Review, the Journal of Political Economy, and the Journal of Economic Theory. In 2009, he was awarded the Bank of Canada Fellowship Award for his contributions in the area of money, banking, and monetary policy. Mr. Andolfatto is a native of Vancouver, Canada and received his Ph.D. in economics from the University of Western Ontario in 1994.

Hon. Diane Bellemare

Senator

Diane Bellemare, Ph.D. in Economics from McGill and M.A. from Western Ontario, was a full professor of economics at UQAM. With both an academic and professional career, she has been a member of the Economic Council of Canada, CEO of the Société Québécoise de Développement de la Main-d'œuvre, President of the Commission des partenaires du marché du travail and Vice-President of the Conseil du patronat du Québec.

She published several books and academic articles on the subjects of full employment, income security, pension and population aging. The last one, Créer et Partager la Prospérité, 2013, was published by the Presses de l'Université du Québec.

She has been a Senator for Quebec since 2012, served as Legislative Coordinator in the Office of the Government Representative in the Senate from 2016 to 2019 and is now a member of the Independent Senators Group.

Kevin Carmichael

Journalist, Financial Post

Senior Fellow, Centre for International Governance Innovation

Kevin Carmichael is the National Business Columnist at the Financial Post and a senior fellow at the Centre for International Governance Innovation.

Carmichael has been writing about the Bank of Canada and economics generally since 2000, first for Bloomberg News, then the Globe and Mail, Canadian Business magazine, Maclean's, FiveThirtyEight, and NBC News Think from Ottawa, Washington, Mumbai, and, currently, Montreal.

Since joining the Post in 2018, he has written extensively about Canadian monetary policy, interviewing the governor and senior deputy governor. Carmichael won gold for commentary at SABEW Canada's 2018 Best in Business awards and was part of the Financial Post team that earned silver in the breaking news category.

MAX BELL SCHOOL
of PUBLIC POLICY