Paul Jenkins: Communication - a vital tool in the implementation of monetary policy

Speech by Mr Paul Jenkins, Senior Deputy Governor of the Bank of Canada, to the FMAC/FMA-USA Joint Conference 2004, Toronto, Ontario, 30 September 2004.

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Introduction

It is a pleasure to have the opportunity to address this joint conference of financial market professionals from Canada and the United States. At the outset, I want to thank the Financial Markets Association of Canada and the Financial Markets Association of the United States for inviting me to be your conference keynote speaker.

The members of these two organizations play an instrumental role in ensuring the efficient functioning of North America's financial markets and, from a central bank perspective, the efficient transmission of monetary policy. You are, therefore, among the Bank of Canada's key target audiences. We rely on the effective two-way flow of information between the Bank and financial markets in order to fulfill our mandate efficiently and serve the public interest responsibly. In aiming to do so, our overriding priority is to provide markets with the confidence that the value of money will be preserved through sound monetary policy. Put differently, financial markets embody the views of savers, investors, and borrowers, and the most basic consideration in the formulation of such views is confidence in the future value of money.

Many of you, who have worked in financial markets for some years, may well take for granted the evolution in the way monetary policy is conducted. But if Rip Van Winkle had been a monetary policy "wonk" and had awakened from his 20-year sleep today, he would surely be bewildered by the extraordinary changes that have occurred in central banking, especially in the way central banks communicate.

The fact is, few aspects of the conduct of monetary policy have changed quite so dramatically as the role of public communications. We have gone from a communication approach that not so long ago had central banks doing little to let people know what they were up to and why, to one that is now progressively transparent and deliberately forthcoming. Indeed, while central banks used to say little and let actions speak for themselves, today it would be accurate to say that words can, and often do, speak louder than actions.

Central bank practitioners of monetary policy have become far more preoccupied with communication because communication is so tightly bound to achieving good economic outcomes. As financial market players, you are one of the publics that are most sensitive to this new reality.

Bearing all this in mind, I want to focus my remarks today on communication and monetary policy. I will structure my remarks to address three key issues:

- first, why communication has become so important in conducting monetary policy;
- second, the need for central banks to be strategic in their communication approach;
- and third, some practical challenges central banks must manage in implementing their communication strategies.

1. Importance of communication in conducting monetary policy

Let me begin, then, with the importance of communication. For the Bank of Canada, communication is a strategic priority in supporting our goal of preserving low, stable, and predictable inflation. Indeed, I would submit that effective communication has become a vital tool in the implementation of monetary policy.

Why this emphasis on communication as an important monetary policy tool? There are at least two key reasons: first, experience has shown that communication improves the effectiveness of monetary policy or, put another way, monetary policy is most effective when it is effectively communicated; and second, communication helps central banks to be more accountable.

I want to touch on each of these points in turn.

Like all public policies, monetary policy benefits from increased public understanding and support. This translates into what I call "legitimacy of policy." Through clear explanation of why our policy objectives and actions are the right ones, we aim to gain public support for what we are doing. With success on this front, we begin to shape expectations and influence behaviour in ways that support policy outcomes.

Central to our effort is clarity of purpose. We at the Bank of Canada have found that a clear statement of our objective - an explicit inflation target - is crucial. With the clear recognition and appreciation of this objective, agents in the economy - consumers, investors, businesses, financial market participants - begin to adjust their behaviour in ways consistent with an expectation that future inflation will be firmly in line with the inflation target. Price, wage, and financial decisions will tend to be consistent with the target. And the net effect will be a more stable macroeconomic environment and greater success in keeping inflation low and stable.

The second reason why communications is important is accountability. A clear basis for judging a central bank's performance is extremely important to its credibility and independence. For the Bank of Canada, the explicit inflation target is that basis for accountability. Put simply, the public can measure our performance by how successful we are in achieving the 2 per cent inflation target. The fact that we have had a pretty good record in this regard has reinforced our credibility and the public's confidence that we will keep inflation at, or near, the target.

But for the Bank to be fully accountable, we must not only communicate the information that the public needs to understand our policy objective and our progress in meeting that objective, but also the challenges that arise in the economic environment and the factors that we take into account in making decisions. Communicating all this information has become one of the Bank's chief activities.

2. The need to be strategic in our communications

To communicate successfully, we need to be strategic. That requires an effective, proactive approach to communications. So we have to identify who our audiences are and what communication vehicles are most effective in reaching them.

We aim for effective dialogue with the public, the media, the markets, and other interested and influential constituencies. We want to further *their* understanding of monetary policy and foster public support for our goals and actions. At the same time, and equally important, we want to increase *our* understanding of the public's views.

This is clearly a continuous and iterative process. And the old communications principle, "Repeat, Repeat, Repeat," is entirely appropriate. By repeating our fundamental messages about the framework we use to conduct policy and about our policy goals and why they are important, we are increasing the odds that these messages will take hold in the public consciousness and resonate in shaping behaviour.

Through all our communications, we are providing the opportunity for public critique of our economic analysis, by economists, financial market players, journalists and reporters, politicians, and the public more broadly. This is constructive. Engaging the public in the issues is important in broadening awareness and understanding of monetary policy.

Let me be a little more specific about this. As I have already noted, expectations play a critical role in the conduct of monetary policy. First and foremost, we want to anchor expectations about future inflation to our 2 per cent target. Financial market expectations about future policy actions are also important to us. Market expectations get reflected in medium- and longer-term interest rates, as well as prices of other financial assets, and these financial prices make up part of the overall financial conditions in the economy. We therefore pay close attention to market expectations, and indeed look to financial markets to get an independent view of the expected future path of interest rates.

Bank staff, in our trading room and in our regional offices, are in regular contact with market dealers and investors in key financial centres, including Toronto, Montréal, New York, and elsewhere around the world. We also apply analytic techniques to extract from asset prices the views of market participants about the future path of interest rates. We look at interest rate futures, expectations implicit in the term structure of interest rates, and markets for instruments such as bankers' acceptances, term repos, and treasury bills. This involves assessment about relevant term, risk, and liquidity premiums. In this way, we keep our finger on the pulse of the market, on its interpretation of our decisions and statements, and on its views as to where policy interest rates are headed. We also stay on top of published economic analyses and commentaries from financial institutions. And we review the surveys of economists' and market participants' expectations for interest rates that are published by the major wire services.

All of this information, together with other economic and financial analysis, feeds into the Bank's deliberations leading to our interest rate decisions and then into the messages we communicate about the decision to the public. If the iterative process and the two-way communication that I have just described work as they should, the views of the Bank and the markets should be broadly consistent. And this should help create an environment in which positive economic outcomes are achieved in an efficient manner.

The Bank of Canada's communications strategy is based on reaching our target audiences through a schedule of key publications and communications events throughout the year. This gives us a regular, continuous, and integrated program of communication with the public. It permits us to communicate our evolving views on the economy and the trend of inflation on a regular basis through the course of the year.

These communications events include eight scheduled policy interest rate announcements, when we issue a press release, publication of our semi-annual *Monetary Policy Report* in April and October, *Updates* to the *Report* in January and July, frequent speeches by the Governor and other Governing Council members, public appearances before parliamentary committees, press conferences, and other media events and interviews. And a recent initiative has been to publish our regional office *Business Outlook Survey*, which summarizes business and industry views on their outlook for the economy and inflation.

From the Bank's perspective, we are encouraged by the progress we are making in engaging public interest in economic and monetary policy issues. The quantity and quality of media coverage of the Bank - both electronic and print - has increased markedly in recent years, especially since the adoption of a fixed schedule of regular dates for announcing policy interest rates. The C.D. Howe Institute's creation of a shadow Monetary Policy Council last year to provide an independent analysis and view on interest rate decisions is making a constructive contribution to public awareness and debate. And the public traffic to the Bank's Web site has grown enormously, indicating a growing public appetite for our published statements and information. These are encouraging indications that the public is reacting to our communications and, in many cases, providing us with tangible feedback.

3. Some practical challenges to a successful communications strategy

Implementing an effective communications strategy for monetary policy in 2004 has some very real challenges. Today, I want to touch on a couple of these: first, how to communicate uncertainty; and second, how to capitalize on new technologies, specifically an effective Web site.

(i) How to communicate about an uncertain future

After many years of being involved in developing and communicating monetary policy, I have found that dealing with the simple fact that the future is uncertain is one of the most difficult communications challenges a central bank faces. Clearly, financial markets are hypersensitive to anything a central bank says about the future because the markets are looking for indications about where interest rates may be going. This makes talking about the future all the more challenging.

Let's remember, central banks do not have a crystal ball. Economies are always subject to events and shocks that are unforeseen. And the fact that monetary policy operates over a medium-term time frame compounds the communications challenge.

How can a central bank best address this communications challenge?

I believe that we must be able to tell a coherent narrative - in other words, a story. The story has to explain the logic of central bank decisions, but allow the public and the markets to make their own assessment of future Bank decisions. The story must be set in the context of a clear statement of the objective of policy, a view of the key macroeconomic relationships, especially the inflation process, and an understanding of the tools and the actions used to achieve our policy objective.

But the story also has to recognize the forward-looking nature of monetary policy; that is, the considerable time lags between monetary policy actions and their effects. And it has to recognize that the outlook is uncertain and that the future path of interest rates will be linked to developments in the economy. In other words, the outlook is conditional - conditional on assumptions, such as an assumption about the world price of oil, and on views and analysis based on circumstances at a given point in time.

This may not be an easy story to tell. But for it to be as clear as possible, the elements have to add up in a way that reflects the monetary policy framework we have adopted to conduct policy. This includes how the exchange rate fits into the framework. Fundamentally, we have to assess the implications of movements in the currency for aggregate demand since, in setting policy, we aim to keep aggregate demand and supply in balance in order to help keep inflation close to our target. Another important aspect of the story is to communicate a sense of the risks and uncertainties facing the economy. If our story does all this, then it will properly convey the key relationships, nuances, and conditional nature of policy.

More specifically, what we do, primarily through our *Monetary Policy Reports* and *Updates*, is to provide a projection of those key macroeconomic variables - real GDP growth, the output gap, and inflation - that drive monetary policy decisions and give indication to the general direction of policy. We do not provide an interest rate path as part of these projections. Under an inflation-targeting framework, the policy consequences of changing circumstances or unanticipated events fall primarily on interest rates, and thus any projected interest rate path would be an unreliable guide to future policy actions.

In other words, our commitment is to the policy objective, not to a particular interest rate path. Our communication focus is therefore on presenting and updating our macroeconomic “base-case” projection consistent with eliminating any output gap - positive or negative - and achieving the 2 per cent inflation target over the policy horizon of roughly 1 1/2 to 2 years. But in order to underscore the conditional nature of the base-case projection, we also discuss the main risks and uncertainties that we see, and we identify those issues that we will be watching closely.

Let me offer a specific example from the Bank of Canada’s fairly recent experience. In the spring of 2002, there was evidence that demand pressures in the economy were growing more rapidly than had been anticipated, even though they were not yet showing up in price increases. Based on the evidence at the time, we raised our policy interest rate three times. By the first quarter of 2003, there was further evidence that inflation was above target, suggesting that strong domestic demand was putting pressure on the economy’s production capacity. So we raised our target overnight rate further in March and again in April. At that time, we concluded that the risks to the global economic outlook were more evenly balanced than they were the previous autumn, and we said so.

Then the Canadian economy was sideswiped by a number of unanticipated developments, most notably SARS, BSE, and a rapid rise in the value of the Canadian dollar as part of a broad-based weakness in the U.S. dollar. The impact of these developments caused us to alter our outlook for economic activity and inflation in Canada. With inflation pressures easing, we lowered the policy interest rate in July and September to help support domestic demand.

Through this period, there was some criticism of the Bank, that we had acted prematurely in raising rates and that, as a result, we had to reverse our decision. The fact of the matter is that conditions did change significantly. So our analysis and outlook changed accordingly, and we communicated the evolving story consistent with our monetary policy framework and its forward-looking nature. Like the baseball umpire says, “there’s strikes and there’s balls, and I calls ‘em as I sees ‘em.”

(ii) Communication technologies: capitalizing on a good Web site

A second communications challenge that I want to highlight is capitalizing on new technology. By shrinking time and space, new communication technologies have created enormous pressure to provide markets and the public with access to real-time information about monetary policy.

Fortunately, these technologies offer the means to help address these pressures. So the Bank of Canada has put a lot of emphasis on developing and maintaining a high-calibre Web site. The Web has become particularly important for monetary policy communication because it helps facilitate equal treatment of target audiences and it enables us to respond more quickly to information needs. Our site gives the general public and more specialized audiences direct and immediate access not only to our releases, publications, speeches, and technical information, but also to more easily understandable information about the Bank and monetary policy. Thus, the Web supports our objective of being proactive in reaching the public, the markets, and specialized audiences with news and information.

Last year, we were honoured to be presented with the “Central Bank Website of the Year” award by Central Banking Publications and Lombard Street Research. Nonetheless, we continue to work at improving and expanding the site. (If I might add a plug, our Web site address is bankofcanada.ca; banqueducanada.ca.)

Our audio “Webcasts” of speeches and press conferences by the Governor have been highly successful. They provide the instant access that markets and media want, to what the Bank is saying on monetary policy issues, as we say it. They also enable journalists and market participants from anywhere in the world to tune in “in real time.”

Our Web site plays an important role in supporting our financial market activities. Dealers and distributors can find up-to-the-minute information on securities auctions and tenders, plus historical yield data and a variety of technical documents. And the site permits much wider distribution of the Bank’s research than was possible in the past.

The Web is maturing as a medium, and the Bank will continue to exploit it to communicate more directly and effectively with its target audiences.

Economic outlook

Now, I want to take a moment to review the economic outlook. As I do this, I will be referring to some of the same terms and concepts that I have identified in my remarks today as important in helping the Bank tell a coherent story about the conduct of monetary policy.

Canada’s economic growth in the first half of this year was somewhat stronger than the Bank had been expecting. This was largely as a result of more robust external demand for Canadian goods and services. With domestic demand only slightly weaker than expected, the growth of aggregate demand in the first six months was a little stronger than we had anticipated. Thus, the output gap at mid-year was smaller than we had projected. Indeed, we judge that the economy is now operating close to its production capacity.

Inflation, both total and core, has been volatile in recent months, primarily because of swings in energy prices and because of automobile purchase-incentive programs. Despite this volatility, we continue to project that core inflation will gradually move up to the 2 per cent target in 2005.

Looking forward, we expect aggregate demand to grow at, or marginally above, the rate of growth of production capacity. With the economy operating close to capacity, monetary stimulus needs to be reduced to avoid a buildup of inflationary pressures and contribute to sustainable, solid economic growth. It is in this context that we raised the target for the overnight rate by 25 basis points on 8 September to 2 1/4 per cent.

As we pointed out then, there are uncertainties around the outlook. These uncertainties continue to relate primarily to three factors: the estimated size of the output gap, the future growth of Canadian exports and imports, and the overall effect on the Canadian economy of current and future movements in the world prices of oil and non-energy commodities. In conducting monetary policy, the Bank will continue to pay attention to these factors as we assess the evolving prospects for pressures on capacity and inflation. We will provide a detailed analysis of the outlook for inflation and the economy in our *Monetary Policy Report*, which will be published on 21 October. That *Report* will also extend our economic projections into 2006.

Conclusion

Let me conclude by summarizing my main points. First, communication has become another vital tool in the implementation of monetary policy. Thanks in part to effective communication, Canadians are now more confident that inflation will be kept near the 2 per cent target, and this expectation is feeding into their day-to-day decision-making.

Second, central banks need to be strategic in their approach to communications. By communicating in a timely and effective way, we can engage the markets and the public in the issues we face. At the same time, public input helps make monetary policy more effective.

And finally, there will continue to be numerous day-to-day challenges in communicating monetary policy. But in addressing these challenges, be they complex ones like the conditionality and forward-looking nature of monetary policy or technical ones like capitalizing on new technology, we are always striving to achieve better, more effective policy.

Communications is indeed a vital tool in helping the Bank achieve the goal of low, stable, and predictable inflation. But it is important to remember that low inflation is not an end in itself. Ultimately, it is the means by which monetary policy contributes to Canada’s solid economic performance and to the rising living standards of Canadians.