John Murray: Monetary policy decision-making at the Bank of Canada

Remarks by Mr John Murray, Deputy Governor of the Bank of Canada, to the Mortgage Brokers Association of British Columbia, Vancouver, British Columbia, 7 May 2012.

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Introduction

I would like to thank the Mortgage Brokers Association of British Columbia for inviting me to speak to you this afternoon. The title of your conference is intriguing.

F. Scott Fitzgerald's novel, *The Great Gatsby*, was set in the Roaring Twenties, a period of notable advances coupled with economic excess – and followed by the devastation of the Great Depression.

I am not sure what the conference organizers had in mind when they picked the theme for today's events, but perhaps they wanted to draw attention to the parallels between this earlier era and recent events. In the past 12 years, we have witnessed a period of phenomenal growth and prosperity in the global economy, followed by a deep and synchronous financial crisis in which we nearly repeated the experience of the 1930s.

Canada weathered the financial crisis that erupted in 2007?08 better than most of its peers, thanks in part to the healthy condition of its banks, prudent regulation of the financial industry and the country's strong fiscal position, which allowed the government to implement aggressive countercyclical measures.

The Bank of Canada's monetary policy, guided by the inflation-targeting framework put in place over 20 years ago, also played a critical role in Canada's performance through the crisis and recovery. It provided significant and timely monetary policy stimulus and, through its hard-earned credibility, helped to anchor household and business confidence in a turbulent time.

My subject today is monetary policy decision-making at the Bank of Canada, and my presentation will cover three related topics that I hope you will find interesting and useful, given the important role you play in Canada's financial industry.[1]

The first topic is how our monetary policy decision-making process is organized. Something that sounds rather simple in theory is quite complex in practice.

The second topic involves the information that is collected and interpreted as part of this process. Monetary policy making, as you shall see, is very information intensive.

The third and final part of my presentation focuses on three popular misconceptions about monetary policy that I would like to correct.

A short primer on monetary policy

Before jumping into a description of the decision-making process, however, it will probably be helpful to say a few words about monetary policy itself, by way of background.

As I mentioned earlier, at a conceptual level everything seems relatively simple. Monetary policy in Canada has one objective – achieving and maintaining a low, stable and predictable level of inflation. This objective was formalized in 1991 in an inflation-control agreement between the federal government and the Bank. It identifies a specific target for the rate of

[1] This presentation updates and extends T. Macklem, "Information and Analysis for Monetary Policy: Coming to a Decision," Bank of Canada Review (Summer 2002):11–18.

inflation – the midpoint of an inflation-control range – as well as the price index that is to be used to measure inflation.

Since 1995, the target level for the inflation rate has been 2 per cent (within a control range of 1 to 3 per cent), as measured by the 12-month rate of change of the total consumer price index (CPI).

This may seem like a rather narrow objective – a topic that we will return to later in the presentation – but experience has shown that this is the best contribution that the Bank can make to the economic well-being of Canadians. The greater certainty that it provides with regard to the future path of prices allows households and businesses to make more informed spending and investment decisions, and minimizes the inequity associated with unexpected movements in prices. Keeping inflation low, stable and predictable is a means to an end, not an end in itself.

Under normal circumstances, this single objective is pursued using a single policy instrument or tool – changes to the overnight rate of interest.[2] The overnight rate is set by the Bank of Canada and determines the rates at which banks and other selected agents are able to borrow and lend at the shortest end of the yield curve. But the story does not end there. Movements in the overnight rate set in train a number of other changes throughout the economy that ultimately affect the rate of inflation.

The transmission mechanism

This monetary policy transmission mechanism can be described as follows (Figure 1). Changes in the overnight interest rate influence the interest rates that the market sets on securities further out the yield curve and with different risk and liquidity characteristics (for example, mortgage rates). They also influence the exchange rate – the external value of the Canadian dollar. Movements in these asset prices, in turn, affect aggregate demand in the Canadian economy by influencing the spending and investment decisions of both Canadians and foreigners.

If strong aggregate demand pressures appeared likely to push output above the economy's capacity limits and lift inflation above the 2 per cent target, the Bank would respond by raising the overnight rate. This would put upward pressure on other interest rates and the exchange rate, other things constant, dampening aggregate demand, eliminating the gap between actual and potential output, and stabilizing inflation to the 2 per cent target. The process would be reversed, of course, if demand were too weak and inflation seemed likely to fall below 2 per cent. The overnight rate would be reduced, boosting aggregate demand, narrowing the excess supply gap and lifting inflation. It is important to note that the Bank takes a symmetric approach to the pursuit of its monetary policy objective, and is as concerned about undershooting the 2 per cent target as overshooting it. Keeping actual output at or near potential is the only way inflation can be maintained at a low, stable and predictable level.

Establishing an explicit inflation target and consistently achieving it helps to build credibility, anchor the inflation expectations of businesses and households, and make monetary policy more effective. An explicit inflation target also provides a direct means by which the Bank's performance can be judged, thereby improving accountability.

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[2] In exceptional circumstances, central banks have a number of other, unconventional, monetary policy tools at their disposal. They include quantitative easing, credit easing and conditional commitments concerning the path of future interest rates. These tools have been used by a number of central banks in the past four years as a means of providing additional monetary policy stimulus once the overnight interest rate approached zero and hit its effective lower bound. For more information, see the appendix of the Bank's April 2009 Monetary Policy Report.

This, then, is what the Bank tries to achieve and how it goes about it – through the monetary policy transmission mechanism.

Life would be easy if, having achieved the target rate of inflation, we could just leave the overnight rate of interest where it was and let the economy motor on. In reality, of course, this is impossible. The economy is constantly being buffeted by shocks of varying size and duration from both internal and external sources. These shocks are difficult to anticipate (if they were easy to foresee, they wouldn't be called shocks). Indeed, it is often difficult to identify the nature and potential intensity of a shock until well after it has occurred. Adding to the challenge is the fact that monetary policy operates on the economy with long and variable lags. Adjustments to the policy rate that we make now typically take four to six quarters to have their full effect on economic activity, and six to eight quarters to have their full effect on inflation (essentially two years). Policy, therefore, has to be forward-looking and policy-makers are forced to make their decisions in conditions of considerable uncertainty.

So a policy that at first glance appears to be relatively simple and mechanical to execute is in fact very complex and challenging.

Fixed Announcement Dates (FADs)

Prior to December 2000, the Bank had no fixed or pre-announced schedule for its interest rate decisions. Instead, it stood ready to move whenever action was deemed appropriate. While this may seem sensible and certainly allowed for a great deal of flexibility, experience here and elsewhere showed that it also added uncertainty to what was already a very uncertain operating environment. Businesses, households and market participants never knew if this was going to be the day when the Bank moved rates. It also made planning the forecasting and policy decision-making activities within the Bank challenging.

In order to avoid these problems and render the process more predictable, the Bank moved to a system of fixed announcement dates (FADs). It now makes its interest rate decisions on eight pre-announced dates through the year, with a six- to seven-week interval between each one. In exceptional circumstances, however, the Bank reserves the right to change rates on dates that fall outside this schedule. The only two occasions when this has occurred over the past 12 years were on 17 September 2001, following the terrorist attacks on the United States, and on 8 October 2008, as part of a synchronized policy easing with other central banks.

The timing of the FADs corresponds to the release of key economic information used for the Bank's forecasting and monitoring exercises. Four of the FADs occur shortly after the publication of the quarterly National Accounts, which report on Canada's gross domestic product (GDP) and its various subcomponents. The other four FADs are situated midway between these dates and are also timed to coincide with the availability of important information.

The most recent fixed announcement date was 17 April.

Who decides?

The major players in the FAD process are the Governing Council, the Monetary Policy Review Committee, and the four economics departments at the Bank.

Starting from the top, the Governing Council, which is responsible for making the interest rate decision, is comprised of the Governor, the Senior Deputy Governor and four Deputy Governors. The Monetary Policy Review Committee, which plays an important role in the discussions leading up to the decision, includes the Governing Council plus five to six advisers – often supplemented with one or two special advisers – as well as chiefs from the

four economics departments, representatives from the Montréal and Toronto regional offices, and certain other senior personnel.

The four economics departments are: Canadian Economic Analysis (CEA), International Economic Analysis (INT), Financial Stability (FSD) and Financial Markets (FMD). Most of these titles are self-explanatory, but I'll note that the Financial Stability Department focuses largely on the activities of Canadian and foreign financial institutions, while the Financial Markets Department concentrates on domestic and foreign financial markets.

What do all these people do? For the most part, they share their information, analysis, experience and judgment with members of the Governing Council. The Bank of Canada makes every effort to minimize the inherent uncertainty and risk associated with policy-making by drawing on whatever useful information and insights are available both inside and outside the Bank. The latter includes data series from agencies such as Statistics Canada, current analysis and forecasts from other central banks, governments, international financial institutions and private sector economists, as well as research from academics. All of this is in addition to the contributions of our own staff.

The information that flows from these sources is comprehensive and diverse and contributes, at each stage of the process, to the final decision. Let me give you a quick overview of what happens at each stage.

A five-stage decision-making process

The five key stages of the decision-making process are as follows (Figure 2).[3]

Stage 1 – the presentation of the staff projection to the Governing Council – occurs three weeks prior to the interest rate decision and has at its centre the Bank's latest forecasting and policy simulation model, ToTEM2.[4] Results from this model are supplemented with information drawn from a number of other sources and alternative models, which either look at a specific sector in greater detail (a satellite model) or view the economy using a different paradigm or set of data.

It is important to note that ToTEM2 and many of the other models used by the Canadian Economic Analysis Department rely critically on inputs provided by a Global Economy Model (GEM) and a detailed Model of the U.S. Economy (MUSE) constructed and overseen by the International Department, again supplemented with many other pieces of information. Since Canada is an open economy, international developments, such as movements in commodity prices, growth in Asian demand and prospects for the U.S. economy, play a major role in determining the path of the Canadian projection.

The combined output of all these models and analyses is blended with judgment to produce a base-case or most likely scenario, which is presented in this first meeting with senior management. A number of key risks and alternative scenarios are also identified at the meeting. Staff will then work on these scenarios over the next two weeks in preparation for Stage 2 – the major briefing.

Unlike Stage 1 – the presentation of the staff projection – which mainly involves the Canadian Economic Analysis Department and the International Department, Stage 2 draws importantly on all four economics departments. There are six key inputs to this meeting:

1. an updated monitoring of economic developments and risks;
2. the *Business Outlook Survey*, compiled by the Bank's five regional offices;

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[3] This is a very general description; the exact process may vary slightly for different FADs.

[4] The acronym stands for Terms-of-Trade Economic Model, version 2.

3. a report focusing on capacity pressures and alternative indicators of inflation;
4. an analysis of money and credit conditions;
5. the Bank's *Senior Loan Officer Survey*; and
6. an overview of financial market conditions and monetary policy expectations in Canada, the United States and the rest of the world.

Stage 3 – the policy recommendations of staff – typically occurs on Friday, two days after the major briefing. A senior member of the Canadian Economic Analysis Department or the International Department is asked to summarize and update the material that has been presented in Stages 1 and 2, and to provide a recommendation regarding any policy action that should be taken. The overview and recommendation serve as the starting point for an extensive discussion by the entire Monetary Policy Review Committee. Tactical and communications issues, as well as various policy options, are then reviewed, based on a note prepared by the Financial Markets Department. The meeting concludes with a tour de table at which each member of the MPRC, except for the six Governing Council members, is asked for a policy recommendation.

Stage 4 – the decision by the Governing Council – begins on Friday afternoon, immediately after the Stage 3 discussions, and resumes on the following Monday. Members of the Governing Council are the policy decision-makers. They review the information and recommendations that they have received, exchange views and explore any outstanding issues. Further discussions are held on Monday, a decision is reached, and a press release is drafted and approved.

The fifth and final Stage of the process – Communication – focuses on the publication of the press release at 9:00 a.m. on Tuesday announcing the Bank's decision and explaining the reasons behind it. Four times a year, this message is reinforced and expanded upon with the release of a *Monetary Policy Report* one day later. The *Report* provides a more detailed account of Canadian and global economic developments, the Bank's projections, and the major upside and downside risks that could affect the inflation outlook.

In addition to this *Report*, two other publications are released four times a year, approximately one week before the interest rate decision. The *Business Outlook Survey (BOS)* summarizes the results of the quarterly interviews that the Bank's five regional offices conduct with a representative sample of businesses across the country. This survey is an important complement to the other material that the MPRC and the Governing Council rely on and serves as a kind of "reality check" of what is happening on a regional basis. The second publication is the *Senior Loan Officer Survey*, which is based on interviews conducted with major banks and financial institutions in Canada to determine whether lending conditions for businesses have eased or tightened in the previous three months.

The final elements of the Bank's communication effort around these four *Monetary Policy Reports* involve a press conference by the Governor and the Senior Deputy Governor and Parliamentary appearances at the House of Commons Standing Committee on Finance, and the Senate Standing Committee on Banking, Trade and Commerce.

As should be clear from the process I have just described, the Bank places a great deal of importance on communication. It is a critical part of our accountability to Canadians and enhances the effectiveness of monetary policy by deepening the public's understanding of the economy and our actions.

Three popular misconceptions about monetary policy

Despite the emphasis that we put on communication and all the time that we devote to these activities, there is frequently some confusion in the minds of the public about what monetary policy does and the constraints that the Bank might operate under. I would like to take the

last few minutes of my presentation, therefore, to discuss three of the most popular misconceptions. They are:

1. *The Bank's narrow focus on inflation ignores more important objectives such as full employment and a rising standard of living.*

Not true. Experience has shown that price stability is the most important contribution that the Bank can make to the economic well-being of Canadians. Since the introduction of inflation targeting in 1991, the low and stable inflation environment has allowed consumers and businesses to manage their finances with greater certainty about the future purchasing power of their savings and income. Interest rates have also been lower in both nominal and real terms across a range of maturities. More broadly, low, stable and predictable inflation has helped to encourage more stable economic growth in Canada as well as lower and less-variable unemployment.

2. *If the Canadian economy is operating close to capacity (i.e., near full employment) and inflation is close to or at the 2 per cent target, interest rates have to be close to their "normal" or "neutral" levels.*

Not true. If there were no forces acting on the economy to push it away from this desired state, the statement would be true. However, this is seldom the case.

Headwinds and tailwinds are often present, threatening to push economic activity and inflation higher or lower. Monetary policy needs to lean against these forces with opposing pressure from higher or lower interest rates in order to stabilize the economy and to keep inflation on target. Monetary policy is seldom static; it has to respond as these forces ease or escalate.

3. *Focusing on price stability limits the Bank's ability to pursue its other major objective, financial stability.*

Not true. While at times there may appear to be tensions between these objectives, the two are in fact inextricably linked; it is impossible to achieve one of them without maintaining the other. Although other policy levers, such as bank regulation and macroprudential tools, are typically the first lines of defence in ensuring financial stability, monetary policy can, in exceptional circumstances, play a complementary role in achieving this end. Fortunately, there is enough flexibility in the present monetary policy framework to do so while achieving our inflation target over the medium term. One is not sacrificed for the benefit of the other.

Some concluding thoughts

Canada's monetary policy framework and the process that the Bank uses to make its decisions have evolved over time. The move to inflation targeting in 1991 and the move to fixed announcement dates are certainly the most noteworthy, but there have been many other refinements in the way policy is formulated and implemented. The process for decision-making that I have described is intensive and collaborative. It has also proved to be very effective. Without doubt, there will be further refinements in the future as we learn from new experiences. The effort to improve the decision-making process is ongoing.

Thank you for your interest. I would be pleased to respond to any questions you might have.

Figure 1: The Monetary Policy Transmission Mechanism

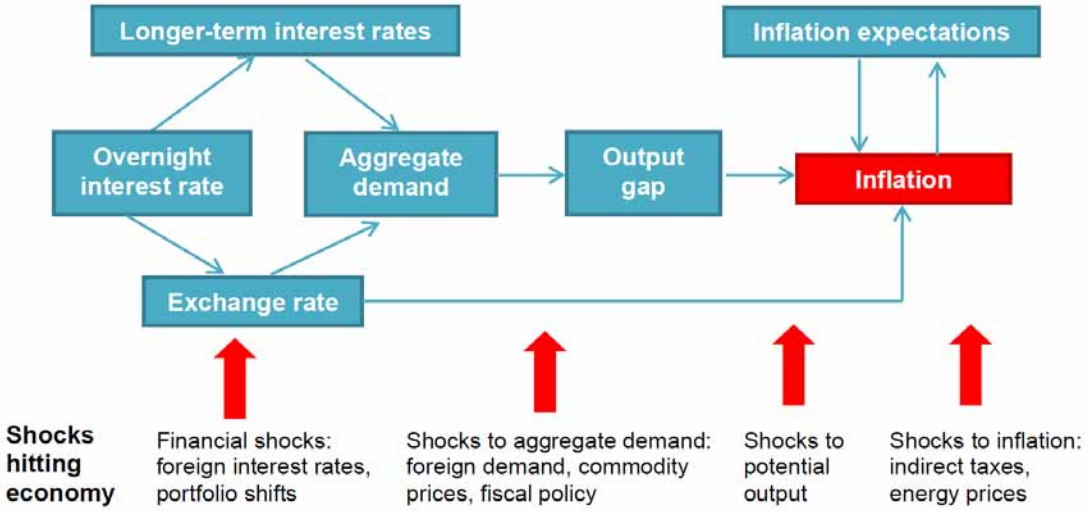

Figure 2: Five-Stage Decision-Making Process