Stephen S Poloz: Let me be clear - from transparency to trust and understanding

Remarks by Mr Stephen S Poloz, Governor of the Bank of Canada, to the Greater Victoria Chamber of Commerce, Victoria, British Columbia, 27 June 2018.

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Introduction

I am happy to be here in Victoria, a city with a beautiful natural setting and an economy that successfully blends old and new. You have the benefits of being a provincial capital and a natural tourist destination. And, today, the high-tech sector is your largest private industry.

The Bank of Canada is also a blend of old and new. For those who have not seen our Ottawa headquarters, at its centre is the original granite building, which was completed in 1938. Its classical architecture projects a sense of security. Its aim was to establish trust in challenging times. The building also embodies the approach that central banks took toward communications back then—meaning it is basically impenetrable. This approach can be summed up in a phrase attributed to Sir Montagu Norman, then Bank of England Governor: “Never explain, never excuse.”

But times change. By the mid-1970s, trust in central banks was low as inflation was high and rising. That was when renowned British Columbia architect Arthur Erickson designed the expansion of our headquarters. Erickson created two glass towers to flank the original granite building, linked by a towering glass atrium. All that glass foreshadowed the modern idea that central banks needed to be transparent to be trusted.

Building trust with transparency

As usual, Erickson was ahead of his time. The Bank rarely felt obliged to explain its actions to Canadians. This remained true even after moving from a fixed exchange rate to a floating one in 1970, which meant that the Bank no longer had an obvious anchor to guide its policy. During the 1970s and 1980s, Bank governors typically gave one public speech per year, while deputy governors gave none.

A big step toward increased transparency came in 1991 with the first inflation-control agreement between the Bank and the federal government. That agreement gave us a clear focus for our monetary policy. It also gave people a simple, easily understandable way to judge our performance over time.

Many other important advances in transparency followed. We started publishing a regular *Monetary Policy Report* (MPR) to detail our economic forecasts and explain our policy. We moved to a system of fixed dates for announcing interest rate decisions, with press releases that explained our rationale.

Governors and deputies began speaking in public much more often—going from one speech a year to dozens. We started webcasting the audio of public appearances, and added video in 2011. In 2014, we began to offer frank opening statements at press conferences to help people understand our policy deliberations—explaining how the information contained in the MPR contributed to the decision itself.

This year, we began offering four economic progress report speeches per year. They happen the day after each interest rate decision that is not accompanied by an MPR. This innovation means that the media can now ask questions of a member of Governing Council after every interest rate decision.

Now, I am not suggesting that more is always better when it comes to transparency and monetary policy. Transparency is not about the volume of communications, it is about clarity. We should always give our straightforward, honest views of the economy and interest rates. We believe that these efforts help build Canadians' trust in us.

Importantly, our policy framework holds the Bank publicly accountable. At least twice a year, Senior Deputy Governor Carolyn Wilkins and I make public appearances before committees of the House of Commons and of the Senate, which are webcast. Parliamentarians grill us on our track record on inflation and the Bank's other functions.

Furthermore, the inflation-target agreement is subjected to a thorough review every five years. During this time, anyone can offer new thinking on our framework. This consultation process ensures widespread buy-in.

But perhaps the most important way to build trust is through results. Because we kept successfully reaching our inflation goals, by the late 1990s, inflation expectations had become solidly anchored on our 2 per cent target. Those expectations even held steady through the trauma of the global financial crisis a decade ago. This level of trust has meant that fluctuations in economic growth and unemployment have become less severe than before the inflation-targeting era.

To illustrate, consider our experience in late 2014, when oil prices collapsed. We knew this would hit the economy hard, leading to cuts in investment spending and layoffs. We needed to respond to prevent inflation from undershooting the target, so we cut interest rates twice, starting in early 2015. The combination of lower oil prices and lower interest rates caused a significant decline in the Canadian dollar, and this pushed up prices of imported goods. Inflation quickly moved higher, but we explained that it would be temporary, and inflation expectations remained well anchored at 2 per cent. As a result, the economy adjusted to lower oil prices much more quickly than it otherwise would.

Working toward understanding

All that being said, transparency is only helpful if people can understand what we are saying.

As a central bank, we have multiple audiences. They all go about their daily lives making economic and financial decisions in the environment we create for them. Yet, not everyone has the same level of interest or familiarity with economics. The father rushing to pick up the kids and get dinner on the table before soccer practice is not as focused on our interest rate announcements as, say, a bond trader on Bay Street.

So, we need to tailor our communication to various audiences and deliver consistent messages through the right channels. These audiences include business leaders such as yourselves, business economists, financial market participants, academics, students and, of course, that soccer dad and other members of the general public, regardless of their occupation.

Consider how we communicate with the academic community. We have hundreds of economists on staff publishing cutting-edge research. This work must be credible with academics, because we rely on them to do research that complements ours, and to train the next generation of central bankers. So, the Bank is making its data and models more open, in multiple digital formats that let researchers more easily verify, enhance and challenge our findings. But, believe me, if the Bank were to communicate with non-specialists the same way we do with academics, we would not seem transparent at all. If you doubt me, just browse a few of the research papers on our website.

We recently commissioned some public opinion research to help us tailor our communications. It showed that about half of Canadians are interested in economic issues. But only about onethird say they understand how the economy works. This means there are roughly 6 million Canadians who are interested in the economy, but who are having trouble understanding economic issues. The challenge for us is to make sure that when we have a message to deliver, you will not need a degree in economics to understand it.

Research by Bank staff shows that we have some work to do on this front. We have been using software to analyze the readability of our speeches and other communications. It turns out that most of our speeches score at university reading levels. That is fine for many people, but not for everyone. This is also true for our interest rate announcements, the MPR and the *Financial System Review*. Only a handful of our public speeches over the past couple of years had a readability score at the high school level—in other words, a level that would be accessible to the majority of Canadians.

Of course, our subject matter is complex. But we can, and we will, make our communications more widely understandable. We want our content to be accessible to everyone who wants to understand our issues. We want those already reading our content to read even more of it. And we want the media to continue to report on our issues accurately and to engage us in constructive commentary.

This speech, in case you are wondering, rates at about a Grade 12 level in terms of vocabulary and sentence structure. Even so, not everybody will read this speech or hear about it on the news. We have to be creative to reach more people who are interested and help them understand what we do.

Social media is an important element in this effort—through Twitter, LinkedIn and other platforms. But it is only part of the effort. Last year, we re-opened the Bank of Canada Museum in Ottawa. The museum helps Canadians understand all the work we do. It takes a hands-on approach—encouraging people to interact with the exhibits. Plus, it is the best deal around, because admission is free!

The museum is working with educators across Canada to help develop material for classrooms. Tied in with that effort is the museum's website, aimed at the whole country. The bottom line is that we want Canadians, especially youth, to understand what the Bank does as part of a solid grounding in basic economics.

We are also replacing one of our regular publications, the *Bank of Canada Review*, which has always been aimed at a specialized audience. In its place, we will be launching a new digital-only publication: *The Economy, Plain and Simple*. It will explain key economic concepts and issues in an understandable way for the general public. We want this publication to stand out for its use of plain language, infographics and other visual content that will make what we do more accessible. In fact, you will see more visual elements—including videos and interactive charts—in the digital versions of all our publications.

And as we announced earlier this month, we are changing how we communicate about financial stability issues. Starting this autumn, a new financial system hub on our website will offer clear and up-to-date reports on the financial system, also aimed at a broad audience.

Let me make one last point about connecting with the general public. Yes, we want people to understand our views on the economy and its prospects. But it is equally important that we get out across the country and listen to people. These two-way conversations help fill in the gaps that economic statistics leave behind.

We organize this effort around our *Business Outlook Survey,* which is based on conversations between our regional representatives and business leaders. Members of Governing Council also engage in these conversations. I am here in British Columbia not just to give a speech—I am also here to meet with business leaders and with students.

Understanding and financial markets

Given the subject matter, getting people more interested in the Bank's work may be a challenge. But there is no shortage of interest in what we do and say from financial market participants.

Financial market participants trade securities based on their understanding of the economic outlook and the Bank's monetary policy. The Bank controls only one interest rate—the overnight rate—so its policy actions are transmitted to the economy through financial markets. This means that market expectations for monetary policy and the economy are embedded in market prices and interest rates. As a result, fluctuations in financial markets provide very useful signals about the future—they summarize the views of a multitude of market participants.

In recent years, many central banks have tried to enhance their impact on financial markets and the economy by giving explicit direction about future policy, or what we call forward guidance. Since this is a speech about transparency, let me be absolutely clear what I mean by that.

Central banks make forward-looking statements all the time because monetary policy takes time to affect inflation. I could say something like: "The economy is running close to capacity, so higher interest rates will be needed to keep inflation on target." That does not meet the textbook definition of forward guidance. Forward guidance is more specific than this. It usually ties future interest rates to an explicit condition, such as a specific time frame or an economic statistic.

The most definitive form of forward guidance in Canada's experience came in 2009, during the global financial crisis. We cut our policy rate effectively to zero, but we believed that the economy required more stimulus than that. So, we committed to keep the policy rate at the lower bound for an extended period, provided that the outlook for inflation remained unchanged. Because this anchored expectations for the overnight rate for some time, it caused longer-term interest rates to decline, too. This stimulated the economy even more. Today we think of this kind of forward guidance as an unconventional policy tool, to be deployed only in extraordinary times.

Some central banks routinely offer financial markets forward guidance about interest rates that is less specific. The Bank of Canada has done so at times in the past. Back in 2005, for example, our interest rate announcements mentioned the need to lower the policy rate "in the near term" and "over the next four to six quarters." The most complete form of this routine forward guidance is to publish a projection for the future path of policy rates. This is the practice of Sweden's central bank, for example. Similarly, the US Federal Reserve publishes so-called "dot plots" to indicate how its Federal Open Market Committee views the likely future path of interest rates.

Offering routine forward guidance obviously makes it easier for financial market participants to predict the actions of the central bank. Arguably, this makes markets more efficient by reducing uncertainty about future policy. However, this comes at a cost: by anchoring financial market expectations, forward guidance reduces the reaction of markets to economic news. In short, it suppresses the signalling role of financial markets.

As Canada recovered from the global financial crisis, the Bank gradually moved away from the most definitive form of forward guidance to a softer form. By 2013, though, we were becoming increasingly uncomfortable with offering even soft forward guidance to markets. The economy was struggling to return to full capacity, and we could not fully explain why exports and business investment were weaker than our economic models were projecting. We wanted markets to appreciate the uncertainty we were facing, and were concerned that providing forward guidance was giving participants a false sense of certainty.

Therefore, during the second half of 2013 we gradually toned down the forward guidance that we were providing in our interest rate announcements. This had the effect of shifting the Bank's uncertainty back out into the marketplace, which caused some market volatility. By 2014, we had stopped providing routine forward guidance altogether. Not everyone was happy about this. But we have seen signs that financial markets have become more responsive to data surprises as a result, particularly over the past year. In other words, market signalling has become stronger.

Since 2014, we have begun drafting each interest rate announcement on a blank page. This is to avoid getting locked into repeating specific language that, when changed, can create big market disruptions. We choose the words that best communicate our expectations for the economy and monetary policy.

Our latest interest rate announcement at the end of May is a case in point. Some observers noted that instead of repeating that we would be cautious about future policy adjustments, we said that we would take a gradual approach to raising interest rates. In fact, this shift in language represented increased confidence that the economy was performing as we expected, and that higher interest rates will indeed be warranted. Financial markets understood our message.

Let me stress that the Bank's decision not to offer routine forward guidance does not mean we want to keep markets in the dark. Indeed, we want markets to understand very well the relationship between how the economy is evolving and the likely future of monetary policy. Economists call this the policy reaction function. Economic models will not work without one. Our model specifications are documented on our website, and our policy reaction function is a form of what economists call a "Taylor Rule," named for the economist John Taylor. According to the Taylor Rule, the policy interest rate depends on projected inflation and economic growth. Our version is calibrated for the Canadian economy. We use it each quarter to calculate a path for interest rates that is predicted to keep inflation under control within our economic model and given the numerous assumptions we must make.

But this exercise gives us only a starting point for our interest rate deliberations. We cannot mechanically follow the rate path provided by our models because there is simply too much uncertainty in the world. We consider it misleading to pretend that uncertainty does not exist.

There is always a degree of uncertainty when using economic models, but these days there is a litany of things we simply do not know. These include the degree to which uncertainty about trade policy is holding back business investment, how new guidelines for mortgage lending are affecting the housing market, and how sensitive the economy is to higher interest rates given the accumulation of household debt.

With all these uncertainties, setting monetary policy is a matter of risk management. We need to understand the upside and downside risks to the outlook for inflation and determine how best to manage and balance those risks. Over time, we learn more about some of these issues as we receive new data.

This is why we say that the Bank is particularly data-dependent right now. Providing routine forward guidance in such a setting would not, in my view, enhance our credibility. Rather, it would put it at risk.

We have taken many steps to be more transparent about our decision making. We explain in detail the reasons for our interest rate decisions, both in statements following the publication of our MPR and in our economic progress report speeches. In the MPR, we now provide details on the most important risks to our projections. We spell out how we have seen these risks evolving and what we will watch so that we can judge their continuing evolution.

Of course, there will always be a desire for the Bank to be more forthcoming about our own interest rate expectations, including by publishing a projected interest rate path. Ironically, the case for doing so is usually based on economic models that are so simple they exclude most financial markets. This means that they cannot even consider the idea that forward guidance might suppress the signalling role of financial markets, which we consider of high value.

Given the complex uncertainties we face today, market signals have never been more valuable to policy-makers. To continue to benefit from those signals, we must be honest and transparent about what we know and what we do not know. We are committed to explaining what issues we are looking at and how we are thinking about them.

Today, as we approach our next interest rate decision, we are working to incorporate in our projections the effects of the recently announced US steel and aluminum tariffs, along with retaliatory measures, both in Canada and globally. We are also analyzing individual-level data to understand how the new lending guidelines in Canada are affecting the housing market and mortgage renewals. We expect these issues to figure prominently in our upcoming deliberations.

Conclusion

It is time for me to conclude. I hope that my talk about transparency has clarified our work at the Bank. We realize the importance of transparency, along with accountability and credibility, in building understanding and trust among all our audiences. We have worked hard at being transparent, and these efforts have been recognized as world-leading among central banks.

But we acknowledge that we have more work to do. We can be clearer in our communications with the general public. And we will be as clear as we can be with financial markets, always guided by what we know and by what we do not know.

My bottom line is this: being transparent is not only the right way to operate in a modern democracy, it also helps us meet our inflation-control target and our commitment to a stronger, more resilient Canadian economy.

I would like to thank Toni Gravelle for his help in preparing this speech.