Intelligence MEMOS

From: David Laidler

To: Central Bank Observers

Date: December 10, 2021

Re: **Freeing the Bank of Canada from its Own Trap**

It was 50 years ago that I first heard the gibe that "central bankers think inflation is always and everywhere a monetary phenomenon – except this time, of course," and it remains as good as new.

Consider the Bank of Canada, now caught in a trap of its own making.

Its mandate, pending an imminent renewal, requires it to maintain inflation in a range around 2 percent, but its "forward guidance," issued consistently for the past year, has promised to keep the overnight rate of interest at 0.25 percent until the real economy has returned to "normal" – at a date that lately seems to have now crept to somewhere around the end of 2022.

The Bank is stuck with two quantitative targets, one, an inflation target agreed with the government that is its ultimate policy goal, and the other, its own creation, the target for the overnight rate, which is its main policy instrument.

Now, however, it has to deal with their incompatibility.

So: how did the Bank get into this mess, and more important, how does it extract itself?

We shouldn't criticize the rapid resort to strong and unconventional stimulus when COVID-19 struck in March 2020. To continue with "inflation targeting as usual" in those circumstances would have been a bit like sticking to the rules of the Gold Standard in the summer of 1914. Nor should we really complain that the stimulus turned out to be a bit excessive – better too much than too little under the circumstances, surely?

The Bank's fault, which it has shared to varying degrees with the Fed, the European Central Bank and the Bank of England, lay in failing to sufficiently appreciate the inherent inflationary risk in its measures, and even more so, in its unwarranted tone of certainty in interest-rate guidance.

At the beginning of 2020, Canada's broad money supply – M2++ – was growing at an annual rate about 8 percent measured over the previous three months, as it had, more or less, for the previous decade. (M2++ includes cash, chequing and savings accounts and other types of highly liquid assets that can be turned into cash quickly.) By the end of June it was growing more than 20 percent, and despite its retreat to a little more than 10 percent by the beginning of 2021, it has shown little sign of slowing further until very recently.

Bursts of broad money growth don't always lead to inflation either. But often they do. So whenever they occur, and especially if they show signs of lingering, policy-makers need to investigate the reasons why – promptly and carefully. To judge by the public record of its forward guidance, the Bank ignored money's warnings this time around and failed even to entertain the thought that it might be overdoing expansion a bit and that an upsurge in inflation might be on the cards for 2021.

It was not alone. The Fed in particular made the same mistake, if anything on a larger scale, thus ensuring that the inflation we face is now well embedded in international as well as Canadian markets.

With the election out of the way, the Bank is now freer to take action than it was earlier this year, and it would be welcome if the current winding down of "Quantitative Easing" were accompanied by an overnight rate increase early in the New Year. But this is not a plea for any major speed-up of monetary tightening thereafter. The damage on the inflationary front is now done and needs to be undone gradually. The national political mood is too fragile to risk a sudden downturn, and the Bank needs to take care about not losing any more public support.

Above all, it needs to begin rebuilding its credibility. To this end, its current inflation control mandate must be renewed with firm political backing, and without the addition of further bells and whistles.

The Bank has already had more than enough trouble meeting a simple goal under trying circumstances, and to give it a more complicated mandate would only expose its reputation to the risk of further damage. And then it needs to set a clear date for getting inflation back to its target range – two or three years hence perhaps – with no accompanying guidance about what this might imply for the time path of interest rates.

There is no way of forecasting this time path under current circumstances, and the Bank should acknowledge this explicitly, as it swears off the kind of forward guidance that has already caused it so much trouble.

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A version of this Memo first appeared in the Financial Post.