Intelligence MEMOS

From: Duncan Munn and Jeremy M. Kronick

To: Canadians Concerned About Inflation

Date: May 30, 2022

Re: **A Monetary Policy Primer for All Seasons**

Canada has an inflation problem. It demands action. Constantly rising prices hurt everyone.

Effective action requires an understanding of how monetary policy works. Misdirected Bank of Canada bashing threatens the future of inflation control since confidence in the Bank of Canada helps anchor inflation expectations in the public consciousness. Eroding it could make getting inflation back to target slower and more painful.

We offer this primer to help make sense of the debate around the Bank's actions. We outline how monetary policy is conducted – in good times and in bad – and how an independent central bank should act when inflation is way off target.

The Bank of Canada has an inflation-targeting agreement with the Government of Canada, and since 1995, the year-over-year inflation target has been 2 percent, within a band of 1-3 percent.

The Bank's primary tool to control the demand for goods and services, and, therefore, inflation, is the overnight rate – the rate large financial institutions pay to borrow from each other in the overnight financing market. When the Bank adjusts the overnight rate, these financial institutions adjust their own interest rates. All other interest rates in the economy follow suit.

Thus, by adjusting one rate – the overnight rate – the Bank influences all interest rates, to one degree or another, more or less simultaneously. This increases or decreases borrowing costs, thereby slowing or stimulating demand and inflation.

There is a limit to how low the overnight rate can go. How low is up for debate, but when this limit is reached, central banks turn to unconventional monetary policies, among them quantitative easing (QE), which is the act of buying up government bonds at longer maturity dates to push up their prices, thereby lowering their interest rate, and by extension lowering other borrowing rates. For example, the Bank might buy up 5-year Government of Canada bonds to lower their yields, which then lowers the interest rate on the popular 5-year fixed rate mortgage.

Unlike the 2008 financial crisis, when Canada was able to stave off the worst of the economic impact and avoided QE, the pandemic spared no one. As a result, the Bank of Canada this time turned to QE – like many other major central banks – in addition to lowering the overnight rate to its lower bound.

The Bank began buying government bonds to stimulate demand during a time of depression-like weakness in the economy, inflation well below target, and real deflation risk. This is fully consistent with the Bank's 2-percent inflation target. So far so good.

In April 2021, the federal government announced its $154.7 billion deficit. Alongside it, the Bank's QE program was running at $3 billion a week, which over the course of a year turns out to be pretty close to the federal shortfall. This has led some to make the charge that the Bank was acting as Ottawa's ATM.

But April's $3 billion a week pace represented a shrinking QE program from the month before – the only central bank doing so at the time. QE shrank again in July 2021 to $2 billion a week, before ending last October.

Should it have reduced its bond purchases more swiftly? In retrospect, it should have. But the charge that the Bank was acting as an ATM is unpersuasive.

Inflation targeting is not a perfect science. Monetary policy operates with a lag, and so central banks need to forecast the future, making educated projections as to how a host of variables will interact to achieve the target inflation. The real test of central bank independence is when they get it wrong and inflation gets out of control, what they then do about it.

The Bank is doing what you would expect an independent central bank to do. It stopped QE, is letting maturing bonds roll of the balance sheet, and, most importantly, hiking the overnight rate – 75 basis points in the last two meetings, with more to come this week. This will hurt.

The pain won't be politically popular but that is precisely why central bank independence is so vital.

Free of political interference, the Bank of Canada should continue to raise rates until it sees inflation back on track towards its 2-percent target. The fact it is raising rates should give us confidence that our central bank is taking ownership to fulfill its mandate to preserve the purchasing power of every Canadian's hard-earned dollars.

Criticize the Bank for being too stimulative for too long, and push it aggressively to get inflation under control if you would like, but there is no need to impugn its motives. That only so sows unhelpful distrust and weakens needed public confidence in the Banks's ability to tame inflation, and in end may only increase the pain of getting back to 2 percent.

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