Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Bank of Canada Governing Council

Date: December 22, 2022

Re: **THE BANK OF CANADA GETS ITS COMMUNICATION RIGHT**

The Bank of Canada's latest interest rate boost, to 4.25 percent, was unsurprising.

The real news was the change in the tone of its announcement. Further tightening will "depend on the data," it said, a marked contrast to its earlier 2022 warnings that more rate hikes were inevitable.

This is welcome because the Bank gives itself more wiggle room in a very uncertain environment, giving it room to pause and evaluate as its hikes work their way through the economy.

Definitive statements can be problematic. Back in the second half of 2020, with the overnight rate at its lower bound, the Bank, in its effort to boost demand and combat low inflation, told Canadian households and businesses that low interest rates were here for a long time.

This is what economists call forward guidance, where a central bank attempts to provide predictability, so people and businesses can confidently move ahead with major planned purchases and investments.

That, unfortunately, contributed to rising inflation and a too-hot economy that the Bank is now trying to cool – revealing the dangers of forward guidance we are seeing today.

People listened to the Bank and borrowed and spent. Many Canadians who heeded the call to take out mortgages at rock-bottom face significantly higher interest rates today. Some have not yet felt the pinch because their mortgages have not yet been adjusted, but the pinch is coming.

While forward guidance does not bind the Bank to a rigid plan, people often perceive it that way. Not a good thing when the environment changes. People think the Bank will continue on its pre-disclosed path, and they make spending decisions that make things worse for both themselves and the economy.

It's a good thing the Bank bent from its earlier forward guidance, even if it did, perhaps, stick with it longer than needed.

Two years ago, with headline inflation still well below target at 0.7 percent, the Bank announced it would hold the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2-percent inflation target is sustainably achieved.

This commitment was conditional on one aspect of the data – the output gap, the difference between actual and potential output of the economy. The Bank's two calculated output-gap indicators remained negative at the end of the third quarter of 2022 (-2.1 and -0.4 percent).

Deviating from that forward guidance was obviously necessary, but doing so risks the credibility of that tool, and might have been in part responsible for the Bank being behind in the timing of its interest-rate hikes. By the time it had started to raise its policy rate last March, inflation had leapt to 6.7 percent and was on its way to its 8.1 percent June peak.

Similar dangers lie on the tightening side as interest rates rise. Too much forward guidance leads to a much deeper dampening of economic activity than necessary. With the Bank's indications that the tightening cycle should come to an end, its announced commitment to more data dependence is even more appropriate.

It is true that headline inflation still looks stubbornly high, at 6.8 percent in November. On the other hand, as we have previously pointed out, the built-in inertia of this metric does not readily reflect the current situation, which is actually starting to look better.

For example, the three-month annualized rates of CPI Trim – so-called because it trims out the parts of the price change in volatile components – has already fallen to 3.4 percent from 7.8 percent in May. CPI Median inflation – another core measure – has fallen to 3.3 percent from 7.4 per cent in May.

The Bank will have much new information before its next decision in January, including headline inflation December, labour force survey data for December and industry GDP data for October. If inflation continues to fall, and if economic conditions prove weaker than forecast, the Bank will want to end its tightening cycle so its policies do not throw the economy into recession.

The Bank's announcement that interest-rate policy will be more data dependent is a welcome change.

We would suggest a further tweak to its communication strategy: Find a way to reduce the focus on headline inflation and use the more telling measures that exist.

Steve Ambler, a Professor of Economics at the Université du Québec à Montréal, is the David Dodge Chair in Monetary Policy at the C.D. Howe Institute. Jeremy M. Kronick is Director, Monetary and Financial Services Research at the C.D. Howe Institute.

To send a comment or leave feedback, email us at blog@cdhowe.org.

A version of this Memo first appeared in The Globe and Mail.