Intelligence MEMOS

From: Jeremy Kronick, Steve Ambler and William B.P. Robson

To: Bank of Canada Watchers

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Re: **Welcome Clarity about Monetary Policy in Pandemic Times**

Amid the health and economic stresses of the coronavirus pandemic, clarity from public officials is especially valuable. The July Monetary Policy Report (MPR) from the Bank of Canada was a model.

Back in March, the Bank cut its traditional instrument, the target overnight rate, to 25 basis points, alongside heavy interventions in financial markets to provide liquidity. The high degree of uncertainty associated with the virus and the ensuing economic lockdown led the Bank to be vague in its accompanying commentary, including the key question of its strategy to hit its 2 percent target. The April MPR did not include the Bank's traditional economic forecast, presenting instead two starkly different scenarios, with no indication of which scenario the Bank thought more likely.

This time, the Bank gave us much more.

First, it provided more explicit guidance concerning its interest rate target than ever before, committing to "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."

Second, the MPR provided a central economic scenario through to the end of 2022. Recognizing that its assumptions concerning the pandemic itself are highly conditional, the Bank laid out a scenario assuming that there will not be a second wave severe enough to throw the economy back into lockdown, and that 2022 will see the development of a vaccine or effective treatment. With that central scenario showing inflation at only 1.7 percent at the end of 2022, the overnight rate will be at its effective lower bound for quite some time.

Third, the MPR provided guidance about quantitative easing (QE). It stated that the Bank will purchase at least $5 billion of Government of Canada bonds until "the recovery is well underway." While at first QE was intended as a liquidity tool to ensure financial markets function properly, its focus now is to keep interest rates low across the yield curve, and help stimulate the economy.

An additional helpful element in the MPR was an analysis of how changes in consumers' spending patterns have affected the consumer price index (CPI). The MPR announced the construction (in cooperation with Statistics Canada) of an adjusted price index with weights that reflect more up to date purchases. The CPI is used to define the Bank's inflation-control target, and this should lead Statistics Canada to update its weights more frequently. The adjusted index revealed slightly less disinflationary pressure from the pandemic, with many goods and services whose prices had fallen, such as travel, being effectively unavailable. This new measure should make for a more accurate reading of the cost of living Canadians face, allowing monetary policy to react more appropriately.

Lastly, the MPR gave a clear picture of how the Bank sees the difference between actual and potential output, and its implications for inflation. With output falling by 15 percent in the first quarter of 2020, and 60 percent of that representing lost or idled capacity, the output gap that matters for inflation is likely 6-7 percent. That will take a long time to close, underpinning the need to keep rates at their effective lower bound for some time.

We would like to see one more piece of information to complete the portrait of the Bank's pandemic strategy. Since the emergency cuts to the overnight rate, the deposit rate – the interest rate banks receive for holding positive settlement balances with the Bank of Canada – has been equal to the rate banks get when lending to each other overnight. This reduces banks' incentives both to lend to each other and to expand their loan portfolios to households and firms. The Bank could be more explicit about whether this situation will continue and, if it does, how the Bank will encourage the financial sector to meet an increased demand for borrowing in an environment of exceptionally low interest rates.

In uncertain times, the more information our public officials can provide the better. The Bank of Canada provided a blueprint for how to do so.

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