Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Central Bank Watchers

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Re: **Parting Ways: The Bank of Canada Holds Steady, the Fed Experiments**

The two most recent announcements by the Bank of Canada and the US Fed are a study in contrasts. The Fed's major shift in its monetary policy framework should be met with caution at home.

Last week's rate announcement by the Bank of Canada contained little new information. The Bank reaffirmed its intention to hold the Overnight Rate Target at 25 basis points "until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved." It did add to the language around the large-scale asset purchase program, indicating these purchases will be calibrated to achieve the inflation target, seemingly providing notice to markets that Bank purchases might taper off in the near future. But, as before, the Bank said it would continue its large-scale asset purchase program of at least $5 billion a week.

Contrast that with the Fed, which, on August 27, announced a major modification of its monetary policy framework, moving towards a policy of average inflation targeting (AIT). The announcement stated that "following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

Let's look at the implications of the announcements in more detail, starting with the Fed.

In the current context, the Fed's AIT policy, if credible, will increase expected inflation because the Fed has committed to letting inflation sit above 2 percent after periods where the US runs below target. This will have the effect of reducing real interest rates (nominal interest rates adjusted for inflation), the main channel through which expansionary monetary policy operates in order to increase spending. When nominal interest rates, both short term and long term, are already low, for monetary policy to encourage more spending, and therefore inflation, it must work through real interest rates.

But there are major problems with the Fed's announcement. A credible AIT regime would specify the exact length of time over which average inflation would be calculated, and critically, it would also be explicitly symmetric, such that both persistent undershoots and overshoots are acknowledged so that in the medium term, inflation sits at the 2 percent target. Otherwise, inflation expectations become unanchored, and in the Fed's case, biased upwards. With unprecedented government debt flooding markets, unanchored inflation above the 2 percent target is a problem.

While there were no major shifts in policy by the Bank of Canada, questions remain. For example, if markets have been calmed, and yields across the curve are quite low, does QE continue to provide additional stimulus to the economy? On September 9, the yield on 10-year government bonds was 0.592 percent, just 34 basis points above the target overnight rate. Shorter-term yields on government bonds (one year or less) were all below the target overnight rate. If the main goal of the QE program is to push down the nominal yield curve, as the Bank says, it seems unlikely that asset purchases can drive down these yields more than a few basis points. And perhaps we want a healthy spread between short and long-term yields, as that would indicate a pick up in inflation expectations.

Some ground that the Bank of Canada could safely explore is its thinking on the overnight rate, given that its own research concluded that the effective lower bound on the Target Overnight rate was much lower than the current 25 basis points, in fact as low as -50 basis points. There are good reasons to keep the lower bound at 25 basis points, including lending spreads for financial institutions, but why not look to lower the interest to financial institutions on what amounts to a significantly higher level of settlement balances held at the central bank if you can?

The Fed's announcement of a move to AIT came after a consultation period much like the Bank of Canada recently announced. For the first time since the Bank became an inflation-targeting central bank, it is giving serious consideration to an alternative framework, of which AIT is one option. A high bar is needed to make any change to Canada's monetary policy framework given that the inflation-targeting framework has been one of the most successful economic policies over this period.

Extraordinary times call for extraordinary measures. A move to AIT might not seem it, but in the context of central banking, it would be.

*Jeremy Kronick is Associate Director, research, at the C.D. Howe Institute. Steve Ambler is David Dodge Chair in Monetary Policy at the C.D. Howe Institute and a professor of economics (retired) at the École des sciences de la gestion, Université du Québec à Montréal.*

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