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E-BRIEF

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MONETARY POLICY

Good Governance of Monetary Policy in Canada: Lessons from the C.D. Howe Institute's Shadow Council

by
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- The existing governance structure of the Bank of Canada is out of step with international practices that have spread quickly over the past decade, and may limit public understanding of important monetary policy questions. Unlike central banks in the US and England, the Bank does not publicly disclose the opinions of individual members of it policy rate committee, the Governing Council.
- However, the experience of the C.D. Howe Institute's Monetary Policy Council shows that a diversity of opinions by members does not appear to create any particular difficulties in setting the appropriate stance of monetary policy in Canada, nor do differences in views appear so large as to threaten the usefulness of the deliberations in providing informed opinion about monetary policy actions.
- Revisions should be made to *The Bank of Canada Act*, which currently deters senior officers from becoming more transparent and, consequently, more accountable. The publication of the Governing Council's deliberations in some form could assist the Bank in communicating and understanding the kind of signals necessary to keep inflation on target.

In 2002, the C.D. Howe Institute (CDHI)[1] created a shadow committee called the Monetary Policy Council (MPC) to provide "…the Bank of Canada, financial-market participants and economic policy commentators with a regular independent assessment of the appropriate stance of Canadian

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1 "…an independent not-for-profit research institute whose mission is to raise living standards by fostering economically sound public policies." See http://www.cdhowe.org/about-cd-howe.

monetary policy."[2] In this E-Brief, we (i) ask whether we can identify differences between its recommendations and the decisions made by the Bank; (ii) discuss differences in the way these two bodies, as well as some other central banks, operate in this respect; and (iii) offer some policy recommendations arising as a result for the governance of the Bank of Canada.

Monetary Policy Committees

One development in recent decades is that monetary policy decisions are more often taken in a committee setting. Such committees have considerable diversity in their size, structure, and influence on monetary policy outcomes. What is noteworthy for this discussion is that research in the last few years suggests that the release of voting records and minutes or meeting transcripts does not destabilize financial markets. In addition, the publication of this type of information does not negatively impact the extent to which the public's expectations of inflation might become unanchored or negatively affect the central bank's reputation. Indeed, the voting record of monetary policy committees provides some useful information about the likely direction of future policy actions (e.g., Hansen, McMahon and Prat 2014; Siklos 2014a).

In Canada, the Governor of the Bank of Canada (BoC) is statutorily responsible for monetary policy decisions, even if a committee of six renders them on the Governing Council (GC). We see only the GC's consensus decision, not any disagreement within the GC. The individual voting records of the CDHI's MPC may offer some clues about whether steps ought to be taken to shine more light on the activities of the GC.

The C. D. Howe Institute's Monetary Policy Committee

The MPC consists of 12 members. Roughly half are academic economists while the other half are professional economists from the financial sector. Members are named by the CDHI based on the background and expertise of potential candidates to comment and provide recommendations on the appropriate stance of monetary policy.[3] The MPC provides independent advice about what the appropriate policy rate ought to be and not a forecast of how the Bank is likely to set future policy rates.[4] The MPC normally meets five days before each Bank of Canada announcement of the overnight rate.[5]

The Bank of Canada's Governing Council

The Bank of Canada's Governing Council (http://www.bankofcanada.ca/about/corporate-governance/governing-council/) makes a recommendation about the overnight rate setting, announced usually on Wednesdays, at

2 http://www.cdhowe.org/monetary-policy-council-2.

3 The list of current members as well as their background and affiliations can be found at http://www.cdhowe.org/monetary-policy-council-2. Members do not receive any financial support from the institute nor are they asked to adopt a particular ideology in making monetary policy recommendations. Siklos and Neuenkirch (2014) provide a detailed account of the organization and structure of the MPC and the GC.

4 As opposed to the Reuters Poll of more than 40 Canadian "economists and strategists" who are asked to provide a forecast of the Bank's upcoming policy stance.

5 "The overnight rate is the interest rate at which major financial institutions borrow and lend one-day (or "overnight") funds among themselves; the Bank sets a target level for that rate. This target for the overnight rate is often referred to as the Bank's key interest rate or key policy rate." Source: http://www.bankofcanada.ca/monetary-policy-introduction/key-interest-rate/.

9:00 a.m. A statement accompanies each Governing Council announcement, which briefly explains its position. Decisions are reached "…through consensus…" The GC has no basis in statute. Accordingly, no votes or minutes are released.[6]

Table 1 provides a comparison of the essential elements of decision-making at the CDHI and the Bank of Canada. By way of comparison, we also provide information for the US Federal Reserve's Federal Open Market Committee (FOMC), the Bank of England (BoE)'s MPC, and the European Central Bank (ECB).

The principal difference between the CDHI and Bank of Canada processes concerns the information that is publicly communicated. Individual recommendations by MPC members are published on the Institute's website. In contrast, we are not able to observe any differences of opinion inside the GC. However, the Bank of Canada publishes macroeconomic forecasts four times a year, whereas the CDHI does not. Instead, the MPC engages in forward guidance for the policy rate for up to one year.

In contrast to the GC, the FOMC has long published minutes, as has the Bank of England since shortly after it obtained operational independence in 1997. Even the ECB has acknowledged, after considerable public debate, the need to release some information from its own Governing Council meetings.[7] A survey of central banks around the world (Siklos 2014) suggests, at least in this area, the BoC is not following best international practices.[8]

The CDHI makes available detailed data concerning the votes and attendance of members of the MPC since its creation. There is also additional information available online through a press release published by the CDHI on behalf of the MPC. The MPC's aim is to "...discuss the Bank of Canada's policy toward the overnight rate, the short-term interest rate that is the Bank's benchmark interest rate for influencing monetary conditions in Canada, shortly before each of the Bank's interest-rate announcements." (http://www.cdhowe.org/monetary-policy-council-2) Hence, the MPC provides independent advice about what the stance of monetary policy ought to be.

Observations Arising from a Comparison of the GC and the MPC

Siklos and Neuenkirch (2014) and Neuenkirch and Siklos (2014a) empirically compare the Bank's decisions with those of the CDHI's MPC. They reach the following conclusions. First, while the MPC and the GC are not too

6 The Governing Council meets 8 times a year, on fixed dates announced at least a year in advance. When the rate decision announcement coincides with the release of a *Monetary Policy Report*, the press release is issued on a Wednesday at 11:15 a.m. (Eastern). See http://www.bankofcanada.ca/core-functions/monetary-policy/key-interest-rate/#schedule.

7 See the ECB's press release on the subject, https://www.ecb.europa.eu/press/pr/date/2014/html/pr140703_1.en.html.

8 An important and often neglected aspect of committee behaviour is the size of the decision-making committee. Theoretical work offers relatively little guidance about the 'optimal' size of a committee of this kind. Sibert (2006), in an overview of the rich literature in psychology and other relevant fields, concludes that committees with more than six members are likely too large. On this score, the monetary policy committees of a large number of central banks are, consequently, too large (e.g., see Mahadeva and Sterne 2000, Siklos 2002). However, by this metric the BoC's GC has the right size. Both the FOMC and the ECB operate with much larger committees. One element that distinguishes the FOMC from smaller committees is that some of its members (from the district Reserve Banks) do rotate over time. Similarly, while the ECB's Executive Board consists of six members, decision-makers also include CEOs from the eurozone's national central banks. See https://www.ecb.europa.eu/ecb/orga/decisions/govc/html/index.en.html.

Table 1: Comparing Governing Councils and C.D. Howe's Monetary Policy Council

Content	Bank of Canada	C.D. Howe	FOMC	Bank of England	ECB
Statement	Yes	Yes	Yes[+]	Yes	Yes[+]
Voting Record	Governor's decision	Yes	Yes	Yes	No
Minutes	No	No	Yes	Yes	No[*]
Macroeconomic Forecasts	Quarterly	No	Yes	Yes	Yes
Forward Guidance	No	Yes	Yes	Yes	Yes

Notes:
+ indicates that a press conference generally follows the release of a statement.

* indicates that minutes are expected to be released as of 2015.

Source: Central bank websites.

far apart in their views about the appropriate setting for the policy rate, differences that do emerge can persist for some time (as highlighted in Figures 1a and 1b). Second, the MPC has tended to almost always recommend a policy rate that is higher than the one actually set by the GC. However, there are few differences in the two committees' responses to inflation and real economic activity. The main such difference was on September 2008. Back then, a worsening financial crisis loomed large. This may have prompted the MPC to make a recommendation 25 basis points lower than the BoC.[9]

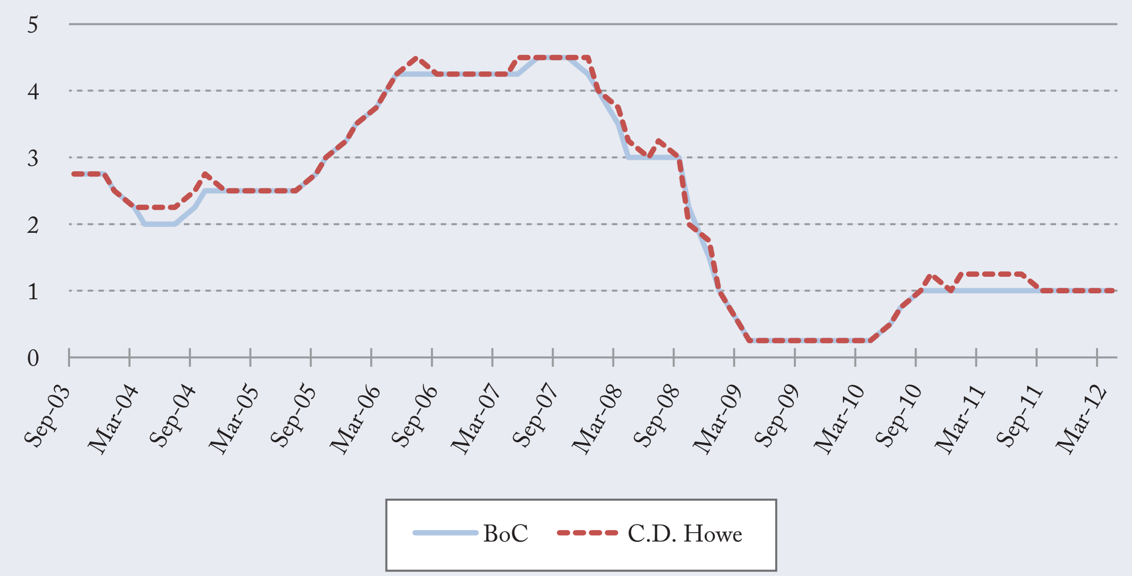
Examining diversity of opinion inside the MPC also reveals some interesting results. There is relatively less consensus inside the MPC when rates are rising or falling than when they remain unchanged. Differences between the MPC and the GC's recommendations are least notable when consensus is found inside the MPC. Also, the period of the Bank of Canada's conditional commitment, from April 2009 to April 2010, when the policy rate was to be left unchanged for up to a year conditional on the inflation outlook, had a relatively larger restrictive impact on the MPC than on the GC (Siklos and Neuenkirch 2014). The MPC's recommendations were biased downward during this period.

Implications and Recommendations

Broadly speaking, there is an overarching constraint on policy rate discussions imposed by inflation targeting and the transparency associated with such a regime. If the GC's policy regime was other than inflation targeting,

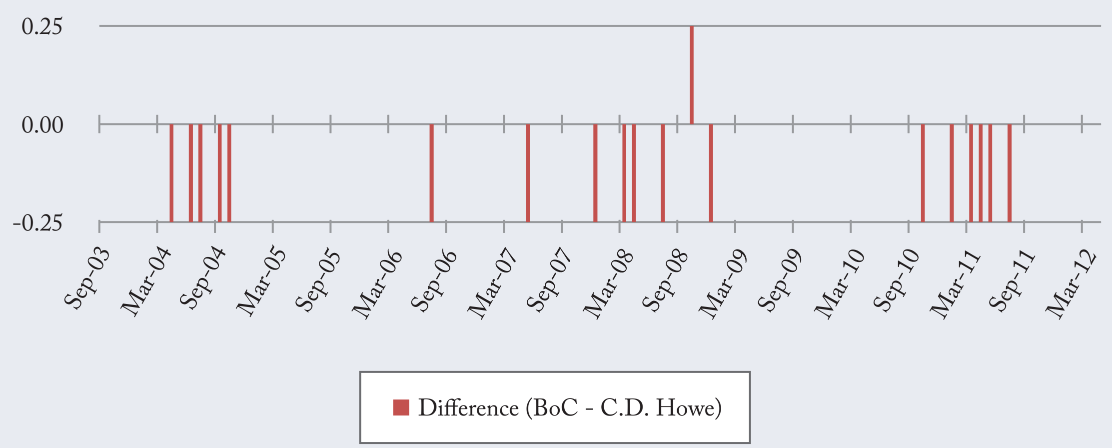
9 The Federal Reserve held firm even longer on its target rate, at least until later that year when the policy rate dropped in large increments. For a sample of the events surrounding the financial crisis, see the St. Louis Fed's crisis timeline: http://timeline.stlouisfed.org/index.cfm?p=timeline#2008-9.

Figure 1a: GC Target Rate and MPC Recommendation



Sources: For MPC, C.D. Howe Institute; for the BoC, the Bank of Canada. The vertical axis is in percent.

Figure 1b: Differences between GC Target Rate and the MPC Recommendation



Source: Authors' calculations. The vertical axis is in fractions of 1 percent.

there may well be more disagreement about the appropriate policy stance (e.g., see Neuenkirch and Siklos 2013 for the European Central Bank's case). Diversity of opinions inside the MPC does not appear to create any particular difficulties in setting the appropriate stance of monetary policy in Canada, nor do differences in views appear so large as to threaten the usefulness of the deliberations in providing informed opinion about monetary policy actions.

The Bank is unlikely to air publicly any disagreement inside the GC. *The Bank of Canada Act*, which governs the behaviour of its senior officers, effectively deters them from becoming more transparent and, consequently, more accountable. It prevents the GC from taking advantage of the benefits of the committee setting, unlike its counterparts in the United States and the United Kingdom. Instead, the Bank of Canada resembles the European Central Bank (ECB) by implying that consensus is akin to widespread agreement among committee members. As noted earlier, the ECB will in the future be releasing information about deliberations inside its policymaking council.

Most policymakers are content with the existing governance structure of the Bank of Canada, especially given the two decades of experience with inflation targeting. However, the existing arrangements are out of step with the increasingly accepted norm of its peers,[10] and may limit public understanding of important monetary policy questions. This situation could be remedied by a revision to the *Bank of Canada Act*. The Act should formally recognize and define the role of the Governing Council. It is beyond the scope of this E-Brief to discuss whether its members should be individually or collectively accountable, among other arrangements that need to be thought through, including term length, overlapping terms, and the like. Because the role of the GC is not embedded in the present *Act*, it is silent on such potentially important matters.

Once the principal features of the role and responsibilities of the Governing Council are properly laid out in a revised *Bank of Canada Act*, it should be left for the central bank to decide whether minutes of their meetings and individual votes in the setting of the overnight rate are released.[11] The international trend clearly favours the publication of this type of material. Indeed, the public may come to welcome the serious and reasoned debate that takes place inside the Bank as opposed to the innuendo and suspicion that has often greeted press releases and statements in countries where the central bank does not reveal as much of its internal thinking. The ECB is a notable example but there are others.

As with all substantial changes in governance, institutions need time to adapt their operations to a new statutory environment. The Bank of Canada has a well-earned reputation for seeking changes that clearly define its place in Canada's society and adapting to new monetary policy strategies.

While other central banks, notably the ECB, struggle with rising deflation risk, the Bank of Japan aggressively attempts to exit its own deflation trap, and global inflation shows signs of falling, the situation is subtly different in Canada. Inflation has recently shown signs of approaching the Bank of Canada's and government's 2 percent target – yet this comes after almost two years of below-target inflation. The BoC should not confuse the fact that

10 For example, see Maier (2010) for extensive international empirical evidence.

11 Past practice suggests that it is preferable for the institution to come to its own decisions about the level of transparency it wishes to aim for. It is notable that the high level of transparency attained by many central banks, including the BoC, was usually a product of the central banks themselves and not legislated by fiat. Arguably, one reason for the success of the inflation targeting regime is it made clear the task of the central bank, generally agreed to jointly with the government, while leaving it up to the institution to decide how to carry out this function. No doubt this type of arrangement serves to increase institutional credibility and reputation.

expectations of inflation apparently remain firm at 2 percent as confirmation that it is doing the best job possible. To paraphrase Alan Greenspan it may simply be that inflation is low enough that the public is inattentive.[12]

Therefore, the publication of the Governing Council's deliberations in some form may well assist the Bank in communicating and understanding the kind of signals necessary to keep inflation on target. Moreover, with the suggested legislative changes, the Bank could continue to lead in promoting central bank transparency and accountability.

12 Greenspan (1994) defined price stability as the situation where "…households and businesses need not factor expectations of changes in the average level of prices in their decisions."

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