Intelligence MEMOS

From: Steve Ambler and Jeremy Kronick

To: Concerned Canadians

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Re: **CENTRAL BANK INDEPENDENCE REMAINS IMPORTANT**

Central bank independence is under increasing attack in several countries. Best-known is Donald Trump's attack on the Fed for raising interest rates. In October he went so far as to express regret that he had appointed Jerome Powell as chair of the Federal Reserve. And, last month, when asked what threatens the US economy, President Trump singled out the Fed as a bigger threat than China.

But he is not alone. Around the world, national governments are pressuring central banks. The governor of the Reserve Bank of India resigned suddenly last month when the Indian government moved to assert tighter control over the bank's regulatory powers. Similar stories have emerged in Argentina, Pakistan, Russia, Nigeria, South Africa and Thailand.

In contrast to these examples, the operational independence of the Bank of Canada seems relatively safe. In a speech in November, Governor Poloz called this "one of the best attributes of Canada's monetary policy framework." Nevertheless, it is critical to remind ourselves exactly why central bank operational independence is so important.

The Bank of Canada and the Canadian government renew their agreement concerning the inflation targeting framework every five years, and then the Bank decides how best to achieve the stated goals without government interference. Since 1992, the Bank has had an explicit inflation target (2 percent for the most part), and the Bank has the mandate of keeping inflation within a band around this target and bringing inflation back to target within a time horizon of approximately eight quarters.

This clear mandate to control inflation and operational independence to achieve that goal makes the central bank more credible and leads to the anchoring of inflation expectations, which in turn helps to stabilize inflation around the target creating a more certain environment for consumption and investment decisions.

Governments typically have short planning horizons. They are concerned with winning the next election, and if this means keeping interest rates low in order to reduce the costs of financing deficits and encourage spending on housing and consumer durables, even at the cost of an overheated economy and more rampant inflation, they will readily do so. Central banks can take a longer-term view, one accountable to their inflation-targeting mandate.

And there is ample empirical evidence in Canada and abroad that shows that inflation targeting improves economic performance. The Figure illustrate just one example, where we see a significant decrease in both inflation and GDP growth volatility after Canada became an inflation-targeting central bank in 1991. It is no coincidence that central bank independence around the world increased after the Great Inflation of the 1970s, which underscored the need for central banks to concentrate on fighting inflation.

Critics say central bank independence requires the delegation of powers to unelected officials. This is fair, but there are ways to mitigate this concern.

In order to preserve their independence, central banks must be transparent and accountable. They must also "stick to their knitting," focusing on their main goal of controlling inflation and avoiding the use of policies having direct consequences for the distribution of income and wealth. The Fed opened itself up to criticism during the financial crisis when it expanded its balance sheet by purchasing assets (such as mortgage derivatives) that favored some sectors and groups over others. Calls to audit the Fed have led to a climate in which President Trump's criticism is more easily accepted. The Bank of Canada avoided this pitfall by adopting clear, market-oriented guidelines for providing liquidity to the financial sector during the financial crisis.

One can question the mandate of a central bank. One should not question its operational independence.

(PLEASE SEE FIGURE IN NEXT PAGE.)

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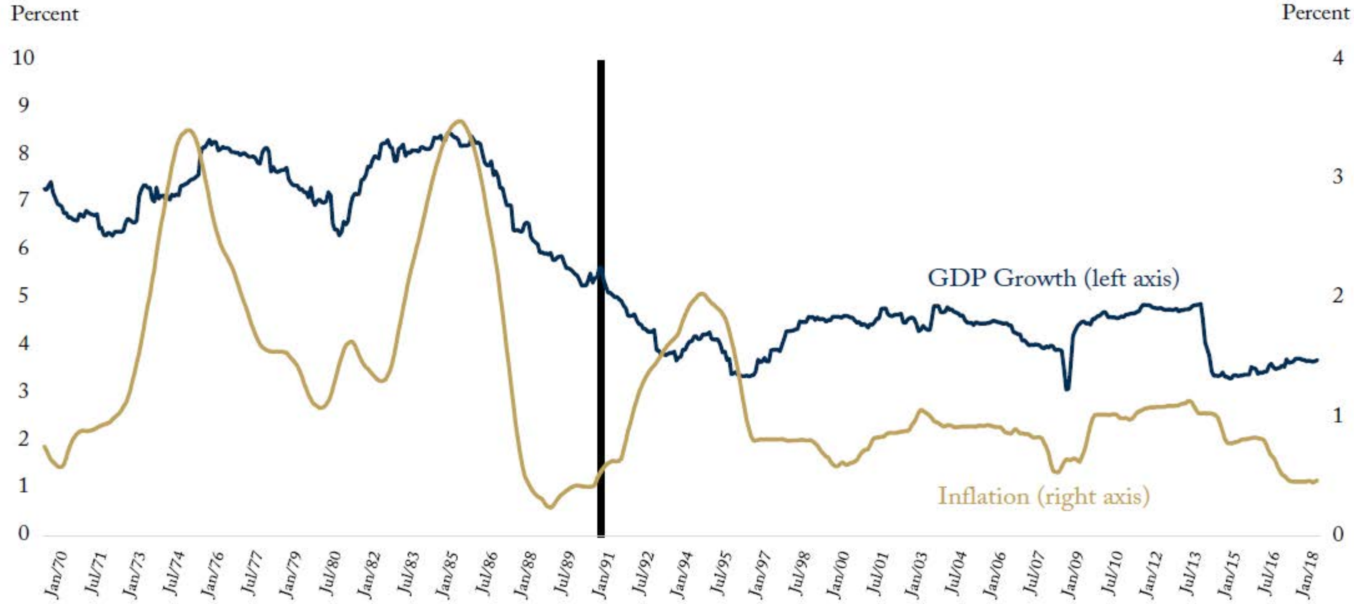
Figure: Volatility of Inflation and GDP Growth, Canada, 1970-2018



Note: Author's calculations where we use standard deviation of a 5-year moving average of annualized monthly GDP growth, and year over year monthly inflation. The black line represents the Bank of Canada becoming an inflation-targeting central bank in early 1991.