Canada's Central Banker Needs to Explain His Hands-Off Approach

Christopher Ragan

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When it comes to central banking, we appear to be living in the era of forward guidance.

U.S. Federal Reserve Chairman Ben Bernanke has stated that his policy interest rate will remain at its ultra-low level until the U.S. unemployment rate falls below 6.5 per cent. The Bank of England's Mark Carney has promised the same until the British unemployment rate falls below 7 per cent. In both cases, the statements are intended to send a clear signal to financial-market participants that they should expect interest rates to remain low for quite a while – and this expectation is then supposed to drive a faster economic recovery.

Yet no such guidance is being provided by the Bank of Canada's governor, Stephen Poloz. In September, the Canadian central bank said that the "considerable monetary policy stimulus currently in place will remain appropriate" until … well … until it isn't. The "inflation outlook," the "slack" in the Canadian economy and the "imbalances in the household sector" were all listed as things to watch, but Mr. Poloz offered no precision of the kind provided by Mr. Bernanke or Mr. Carney. Nada.

What might explain Mr. Poloz's decision to avoid this latest fad in monetary policy? I can think of three possible reasons, but none is very satisfying.

First, maybe Mr. Poloz wants to be his own man and avoid repeating his predecessor's signature move. After all, Mr. Carney more or less invented forward guidance in April, 2009, when, as head of the Bank of Canada, he committed to holding the bank's target for the overnight interest rate until the summer of 2010. But this would be childish on Mr. Poloz's part, especially if forward guidance would be useful, so I think we can rule out this explanation.

Second, maybe Mr. Poloz actually doesn't think that forward guidance is an effective tool for central banks. But such a belief would represent a clear shift from the Carney years in the Bank of Canada's thinking – one that would deserve a clear public explanation, which hasn't occurred. And a speech by deputy Governor John Murray just two months ago argued that the bank's actions in April, 2009, were a great success. So this explanation also needs to be ruled out.

Finally, Mr. Poloz may believe that forward guidance works well, and is appropriate for the U.S. and British economies, but is not needed in Canada because our economic recovery is much more solid.

The problem with this explanation is that by the most common measures of labour-market performance, Canada's recovery is actually pretty similar to those in the United States and Britain.

Judging by official unemployment rates, Canada's recovery has been a little stronger. But the unemployment rate does not capture the problem created when discouraged workers give up their job search and drop out of the labour market. If we look instead at the employment-to-population ratio – a better measure of the economy's job-creation performance – Canada's recovery is actually slightly weaker than those of the U.S. and Britain.

Looking at inflation doesn't help provide an explanation. The U.S. inflation rate has averaged about 1.7 per cent over the past year, compared with the Fed's target of 2 per cent. The lack of a serious inflationary threat gives Mr. Bernanke some confidence that his promise of low interest rates can be sustained. Britain's inflation rate has averaged about 2.6 per cent, well above the Bank of England's 2-per-cent target. This may explain why the financial markets aren't too enthralled with Mr. Carney's forward guidance; perhaps they don't believe that he can deliver because inflation is already too high. In Canada, however, both CPI inflation and the less volatile measure of core inflation have averaged well below the Bank of Canada's 2-per-cent target for the past year, at 1 and 1.3 per cent, respectively. Canada has plenty of room for forward guidance before inflationary pressures are confronted.

All of this leaves me wondering why Mr. Poloz is avoiding forward guidance. I'm not arguing that he should necessarily take the plunge. There are sensible debates about its merits, and many economists argue that forward guidance is not as effective as Mr. Bernanke and Mr. Carney seem to think. I frankly admit to being pretty unsure about the whole issue.

But in a world in which Mr. Poloz's two closest central-bank chiefs seem to place such a high value on forward guidance, it would be helpful for us all to know why he has chosen to stay off the bandwagon.

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Christopher Ragan is an associate professor of economics at McGill University and holds the David Dodge Chair in Monetary Policy at C.D. Howe Institute.