Stephen Poloz and His Job Are Still Misunderstood

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The Globe and Mail, February 11, 2015

Many observers of monetary policy are once again accusing the Governor of the Bank of Canada of favouring a weaker Canadian dollar as a way to promote our exports. Once again, both Stephen Poloz and the workings of monetary policy are being misunderstood.

Mr. Poloz has been thinking about monetary policy since his student days. His PhD thesis was about the determinants of money demand, a central topic for any central bank. He then spent 14 years at the Bank of Canada, thinking through the many details of monetary policy, including inflation targeting, labour market hysteresis, measures of inflation and the role of commodity prices.

He then left the bank for almost twenty years, learning more about the high-frequency world of financial markets and also the lower-frequency world of Canadian export finance. These experiences rounded out his economic perspective, and the latter certainly informed him of the challenges facing Canadian exporters. But monetary policy was never far from his mind.

One of the things he knew very well back in the mid-1990s (I recall a discussion with him on this very point) was the futility of central bank intervention in foreign exchange markets and the importance of having a flexible exchange rate at the heart of any successful inflation-targeting regime. He believed that central banks needed to keep their eye on inflation, and let the exchange rate follow its own path. There is no indication his views on this crucial point have changed.

As part of targeting inflation as their overall objective, central banks also track many other economic variables. They know that sustained inflationary forces are driven by deviations between the actual level of economic activity, measured by gross domestic product, and the economy's "potential" activity. They also know that changes in aggregate demand, which often originate in other countries, are usually the largest forces affecting our economy.

What the Bank of Canada is really doing when it's targeting inflation is making adjustments to its single policy instrument – its target for the overnight interest rate – in an effort to keep aggregate demand growing at a healthy rate, not too slow and not too fast, so that actual GDP tracks potential as closely as possible.

Where does the exchange rate enter this picture? Its fluctuations matter for two reasons. First, when the exchange rate rises or falls, the Bank learns a lot about which fundamental shocks are occurring in the Canadian and world economies. Second, since the exchange rate is an important component of international relative prices, its changes have an important effect on our exports and imports.

Despite the exchange rate's importance, however, it is not a target for monetary policy. In fact, the Bank doesn't have enough policy instruments to target more than one macro variable at a time. In an open economy like ours, however, with financial capital highly mobile across international borders, changes in monetary policy usually lead to changes in the exchange rate.

When the Bank of Canada lowered its target for the overnight interest rate to 0.75 per cent two weeks ago, Mr. Poloz knew two things would happen. First, longer-term interest rates would slowly adjust downward, thus providing a nudge to investment and aggregate demand. Second, the fall in short-term interest rates would weaken the currency – especially since the policy action was unexpected – and eventually encourage Canada's exports. This was textbook monetary policy.

Some observers may see little difference between a central banker driven by a desire to weaken the currency and a central banker taking an appropriately expansionary action that works partly by weakening the currency. But there is a big difference.

A 55-per-cent reduction in the world oil price represents a substantial decline in Canadian aggregate demand. The appropriate response for monetary policy is to cut the policy interest rate, which stimulates aggregate demand both through lower interest rates and a weaker Canadian dollar. This is exactly what the Bank did. What's more, faced with the same shock, it's a pretty good bet that the Bank would have done exactly the same thing had the Canadian dollar initially been at 65 U.S. cents or 95 cents.

People who argue that Mr. Poloz is too guided by a desire to weaken the Canadian dollar are missing the bigger picture. They need to get reacquainted with the detailed workings of monetary policy.

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