

ECONOMIC VIEWPOINT



Lack of Clear Indication on Future Key Interest Rate Changes Is Hurting Bank of Canada Communications

The fairly sudden monetary tightening in Canada over the summer led to a debate on the Bank of Canada's (BoC) communications. While there is no denying that the spectacular rebound of the Canadian economy is an exceptional circumstance that warranted a change in the monetary policy stance, recent events bring to light some shortcomings in the communication process employed by Canada's monetary authorities. Like many other central banks are already doing, the BoC should seriously consider starting to publish detailed minutes of the discussions surrounding each of its monetary policy meetings, rather than relying on short statements and speeches. Now that the effects of the financial crisis appear to be gradually dissipating, the BoC should also place greater emphasis on the medium term, particularly by disclosing the key interest rate path used for the *Monetary Policy Report* (MPR) economic scenario.

A Fairly Sudden Shift in Canada's Monetary Policy

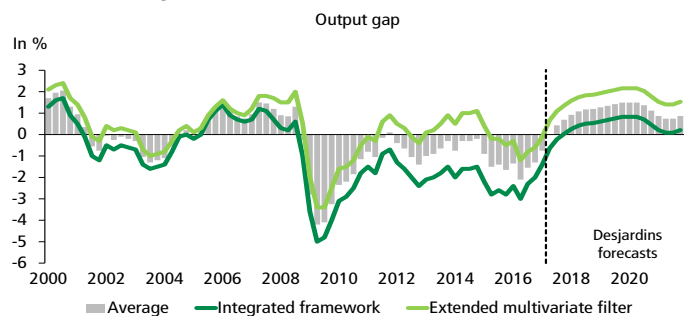
One year ago, hardly anyone would have guessed that the BoC would be tightening monetary policy in 2017. The worst of the oil shock that beleaguered the Canadian economy in 2015 and in the first half of 2016 seemed to be behind us, but most analysts predicted that job losses in the oil industry and the drop in national income as a result of lower oil prices would slow Canadian domestic demand for a while. The robust real estate market and elevated household debt raised concerns about the consequences of ultra-accommodative monetary policy, but the federal government's announcement of new measures to rein in mortgage credit foreshadowed a slowdown in that respect. Accordingly, the BoC estimated in its October 2016 statement that excess production capacity would be present until mid-2018, and was still seriously considering further softening its monetary policy. Things are quite different today, as the BoC has increased the target for the overnight rate in July and September to bring it to 1.00%.

The Spectacular Performance of the Canadian Economy was a Game-Changer

The fairly abrupt shift in Canada's monetary policy is reflective, above all, of our economy's formidable performance. A surge in household and business confidence combined with government stimulus efforts resulted in a 3.7% increase in Canada's real GDP

between mid-2016 and mid-2017. This activity resulted in a much faster-than-expected reduction in excess production capacity (graph 1). Higher confidence also had very positive effects on the real estate market, completely counteracting the restrictive impact expected as a result of the measures announced by the federal government in fall 2016. New provincial measures had a marked effect on the resale market in Toronto, but the Canadian housing market has remained quite lively overall since the start of 2017 (graph 2 on page 2).

GRAPH 1
The Canadian economy's excess capacity disappeared much faster than expected



Sources: Statistics Canada, Bank of Canada and Desjardins, Economic Studies

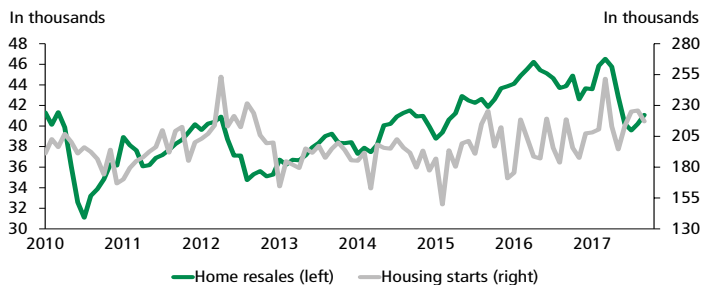
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NOTE TO READERS: The letters k, M and B are used in texts and tables to refer to thousands, millions and billions respectively.

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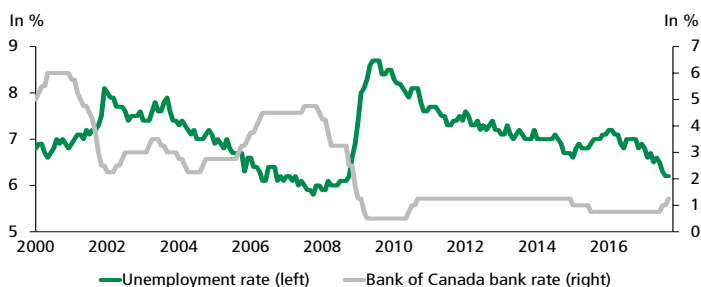
GRAPH 2
A real slowdown in Canada's real estate market is still awaited



Sources: Canada Mortgage and Housing Corporation, Canadian Real Estate Association and Desjardins, Economic Studies

Consequently, an adjustment in monetary policy was clearly needed. The change in situation even begs the question as to whether key rates are still not much too low (graph 3).

GRAPH 3
While the unemployment rate has returned to its pre-crisis level, key interest rates continue to be very close to their trough



Sources: Datastream and Desjardins, Economic Studies

Greater Uncertainty Makes the Job Harder for Central Banks

While the recent increase in Canadian key interest rates appears to be clearly warranted, it may be questioned whether the way in which the BoC went about the hike was optimal. The era in which central banks seemed to relish surprising markets is long gone, as central banks realized that their monetary policies are far more effective when they are well understood and predictable, which also makes them more credible and limits financial market volatility.

Before the 2008 crisis, monetary policy decisions, particularly in Canada, were based largely on economic models. In short, BoC experts used their tools to forecast changes in Canada's economy and in the output gap, which enabled them to predict movement in inflation. Leaders then adjusted key interest rates to lay the most favourable inflation path. This

predominance of models in the decision-making process limited the role played by judgement. The BoC's main communication tool was the MPR, which provided rather clear insight into how key interest rates were expected to change if the economy evolved as expected.

Central banks now navigate much murkier waters, with economic variables reacting differently since the crisis. In a [discussion paper on the topic](#) published in 2014, Governor Stephen Poloz described this situation well and noted that "[...] after some 20 years of successful inflation targeting, it has become increasingly difficult to parameterize the relationship between the output gap and inflation here in Canada." At the time, he argued that monetary policy could no longer be an exercise in reverse engineering and must instead transform into a process of risk management, which injects more realism about uncertainty. In a [recent speech](#), Stephen Poloz repeated similar observations and recognized that monetary policy required far more judgement than in the past.

Since leaders' judgement has become a determining factor for monetary policy, it is normal for observers to have an increasingly difficult time anticipating monetary policy decisions. Consequently, all central banks improved their communication to make their decision-making process as clear as possible. Most central banks therefore publish detailed minutes of their monetary policy meetings and many lay out, more or less explicitly, a path for their key interest rates (table 1 on page 3), always subject to outlooks on inflation. Although not going as far, the BoC also improved the transparency of its monetary policy, notably by providing a more detailed outline of the risks influencing its decision-making. The MPR press conference has also changed to include more information about the discussions leading to the monetary policy decision.

Recap of BoC Communications Since the Beginning of the Year

The BoC had kept a worried tone throughout the first quarter of 2017 despite new signs of improvement in the Canadian economy, even continuing to indicate the possibility of a key rate cut. The first change in the monetary policy stance came during the release of the April MPR. While still conveying considerable uncertainty, the BoC acknowledged that the Canadian economy's good performance suggested a slightly faster closure of the output gap, and the Governor confirmed that the BoC had not discussed a rate decrease and was now in a "decidedly neutral" stance.

The May 24 meeting offered little new information. As with any meeting during which an MPR is not presented, the BoC's communications at that time were limited to a short statement. The fact that the BoC felt the Canadian economy's adjustment to lower oil prices was behind us seemed to be a positive development, but the absence of any signal about

TABLE 1
Communication tools of some central banks

	INDICATION ON KEY INTEREST RATE CHANGES	MEETING MINUTES
Federal Reserve	Yes	Yes
Bank of Canada	No	No
European Central Bank	*	Yes
Bank of England	Yes	Yes
Bank of Japan	No	Yes
Reserve Bank of Australia	No	Yes
Reserve Bank of New Zealand	Yes	No
Bank of Sweden	Yes	Yes
Swiss National Bank	Yes	No

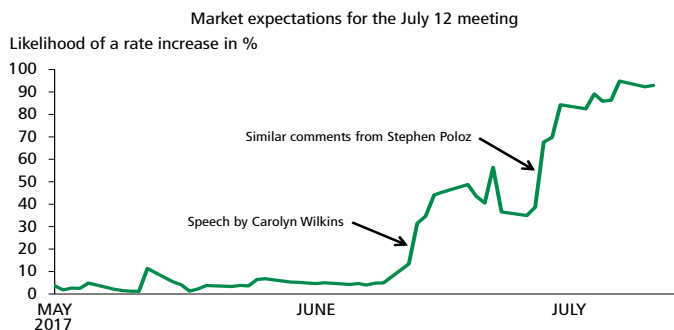
* The European Central Bank currently uses a forward guidance that may disappear when monetary normalization begins.
 Source: Desjardins, Economic Studies

future changes in monetary policy had to be interpreted as the continuation of a neutral stance.

As Canadian data continued to be very positive in the weeks that followed, monetary tightening started to be conceivable. However, the BoC's neutral stance was a significant obstacle to an increase before fall. Things changed on June 12 when Senior Deputy Governor Carolyn Wilkins clearly hinted at a rate hike in her [speech](#), questioning the need to maintain the monetary easing put in place in 2015.

Against this backdrop, the first key interest rate hike in July did not cause too many waves, as the financial markets had already braced for the change in the weeks leading up to the increase (graph 4). The press release and the MPR were very good at explaining the reasons for initiating monetary tightening, but contained very little information on what would follow.

GRAPH 4
Bank of Canada leaders had prepared the markets for a July hike

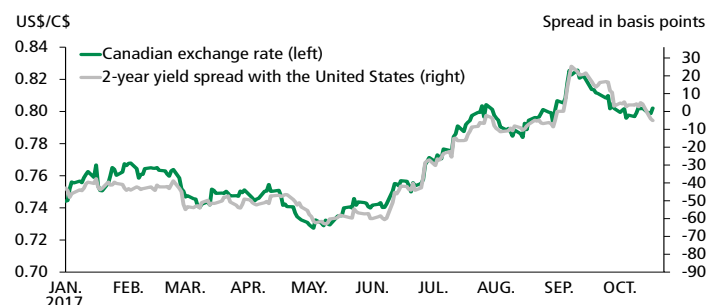


Sources: Bloomberg and Desjardins, Economic Studies

Despite a lack of a clear stance, it was obvious that further increases in Canadian key rates would follow in the months ahead. The publication of very encouraging new economic data, particularly economic growth of 4.5% for the second quarter of 2017, confirmed this scenario. Most observers thought, however, that just like the Federal Reserve (Fed) since it began its monetary tightening, the BoC would wait until the next MPR was published before going ahead with a second increase. The absence of a speech similar to the one given on June 12 to signal imminent tightening was another argument in favour of an increase that would only come in October, even though BoC communications are often less common at this time of year.

Nevertheless, the BoC moved forward with a second 0.25% increase on September 6. This time, the rate increase surprised observers, prompting market reactions and sending the Canadian dollar to about US\$0.83 (graph 5). The short statement accompanying the decision even seemed to indicate that the BoC was comfortable with a higher loonie. Once again, the statement did not contain a clear stance on what was to come, but the start

GRAPH 5
Following interest rate spreads, the Canadian dollar recently dropped back near US\$0.80



Sources: Datastream and Desjardins, Economic Studies

of such aggressive tightening was seen by many as a sign that at least one more rate hike might be coming in 2017.

Consequently, many analysts began to position themselves for a third consecutive key interest rate increase in October. Then, comments by Governor Stephen Poloz insisting that the future path of interest rates was not predetermined as well as weaker Canadian data prompted investors to put off their expectations of an increase until December or January, which drove the loonie back near US\$0.80.

The BoC Could Have Gotten to the Same Point, Causing Less Fluctuation in the Market

Looking at the situation after the fact, it seems obvious that the BoC could have done more to limit fluctuations in financial markets. In particular, it could have signalled a hawkish turn during the May meeting. Similarly, as soon as it tightened monetary policy in September, it should have made it clear that this was by no means an indication of what was to come, rather than doing so a few weeks later in speeches.

In our opinion, recent events show that the short statements published during monetary policy meetings without an MPR do not contain enough information, especially when monetary policy changes. Both in May and in September, the absence of any indication as to what was to happen next caused investors to position themselves incorrectly, leading to unnecessary volatility in Canadian financial markets. The fact that a BoC spokesperson had to come out a few days after the September meeting to defend and explain the rate increase also shows shortcomings in the statement.

The BoC should, at a minimum, provide a clear stance on short-term developments in key interest rates in each statement. It would be even better for the BoC to find a way to convey all critical information regarding monetary policy during the eight annual monetary policy meetings rather than during speeches. The publication of detailed minutes, ideally at the same time as the press release (like the Bank of England), or a press conference at each meeting would enable the BoC to pass along comprehensive, nuanced information about its monetary policy.

The BoC Will Have to Refocus on the Medium Term

Leaving aside the issue of whether the BoC was transparent enough in its communications, we find it disconcerting that all the attention is currently turned to the next BoC meeting and not the future path of its key interest rates. Given the long time it takes a monetary policy move to have an effect on the economy and inflation, monetary policy should always focus on the medium term, except during very serious crises. That is why central banks pay so much attention to outlooks on economic growth and inflation. The start of monetary tightening this year despite Canadian inflation remaining weak shows that the BoC is more concerned about future rather than current inflation.

However, some recent actions and comments by BoC leaders seem to reflect excessive concern for the short term. In particular, it is hard to ignore how quickly the situation changed from the BoC considering a rate cut at the beginning of the year to a decidedly neutral stance in April, before finishing with two key interest rate hikes in the summer. Justifying the September increase with essentially the stronger-than-expected growth in the second quarter of 2017 also seems problematic, as this good statistic in and of itself had hardly any bearing on the medium-term outlook for the Canadian economy.

The data dependence of which the BoC speaks so much is also adding somewhat to the confusion. First, monetary policy is never predetermined, which is why central banks always pay a great deal of attention to changing economic outlooks. Monetary policy is therefore always dependent on data, but again, over the medium term. In his most [recent speech](#), Governor Stephen Poloz explained that, in light of greater uncertainty, it has become even more important for the BoC to continually integrate all available information in order to refine its understanding of the economy and adjust its inflation outlooks. We feel this positioning is entirely justified in the current climate, and most other central banks seem to have drawn similar conclusions.

The BoC should, however, make it clearer that it is trends in economic data that will affect the medium-term evolution of its key interest rates and not short-term changes in data that will affect its next monetary policy decision. In the second case, Canada's monetary policy would become completely unpredictable since it would reflect primarily statistical noise surrounding high-frequency economic data. Markets would react excessively to any data surprise. Like Janet Yellen recently said¹, increased uncertainty argues in favour of a gradual adjustment in monetary policy, especially in the presence of low inflation, but it does not justify maintaining ultra-accommodative monetary policy until inflation has returned to target.

The BoC Should Reveal the Interest Rates Path Corresponding to the MPR Scenario

The BoC's great reluctance to indicate how it anticipates its key interest rates to change also places too much emphasis on the short term. This reluctance could be due to the BoC wanting to give itself as much flexibility as possible to, among other things, address fluctuations in the Canadian dollar. By stressing that the interest rate path is not predetermined, the BoC risks however giving the impression that it has no idea how its key interest rates should change in the future. In reality, although not perfect, its models give the BoC a good idea of how key interest rates are expected to move in the coming quarters, and the economic

¹ Speech by Janet Yellen on September 26, 2017: [Inflation, Uncertainty, and Monetary Policy](#), 59th Annual Meeting of the National Association for Business Economics, *Prospects for Growth: Reassessing the Fundamentals*, Cleveland, Ohio.

scenarios it presents in its MPRs are reflective, implicitly, of an appropriate key interest rate path.

With the BoC forecasting that inflation will rise in the coming quarters, thereby steering the Canadian economy back home, and since economic growth should remain above potential growth, it seems clear that the BoC's current economic scenario calls for increases in key interest rates in the coming quarters. To be truly transparent, the BoC should, for example, publish in the MPR the level of the key interest rate in 18 or 24 months that corresponds to its economic scenario and to leaders' judgement with respect to various uncertainties. It could, of course, stress that this rate level is not a commitment or even a forecast, and that adjustments will gradually be made as new data change the inflation outlook.

In this type of system, which would be very much like the one used by the Fed whereby leaders' key rate forecasts are published every quarter, the BoC could gradually integrate new information into its conditional outlook for key interest rates, without constantly worrying about its next monetary policy meeting. Monetary policy could be changed in a gradual and predictable way, which would only change if new information were to significantly alter the economic outlook or the monetary authorities' judgement. A sudden monetary policy reversal similar to what we have seen this year would become far less likely in this context. Rather than rushing in June to prepare the markets for a rate hike, the BoC could have opted for the status quo in July but also declare that the Canadian economy's good performance was now prompting it to anticipate an overnight rate of about 1.50% by the end of 2018. After sending such a clear signal, which would have given the markets time to adjust, the BoC could have waited until the October meeting to go ahead with the first increase, in addition to reviewing its outlooks for GDP, inflation and key interest rates in the medium term. In our opinion, acting that way would be far more appropriate in the uncertain climate that central banks now face. The big question for the BoC given the current state of affairs should be how high it should raise key rates approximately in the medium term, not whether the next increase should be announced in October, December or January.

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