Central banks should move beyond inflation targets

By Barrie McKenna
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Stephen Poloz says the time has come for the Bank of Canada and other central banks to reinvent monetary policy by moving beyond solely targeting inflation.

Central bankers need do a better job of making sense of a host of new risks buffeting the financial system, such as exchange rate moves and globalized production chains, the Bank of Canada governor said Tuesday.

"We need to develop a monetary policy framework that integrates inflation risks and financial stability risks, both statically and dynamically, and captures much more accurately the uncertainties we face," he said.

But Mr. Poloz, speaking to an audience at Western University, offered no fresh clues about whether the bank intends to cuts interest rates again – either at its next scheduled rate-setting announcement March 4, or the following one in April.

But he did offer a more fulsome explanation for why the bank cut its main lending rate by a quarter-percentage point to 0.75 per cent in January – a move that caught financial markets by surprise.

Mr. Poloz said the rate cut "buys us some time" to see how the Canadian economy responds to the dramatic plunge in the price of oil.

In January, the bank characterized its rate move as "insurance" against oil's blow to economic growth, inflation and already-high household debt levels.

He pointed out that while the negative effects of cheaper oil hit hard and fast – though lower export revenues, layoffs and cancelled invesments – the benefits will take longer to come and are of "uncertain" magnitude.

"Using the term 'insurance' underscores that we are in a very uncertain setting, and what we are trying to do is to manage the risks we face, not eliminate them," said Mr. Poloz, who did both his Masters and PhD in economics at Western University.

"We are not in a position to engineer the perfect outcome."

The speech marked a rare public foray by a Canadian central bank chief so close to the self-imposed the blackout period prior to rate announcements.

Most economists expect at least one more rate cut by April, and a move is already built into Canadian bond yields.

The price of Brent crude, after bottoming out at $47 (U.S.) per barrel, is now near $60.

He pointed out that it will take time for the now-lower Canadian dollar and faster U.S. growth to boost exports, and for cheaper oil to help consumers.

In 2016, the Bank of Canada is slated to renew its inflation-targeting agreement with the government, which now requires the bank to keep inflation at or near two per cent.

Mr. Poloz said the bank remains committed to inflation targeting, which has "served us well."

But he added that low inflation is no guarantee of financial stability, and it has left the bank "very little room" to respond to large shocks in the face of a lower so-called neutral real interest rate.

"We need to take account of a wider range of economic and financial consequences while targeting low inflation," he said.

Among what he called the "known unknowns" are the effect of global production chains, countries that manipulate their currencies, the aging population and the unpredictability of corporate behaviour when so many companies have disappeared, he said.