Poloz ready to stop 'playing defence' as Canada's economy rebounds

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Stephen Poloz has a new swagger these days.

The Bank of Canada Governor is watching 2017 come to a close, satisfied that the economy is finally emerging from years of false starts and surprise jolts to reach what he calls a "sweet spot." Job growth is strong, companies are running flat-out and consumers are in a joyous mood.

"It's the first year where we had a steady flow of encouraging news on the economy," Mr. Poloz tells The Globe and Mail in an exclusive interview. "It just feels like we've been playing defence a lot – more than expected."

Mr. Poloz's tenure, which many had expected to be relatively uneventful when he took the job in 2013 after the pressure-cooker financial crisis years, has proven anything but. Years of what Mr. Poloz coined "serial disappointment" were followed by the oil shock, which sent the economic recovery into a ditch. But now, finally, things are going Mr. Poloz's way.

And it's about more than just better economic headlines. There is an air of self-assurance – occasionally bordering on intellectual arrogance – to Mr. Poloz as he approaches the two-thirds point of his seven-year term. The aw-shucks demeanour and slightly ill-fitting suits of his early days are gone; in their place is a sharply dressed leader exuding the confidence of a major central banker who believes he's steering Canada's economy in the right direction. He's aggressively taking on his detractors and forcefully staking out the contours of his monetary and communications style.

He has served notice to financial markets that there will be less spoon-feeding of code words and explicit signals that offer one-way bets on where rates are headed – what's known as "forward guidance" in central-bank-speak.

Mr. Poloz has placed the Bank of Canada at the vanguard of what he hopes will become a global movement, setting an example for the world's leading central banks to follow.

"I'm confident that other central banks, now that we are getting much more into normalcy, will gradually temper down the details around their forward guidance, too."

While the improved economic picture has allowed the central bank to finally shift to offence in its interest-rate policy – with two rate hikes last summer and a promise of more to come – Mr. Poloz still finds himself defending his position on other fronts, most prominently on the evolving communications style he has introduced.

While few observers questioned the bank's decision to raise interest rates this year, many took issue with the lack of communication ahead of the second hike, in early September, which came even though no one at the bank had made any public statements in the preceding eight weeks. That earlier-than-expected rate hike was followed by some much more cautious language from the bank, leaving some central-bank watchers wondering which signal they should be honing in on – the aggressive rate actions, or the we're-in-no-rush language.

Just this week, Mr. Poloz had another minor adventure with the market's mixed interpretations of his message. The Canadian dollar surged in response to a speech the governor gave to a Toronto lunch audience Thursday, as market players read the text as clearing the way for another rate hike as soon as January. Within hours, the dollar did a 180-degree turn, after Mr. Poloz gave an interview to CBC television that traders felt was much less upbeat.

Meanwhile, Mr. Poloz doused another communications fire during his Toronto visit. He quelled some misconceptions around the central bank's recent use of the word "cautious" to describe its approach to further rate increases – something the markets have latched onto as a one-word code, embedded in the bank's rate-decision statements, that further rate hikes are not imminent. The appearance of the word in the last sentence of the bank's most recent statement, earlier this month, sparked a sell-off in the Canadian dollar, despite the statement's otherwise relatively positive tone.

"I'm not going to judge whether the market got it right or not. But it does seem like the market has a tendency to seize on a new word as if it's a new secret code," he says.

"Caution does not mean sitting back and doing nothing," he says, noting that the U.S. Federal Reserve has talked cautiously for much of the past year while raising its benchmark rate four times. "So to interpret caution in a very narrow way is just a mistake. They need to think of it as a word. We are being careful, thoughtful, not mechanical. There is no pre-set course for interest rates. It means all those things."

"It's only language."

That short statement – "it's only language" – encapsulates the major departure from common practice that Mr. Poloz has pursued at the Bank of Canada. He continues to redefine the bank's approach to communication – a critical element in transmitting monetary policy to both financial markets and ordinary Canadians – to replace traditional forward guidance with what the bank calls "risk management." Traditional guidance sticks with consistent wording in public statements that imply the bank's intentions on rate policy, with only minor tweaks to indicate shifts in its stand. The Poloz way is to build each statement from the ground up, laying out the areas of uncertainty the bank faces in determining policy, and allowing market players to assess for themselves which way those concerns are tilting the bank's decision-making as the economy evolves.

The development of this risk-management framework is shaping up to be Mr. Poloz's biggest legacy as governor. But it has also proven to be one of his toughest challenges. Even after several years of effort, it remains a work in progress: How to shake markets of their habit of expecting the central bank to tell them what to think, while still providing them with the information they need to think for themselves.

"I set out to wean us off of forward guidance in the early days, and it hasn't been simple to do," he acknowledges.

"Uncertainty is a real thing. And pretending that it doesn't exist, by giving precise forward guidance, doesn't work in a normal operating environment."

He argues that the market is coming around to seeing things through his risk-management lens – and he presents the September rate hike as evidence. While many Bay Street economic commentators cried foul at what they considered a surprise move, Bloomberg data show that the bond market had priced in about a 50-50 chance of a September rate hike, in light of stunningly strong second-quarter economic growth numbers that hit the market just days before the rate decision.

"How on earth did they get it right, if we're not communicating clearly?" Mr. Poloz asks.

Nevertheless, the bank has tacitly acknowledged that it needs to deliver more timely information to the marketplace around rate decisions, such as the one in September, that fall in between its quarterly Monetary Policy Reports. Mr. Poloz says that, starting next year, the Bank of Canada plans to provide a speech from the governor or one of his deputy governors after these rate decisions, to help illuminate the bank's thinking.

"I get it [that] it's been challenging for some. Apparently, not quite as challenging for others," he says. "Most of the commentary is coming from those who find it challenging."

"People have forgotten what normal market play looks like. It's volatile," he says.

But not everyone is convinced that Mr. Poloz's appetite for volatility is so healthy – especially given that the Canadian dollar is typically the focal point of market volatility surrounding interest-rate policy.

"The exchange rate is an incredibly important variable for the Canadian economy. I think unnecessary volatility is not a positive," says Douglas Porter, chief economist at Bank of Montreal. "The exchange rate is a very important variable when businesses are trying to plan. If they're faced with 10-cent swings in the currency in the space of a few months, that makes planning very, very difficult."

Some critics also worry that the central bank is moving too slowly on rate hikes – including David Dodge, who held Mr. Poloz's job from 2001 to 2008. In a rare dig by a former bank governor, Mr. Dodge told Bloomberg News recently that the bank is making a "mistake" by keeping rates too low for too long and overstimulating key parts of the economy, including housing.

Others charge that Mr. Poloz and the bank are trying too hard micromanage the economy to a perfect state of equilibrium, amid a constantly evolving stream of often conflicting economic information.

"It seems the Bank of Canada would like to engineer the economy to some precise view of capacity in product and labour markets," argues Don Drummond, a former top federal finance official and Toronto-Dominion Bank chief economist.

"A more prudent and vastly simpler approach would be to say that the economy is operating at around its potential capacity, therefore the key policy interest rate should be around its neutral setting, where it is neither fuelling nor braking the economy."

The central bank believes that the neutral point is roughly 3 per cent for the benchmark overnight rate, or a full two percentage points higher than where it is now.

Mr. Poloz is defiant. He calls Mr. Dodge's suggestion that the Bank of Canada is moving too slow "curious," especially since the bank has raised rates twice and is signalling more to come.

Pushing rates higher to deal with financial imbalances would push inflation even lower than it is now, Mr. Poloz points out. And that would be an "inappropriate" trade-off, given the bank's inflation-targeting mandate.

"The potential to slip into a deflationary scenario is much more preoccupying," he says. "We need to get ourselves up there for real, and to the 2-per-cent zone, so we have room to manoeuvre for the next shock that comes along."

And that, for Mr. Poloz, is the bottom line. He's not the finance minister or the superintendent of financial institutions. He's the inflation slayer-in-chief.

"We said all along: We only have one instrument – interest rates – and one target – inflation. All the other stuff people would like us to control is not actually our job. It's a side-effect," he says.