# *Intelligence* MEMOS

From: Steve Ambler

To: The Bank of Canada

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Re: **GETTING MONETARY POLICY RIGHT AS A RESPONSE TO OIL SHOCKS**

Uncertainty is harming Alberta's petroleum sector in many ways. Oil prices are likely to remain depressed until well into next year, though this result depends on many factors including world demand and the Saudi strategy of undermining the fracking revolution by keeping production high. Additionally, issues surrounding access to markets, regulations, royalties, and taxes have all hurt the oil patch. Investment in the sector fell 37.5% between 2014 and 2015 and is forecast to decline further this year.

The Bank of Canada's reaction to oil price shocks adds another potential layer of uncertainty. The Bank recognizes the complexities of the effects of these shocks on the Canadian economy. It conveys this complexity in a qualitative way in its public announcements. While it generally tries to prepare markets for changes in its policy, the January 2015 rate cut as an "insurance policy" against the effects of low oil prices was largely a surprise.

In a recent C.D. Howe E-Brief, I argued how the Bank's monetary policy could be made more predictable in response to oil price shocks. A more predictable path for short-term interest rates means a stronger impact on the longer-term rates of return that are the main determinants of spending. The Bank should be explicit about the assumptions behind its economic forecasts and how they interact. With that in mind, the Bank should do the following:

- Indicate how demand factors (world economic growth) and supply factors (production costs) interact to determine its oil price forecast.
- Relate its forecasts for GDP, sectoral outputs and employment explicitly to these assumptions and to the projected path for the overnight rate.
- Publish a forecast using its main forecasting model for how the economy would evolve under the assumption of flexible wages and prices; economic theory tells us that the best monetary policy can do in response to shocks is to offset the impact of wage and price rigidities and move the economy towards the ideal counterfactual of a flexible-price economy.
- Forecast the output gap in a manner consistent with the rest of the Bank's forecasts. Currently, the Bank's estimate of potential output is based on statistical methods that are divorced from the rest of its forecasting and that don't allow potential output to be directly affected by supply shocks such as oil price changes.
- Be explicit about the sectoral effects of its policy.
- In cases where there are differences between the Bank's forecasting models and the judgment of Governing Council, explain the reasoning behind these differences. These differences arise naturally since forecasting models are simplifications of reality and may not take the most recently available information into account.

These changes would make the Bank's policies more predictable, reducing overall policy uncertainty. This would be a benefit not only for the oil and gas sector but also for the Albertan and Canadian economies as a whole. It would also increase the effectiveness of monetary policy by making private-sector forecasts of the overnight rate more precise, thereby increasing the impact of policy changes on longer-term rates of return and aggregate demand.

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