Intelligence MEMOS

From: Pierre L. Siklos

To: Minister of Finance

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Re: **FOR CENTRAL BANKS, IT'S A QUESTION OF CREDIBILITY**

Central bankers have become fond of repeating to the public that they were, and are, following a flexible rule for setting interest rates in response to movements in inflation or the amount of slack in the economy. However, flexibility taken too far is equivalent to stating that rules are not being followed. Of late, it appears that a backlash against this central bank flexibility has emerged and has yet to dissipate. This helps explains continued efforts in the US Congress to legislate policy rules for the Federal Reserve. The counterargument, Central banks repeatedly stress, is that "judgment" based on a wide variety of data, together with a recognition that the economy is complex, translates into good monetary policy.

However, it is equally clear that successful monetary policy also demands transparency and clarity. These are critical ingredients that contribute to ensuring accountability. A central bank must publicly explain the complexities it faces and how its decision-making avoids being a slave to simple formulae. Indeed, this kind of strategy provides a window into understanding how well a central bank forecasts inflation (not to mention how well it measures the amount of slack in the economy).

In *Central Bank Into the Breach: From Triumph to Crisis and the Road Ahead* (Oxford: Oxford University Press, 2017) I analyze the positions taken by central banks over the past decade or so, including the Bank of Canada, how the so-called Great Financial Crisis influenced central bank policies more generally, and what the future might hold for central banks' current exalted position among public institutions.

One of the policy recommendations, with some resonance for Canada, is that more concerted external reviews of the work of central banks are required, most notably their forecasting performance. This is not to suggest that some kind of witch-hunt is in order. Far from it, as this would not serve the interests of either the Bank of Canada or the Government with whom it jointly reviews the current inflation targeting regime every five years. Instead, this would offer the public another window through which it and the government can be reassured on a regular, but infrequent, basis that monetary policy is delivering the best that it can do to ensure low and stable inflation contributes to providing satisfactory economic performance.

Furthermore, it might also contribute to better anchoring inflation expectations to the inflation target and might also help explain persistent differences between the Bank's own forecasts and those published by professional forecasters or ones based on surveys of households and businesses. Since professional forecasters are not expected to divulge the details of their forecasting models or objectives, reviews of this kind would contribute to enhance the Bank of Canada's transparency, already among the highest in the world.

Other central banks where such reviews have arguably improved their credibility include the Bank of England, Norway's Norges Bank, and Sweden's Riksbank. In light of the persistent undershooting of the 2 percent inflation target, it is imperative that the federal government's next renewal of the target in 2021 take the forecasting process more seriously.

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