Intelligence MEMOS

From: Steve Ambler, Jeremy M. Kronick and William B.P. Robson

To: Bank of Canada Observers

Date: May 16, 2022

Re: **THE IMPORTANCE OF CENTRAL BANK INDEPENDENCE**

Happy times prevail when inflation is low and few people are paying attention to central banking.

These are not happy times.

Inflation is high and the Bank of Canada is under scrutiny. People dislike inflation, and politicians reflect that dislike. But people also dislike tighter monetary policy, and politicians reflect that dislike also. Odd though it may seem when the Bank has let inflation get so high, protecting the Bank's independence is the most promising route to getting it low again.

Criticism of Bank policies over the past 18 months or so is fair. After all, the year-over-year increase in the consumer price index was 6.7 percent in March – more than twice the top of the Bank's 1-to-3-percent target. However well calibrated the Bank's reaction was in the pandemic's early days, it stayed too strong for too long.

The Bank lowered the overnight rate quickly when the pandemic started, and started buying financial assets, including longer-term Government of Canada bonds – the program known as quantitative easing (QE) – to ensure liquidity was cheap and readily available when the economy looked likely to seize up entirely.

However, the Bank, along with many other central banks, misjudged the extent to which further stimulus was needed once the worst of the crisis was over.

They took their cue from the period after the 2008-2009 financial crisis and recession, when central banks kept policy interest rates extremely low for more than a year, and many pursued QE programs to the point where their balance sheets were many times bigger than before the crisis. Despite this monetary stimulus, inflation remained low.

A key difference this time is that, in addition to continued monetary stimulus, governments in many countries, and notably in Canada, have continued to run huge deficits focused on consumption long after the crisis was over. That boosted demand in a world where supply cannot keep pace because of snarled supply chains, Russia's invasion of Ukraine and damage to productive capacity from two years of lockdowns.

Staying too strong for too long was a mistake, especially while massive fiscal stimulus continued.

The Bank of Canada was not alone. The US Federal Reserve, the Bank of England, the European Central Bank and many others did likewise, and their currencies are also losing purchasing power.

Prior to this pandemic episode, the Bank of Canada had a superb record of controlling inflation. Between 1995 and 2019, inflation averaged 1.9 percent and was inside the 1-to-3-percent target band almost 80 percent of the time. That record not only reflects adept monetary policy, but also the advantages of independence for the Bank of Canada and its ability to adjust policy in response to inflation rather than following other imperatives, such as keeping interest rates low in advance of elections.

The need for monetary policy independence will be stronger than ever in the months and years ahead. To tame inflation, the Bank recently raised the overnight rate by 50 basis points – the first hike greater than 25 basis points in over two decades. It is also reversing QE by allowing the bonds it owns to mature and not buying new ones, even while the federal government continues to issue new debt. Higher interest rates will pinch and put pressure on the federal budget. The Bank must continue to be free to raise its policy rate and manage its balance sheet without political interference.

Meanwhile, further ahead, and notwithstanding recent turbulence, digital currencies of various kinds may become serious competitors to currencies issued by central banks, including the Bank of Canada.

While there are potential benefits to these competitors, there are also dangers to the Bank's ability to conduct its monetary policy. A central-bank digital currency linked to the loonie can help the Bank encourage Canadians to use our own dollar rather than, for example, a cryptocurrency linked to a foreign currency.

But if threats to the Bank's independence hurt confidence in the Canadian dollar, either its current or a future digital form, the Bank's ability to provide a currency with a predictable purchasing power could erode – further undermining inflation control.

The Bank of Canada has some heavy lifting to do. In the near term, it must get inflation back to target. In the longer term, it needs to keep the Canadian dollar attractive against existing and emerging rivals. Independence will help the Bank provide Canadians with the reliable currency they want.

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A version of this Memo first appeared in The Globe and Mail.