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Answers to the Questions posed by the Senate of Canada's Standing Committee on Banking, Commerce and the Economy in regards to the Committee's study on Canada's monetary policy framework.

Question 1: In your personal opinion and given your experiences with central banks around the world, what do you consider to be best practices with respect to monetary policy governance? For example, how do you view the importance of the role of deputy governors within central banks and how transparent should their appointment process be?

What follows are my reflections at a high-level on key considerations with regards to best practices, and not an exhaustive review of the Bank of Canada's monetary policy governance. Such a review is best done in a structured manner, led by a team of experts with a clear, focused mandate and extensive consultation. My reflections are also given in my personal capacity, and do not represent the views of my colleagues at either Princeton University or the Bank of England.

In my experience with a number of central banks in different jurisdictions, there is no single "best practice" for the design of monetary policy frameworks and governance. This is primarily because successful designs are tailored to the unique legal, economic, and cultural features of different countries. That said, the ultimate success of monetary policy in inflation-targeting central banks does depend on adhering to a number of foundational principles for effective and credible monetary policy decision-making.[1]

1. Independence to pursue shared objectives

Central banks require a high degree of *independence* in pursuing their objectives to in order to safeguard against short-term political interference in the setting of monetary policy. Figure 1 outlines the elements that the International Monetary Fund now looks at when assessing the extent to which any particular central bank is independent.

Ideally, the main parameters outlining the scope of a central bank's independence are in legislation to anchor the central bank's mandate, governance and powers in a manner that allows for "constrained flexibility" to respond to extraordinary circumstances (e.g. subparagraph 18(g)(ii) of the *Bank of Canada Act*). Memorandums of understanding between the government and the central bank are a powerful supplement to legislation by creating a more detailed and current understanding of the precise shared objectives for monetary policy and scope of operational autonomy in pursuit of these objectives. For example:

[1] These principles are adapted from those that guided some of the recommendation in the 2023 review of the Reserve Bank of Australia (https://rbareview.gov.au/sites/rbareview.gov.au/files/2023-06/rbareview-report-at_0.pdf). The principles were informed by work commissioned by the Review Panel, as were some recommendations in the final report (see Levin A (2023) 'Principles & Practical Recommendations for Strengthening the Governance and Accountability of the Reserve Bank of Australia' https://rbareview.gov.au/resources and Gai P (2023) 'The Governance of monetary policy – process, structure and international experience' https://rbareview.gov.au/resources).

- monetary policy ***objectives*** *are* framed by a clear policy strategy that includes a stable, shared policy objective between the central bank and government. This shared objective provides a strong basis for accountability to government and citizens. In Canada, this is codified in the Agreement on the Inflation-Control Target between the Minister of Finance and the Governor.[2] Other inflation-targeting central banks may set their target with Parliament (e.g., Riksbank), or the Government sets the target (e.g., Bank of England).

- monetary policy ***tools*** are defined within a framework that provides operational autonomy and related accountability for the central bank to pursue its objective, particularly with regards to the extended toolkit that may be needed when the policy rate reaches the effective lower bound. The Bank of Canada outlined its framework for monetary policy tools in the Monetary Policy Framework Renewal (2021)[3]; and

- the monetary policy ***framework*** is reviewed on a regular schedule. Canada is a leader in terms of reviewing the agreement on Canada's monetary policy framework every five years. This helps ensure that the framework is stable, yet remains fit for purpose and avoids the risks that changes undermine credibility. Other countries have also committed to regular reviews of monetary policy objectives and tools (e.g., European Central Bank, Sweden and the US Federal Reserve).

Figure 1: Metrics used in the IMF's New Central Bank Independence Index

1. Is the central bank CEO independent of executive branch officials?
2. Is the central bank's highest governing body independent of executive branch officials?
3. Does the central bank have budgetary independence from the legislature?
4. Can the central bank set monetary policy independently from executive branch officials?
5. Is price stability the primary objective of the central bank?
6. Is the central bank prohibited from long-term direct lending to the government?
7. Is the central bank prohibited from short-term direct lending to the government?
8. Does the central bank have financial independence?
9. Is the central bank restricted from lending outside the financial system?
10. Are state audit bodies with oversight powers explicitly restricted to examining operational efficiency aspects of the central bank (without the power, for example, to examine monetary policy decision)?

Source: IMF Working Paper 2024/035 (file:///C:/Users/cw9142/Downloads/wpiea2024035-print-pdf.pdf)

2. Sound decision making

John Maynard Keynes wrote during the Depression that "It is astonishing what foolish things one can temporarily believe if one thinks too long alone, particularly in economics."[4] In a similar vein, my experience is that monetary policy decisions (as well with other important public policy decisions) are best made by a *group*, rather than a single individual. It's important that members of this group have:

- ***deep expertise and a range of knowledge and experience*** **relevant to monetary policy**, particularly because these decisions involve complex tradeoffs in a changing and uncertain environment**.** Again, there are many different models that monetary policy committees follow, with varying numbers of members, internal versus external membership and processes to come to decisions. And, there does not appear to be a strong link between these different models and inflation forecast performance over the recent inflationary period, nor with inflation outcomes over a

[2] In 1991, the Bank of Canada Governor and the Minister of Finance agreed on an inflation-control target framework to guide Canadian monetary policy. The target agreement has been renewed several times since, most recently in 2021 to the end of 2026.

[3] See Monetary Policy Framework Renewal (December 2021)

[4] J. M. Keynes, *The General Theory of Employment, Interest and Money,* 1936

longer period.[5] The Bank of Canada's recent initiative to expand Governing Council to include external members has created the opportunity to strengthen the depth and range of knowledge and experience in decision-making.

- ***the same rich set of information, and influence over both the type of questions staff are asked to answer and the economic scenarios that are investigated.*** This is supported by the Bank of Canada's comprehensive, structured decision-making process. All Governing Council members participate in the four critical stages: i) presentation of the staff projection and economic briefing; ii) final policy recommendations from staff, iii) Governing Council deliberations, and; iv) publication and communication of the decision.[6] This process informed several recommendations made as part of the external review of the Reserve Bank of Australia.
- ***roughly comparable influence on the decision*.** Central banks typically take monetary policy decisions either through explicit majority voting or through a consensus-based approach that does not rely on formal voting. The Bank of Canada's Governing Council follows the latter approach. Given that all members report to the Governor (either directly or via the Board of Directors, which the Governor chairs), it is critical that the consensus regime is collegial and not autocratic. It was my experience that the monetary policy discussions were collegial, in that information and proposals were considered on an equal footing such that discussions were robust and productive. However, the degree of collegiality in the consensus model ultimately depends on the leadership approach of the Governor of the day.[7]

3. Accountability and transparency

Independence must be supported by **accountability** and **transparency** to maintain public trust in the central bank's role. While best practices for central bank communications necessarily evolve over time as media for communications and other circumstances evolve, there are communications tools and practices that anchor any good strategy.[8]

- ***Communications should be systematic, transparent, and impactful to support operational autonomy and public trust*.** Communication can also be a powerful tool in affecting market expectations for the policy rate, strengthening the transmission of monetary policy and anchoring inflation expectations. The Bank of Canada has many of the modern communication tools that central banks use, including regular press conferences, key publications. These include the press release, Governor's opening statement and press conference following monetary policy decisions. It also includes the Monetary Policy Report (MPR), outreach events, use of social media and other initiatives. The Bank of Canada is among growing number of institutions that formalize these

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[5] See Bernanke (2024) Forecasting for monetary policy making and communication at the Bank of England: a review | Bank of England and Gai P (2023) 'The Governance of monetary policy – process, structure and international experience' https://rbareview.gov.au/resources.

[6] For more information, see Decision-making process - Bank of Canada.

[7] See Gai (2023) (https://rbareview.gov.au/resources) for an informative discussion of how the approach of central bank governors can influence the quality of monetary policy discussions in both consensus-based and voting models.

[8] For instance, see Casiraghi and Pio Perez (2022) "Central Bank Communications" file:///C:/Users/cw9142/Downloads/handbookcommunications-jan-14-2022-v2-1.pdf.

conventions in a public document (see the Bank of Canada's Principles for External Communication by members of Governing Council and Reserve Bank of New Zealand's MPC Charter).

- ***Communications should focus on the rational for decisions and the range of views that informed the discussions****, including views on the outlook and related uncertainties, and implications for monetary policy strategy.* In this respect, publishing a summary of deliberations (SOD) or meeting minutes has emerged as a best practice for promoting transparency around policy deliberations. No single best practice exists in terms of an "optimal" level of detail for which all central banks should aim, as the decision invariably involves a trade-off between the benefits of transparency and the danger that publicizing detailed records of individual views could muddle key messages or stifle internal debate.[9] The Bank of Canada, which operates under a consensus system, introduced a Summary of Decision (SOD) in January 2023 that provides a synopsis of the discussion, including unattributed summaries of the different views aired during deliberations. Some central banks with monetary policy committees that operate under a voting system give the public more insight into the range of policymakers' individual views, such as the Bank of England that publishes attributed votes**.** In the United States, the Federal Reserve's quarterly Summary of Economic Projections collects policymakers' individual views on how the policy rate and other key variables would evolve "under appropriate monetary policy", and then publishes these views as a set of anonymized "dots." In principle, this latter tool could be used in both voting and consensus-based models for monetary policy decisions.
- *The process of selecting members of the monetary policy committee should be systematic, transparent and open, with a regard to avoiding material conflicts of interest*. The Governor and Senior Deputy Governor are chosen for a seven-year term following a clear, legislated process, led by the Bank of Canada's independent Board of Directors (excluding the Governor and Senior Deputy), and with GIC approval. This process is guided by well-articulated eligibility and ineligibility requirements (e.g., must be a Canadian citizen, cannot be a member of the Senate or House of Commons), consistent with some of the independence metrics in Figure 1. The Deputy Governors are selected by the independent Board of Directors (including the Governor and Senior Deputy). Unlike the Governor and the Senior Deputy Governor, the Deputy Governors are regular members of Bank of Canada staff, with no fixed term and compensated within the Bank's total compensation framework. All Governing Council positions are routinely advertised widely in the recruitment process, which is an effective and transparent way to attract candidates, and the results of the process announced when the selection is complete.

Q2: The committee has reviewed your September 2017 remarks, Monetary Policy Framework Issues: Toward the 2021 Inflation-Target Renewal, as well as your November 2018 remarks, Choosing the Best Monetary Policy Framework for Canada. Given the experiences of central banks resulting from the COVID-19 pandemic, would you make any updates to these remarks or do you still feel that they are applicable to today's realities?

What follows are my reflections at a high-level on some key points, and should not be interpreted as an assessment of Bank's monetary policy framework. The Bank of Canada is to be commended for having commissioned an external review of its COVID response, led by world experts in the field of central banking. I was happy to participate in this review when requested to do so by the reviewers, and look forward to their report. My reflections are given in my personal capacity, and do not represent the views of my colleagues at either Princeton University or the Bank of England.

[9] There is also no clear evidence of better policy outcomes with that monetary policy committees that vote, relative to or operated by consensus (Gai 2023 cited in footnote 1).

As highlighted in my answer to the previous question, Canada's monetary policy objectives are framed in a clear policy strategy that includes a stable, *shared* objective between the Minister of Finance and Bank of Canada Governor.[10] This shared policy objective provides a strong basis for operational independence, and accountability to government and citizens. Canada's monetary policy framework, including monetary policy tools, is reviewed every five years. This helps ensure that the framework is stable and remains fit for purpose in a changing economic environment. Other jurisdictions have looked to Canada's framework review process to shape their own (e.g., US Federal Reserve).

Leading up to the last review, which was finalized late 2021, my colleagues and I were of the opinion that Canada's flexible inflation targeting framework had served Canada very well over an extended period. Nevertheless, as outlined in the speeches mentioned in this question, we saw a couple of important challenges facing our framework that merited consideration:

- ***Firepower*** – our concern was that the Bank of Canada, as with many other inflation-targeting central banks, would be more likely than in the past to run out of conventional firepower in the event of an economic downturn. As explained in my 2018 remarks, this was because the Bank's estimate of the nominal neutral rate of interest—where monetary policy is neither stimulative nor restrictive—was much lower than it had been in the early 2000s. This meant that there was less room to lower interest rates in response to events that drag the Canadian economy down, given the Bank's policy rate cannot be set much below zero (there is an "effective lower bound"). Bank staff were therefore asked to work on a variety of alternative frameworks that might give the Bank more room to maneuver, such as price level targeting and a higher inflation target. The Bank also further developed its extended tool kit that could be used in the case of hitting the effective lower bound (e.g., forward guidance, balance sheet tools). The Bank also, jointly with the Department of Finance, looked at the stabilization properties of the Canadian fiscal system to help reduce the chances of the policy rate hitting the effective lower bound.
- ***Risk-taking*** - we were concerned that the lower neutral rate might encourage households and investors to take on excessive risk, leaving the economy exposed to boom-bust financial cycles. We recognized that this was not a straightforward issue for the monetary policy framework, since other policies outside the Bank's remit (i.e., micro and macroprudential policies, tax policies) are much better-suited than monetary policy to dealing with the problem.

The underlying research and outcomes of this review were outlined extensively in a document entitled "Monetary Policy Framework Renewal," published in 2021.[11] It is evident in my work with other governments and central banks that the transparency and analytical underpinnings of the Bank of Canada's framework are highly-respected.

Today's realities only reinforce the need for regular reviews of the monetary policy framework, seeking input from a wide range of perspectives and operating in a transparent manner. The reviews should continue to include a clear-eyed assessment of the performance of the current monetary policy framework, and dig deeper into the concerns and issues that are most relevant to the period in question.

The scope of the next review is a matter for the Minister of Finance and the Governor of the Bank of Canada to determine. I expect the external review of the Bank's COVID response will provide a useful perspective. Therefore, I will make only a few general observations based on my work with several central banks:

[10] As noted in question 1, this is codified in the Agreement on the Inflation-Control Target between the Minister of Finance and the Government.

[11] See https://www.bankofcanada.ca/wp-content/uploads/2021/12/Monetary-Policy-Framework-Renewal-December-2021.pdf

- **Extend the focus past the last battle**. For instance, while subject to substantial uncertainty, central banks need to consider the possibility that the neutral rate of interest has moved up since COVID. There may also be more upward pressures on inflation than in the pre-COVID period, particularly given the implications for supply constraints on a number of fronts, including from geopolitical tensions, climate change and lowering the carbon footprint, and demographic trends. More frequent supply constraints (or supply "shocks") could result in a different set of tradeoffs for monetary policy.
- **Consider the interactions between fiscal and monetary policies**, especially when the policy rate is nearing the effective lower bound. More work should be undertaken to assess which *combinations* of monetary and fiscal policies are best suited to address extraordinary circumstances.
- **Strengthen the framework for the Bank's extended toolkit,** informed by the lessons learned from the COVID response in Canada and elsewhere. This should cover areas such as the cost-benefit assessment of the tools, including relative to other policy measures such as fiscal policy, as well as exit strategies under different scenarios. It should also include tool design and governance -- with a regard to effectiveness and mitigating moral hazard -- to better distinguish between use of tools to restore market functioning and those to meet monetary policy objectives. There are relevant positive lessons in this regard from the experience in the United Kingdom during the period of market disfunction in the fall of 2022.[12]

Finally, as the Senate's work continues, I would encourage Senators to also consider the fundamentals outside of the Bank's remit that are *critical to successful monetary* policy outcomes for Canadians. For instance:

i) A *sound financial system*, supported by prudent and efficient regulatory safeguards and governance, is needed to properly serve households and businesses.

ii) Fiscal policy must be on a *sustainable track* for monetary policy to achieve price stability.

iii) Forward-looking structural policies and reform can build capacity and supply chain resilience in a way that alleviates some upward pressures on prices (e.g., housing supply, efficient and reliable transportation of goods to market, higher productivity).

[12] Wilkins, Carolyn (2024), "Financial Stability and Monetary Policy: Lessons from the UK's LDI Crisis," Griswold Center for Economic Policy Studies Working Paper No. 336, Princeton University (https://gceps.princeton.edu/wp-content/uploads/2024/08/wp336_Carolyn-Wilkins_UK-LDI-Crisis.pdf)