TD Bank Financial Group

TD Economics

Special Report

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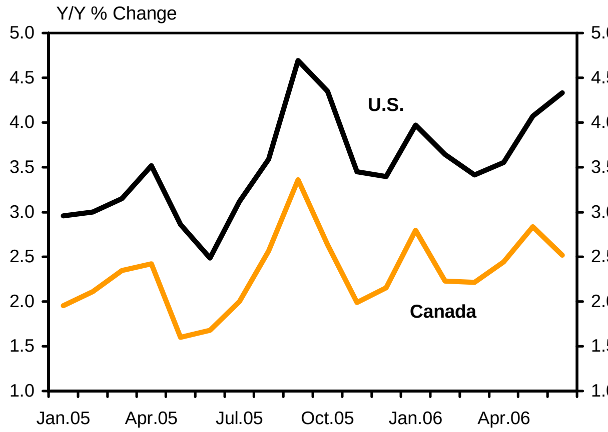
COMPARISON OF MONETARY POLICY IN CANADA AND THE UNITED STATES: WEAKER FED TRANSPARENCY THE BIGGEST DIFFERENCE

"with appropriate monetary policy and in the absence of significant unforeseen developments, the economy should continue to expand at a solid and sustainable pace and core inflation should decline from its recent level over the medium term"

Quick, pop quiz: In considering the current state of North American monetary policy, which central bank can the above quote be attributed to? If the answer isn't immediately clear, fear not. Indeed, recent monetary policy events on both sides of the border have had common rings (if you are still pondering, the answer is the Federal Reserve and the quote was part of Chairman Bernanke's testimony to Congress). This isn't surprising given the broad similarities of the two economies, some common features in the general monetary policy objectives, and the common point of full capacity both economies have reached in the economic cycle. Still, there is an eeriness to the commonality of some recent aspects. The most intriguing is the frankness with which both central banks have stated in the past two weeks that monetary policy must and will be conducted in a forward-looking manner. Both banks have released sketchy details of economic forecasts that feature moderating growth that is argued to contain inflation pressures. Indeed, the central tendency forecast of the Federal Open Market Committee (FOMC) members showing 3 to 3 ¼ per cent growth over the 4 quarters of 2007 is nearly identical with the Bank of Canada's forecast that U.S. growth moderates "to a rate close to potential growth of about 3.2 per cent in 2007 and 2008". Also in common is no shortage of yipping and yammering by policy commentators that the central banks are not putting enough emphasis on recent inflation data. This is ironic because commentators more typically chastise central bankers for not being sufficiently forward looking.

CONSUMER PRICE INDEX - ALL ITEMS



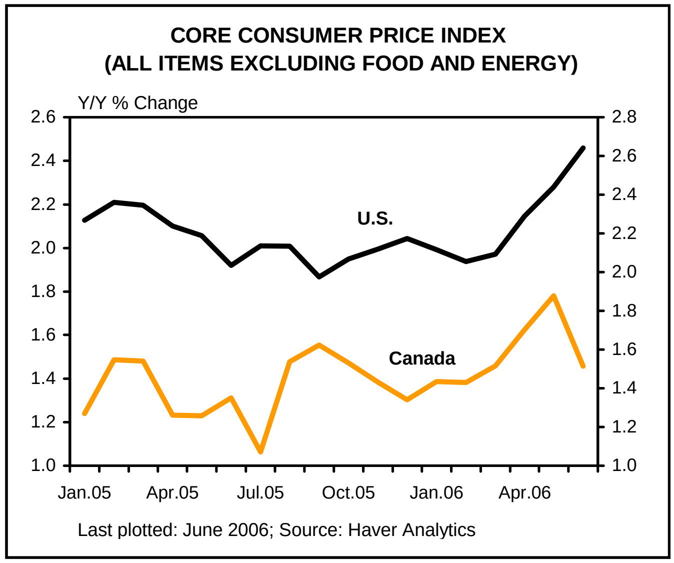
Last plotted: June 2006; Source: Haver Analytics

Similar Views (We Think) on Capacity Pressures but Higher U.S. Inflation (Maybe)

The Bank of Canada points to its estimate that actual output slightly exceeds potential output as a critical piece of evidence that the Canadian economy is operating under a slight degree of excess demand. The Federal Reserve Board uses fairly similar words in describing capacity pressures in the United States, but does not provide an official estimate of the level of potential output so their view seems much less precise. In June total CPI inflation was 2.5 per cent year-over-year in Canada and the core measure (defined as all items less food and energy prices) was 1.5 per cent. These are much lower than the U.S. figures of 4.3 and 2.6 per cent respectively. The main reason for this difference is that prices for energy as well as health and personal care have been rising at a much faster rate in the United States than in Canada. But the Federal Reserve Board is making it increasingly apparent that it puts more stock in the core deflator for personal consumption expenditure (PCE) than any CPI measures. In May, that measure of inflation was running at 2.1 per cent on a year-over-year basis. In Canada there is no equivalent monthly series available. The central tendency forecast of FOMC members is that inflation under this measure will slow from 2 ¼ to 2 ½ per cent over the four quarters of 2006 to 2 to 2 ¼ per cent over the four quarters of 2007. The Bank of Canada forecasts Canadian inflation as measured by the core CPI to continue tracking around 2 per cent through 2007. So similar numbers in the U.S. and Canadian central bank forecasts, although the measures differ somewhat. As the implicit deflator should rise less quickly than the fixed-weight CPI, the expected "true" pace of inflation is lower in the Bank of Canada's forecast.

Similar Views on Impact of Softening Growth on Inflation

In its Monetary Policy Report to Congress on July 19th the Federal Reserve Board said: "the more moderate pace of expansion and the stability in resource utilization, when coupled with less pressure from the prices of energy and other commodities, should contribute to an environment in which inflation expectations are contained and inflation edges lower." In his testimony Chairman Bernanke added: "We must take account of the possible future effects of previous policy actions – that is, of policy effects still "in the pipeline"". In its July Monetary Policy Update the Bank of Canada said: "…the anticipated moderation of U.S. growth, combined with the lagged effects of past interest rate and exchange rate increases, brings aggregate supply and demand back into balance. Hence, in this projection, the current level of the policy interest rate is consistent with achieving the 2 per cent inflation target." The statements express similar sentiments about the impact of softening growth in curbing inflation pressures. But there are two critical distinctions. The Bank of Canada statement makes it clear that inflation is expected to be contained to an acceptable pace and that the current level



of the key policy interest rate is, "at this time" viewed to be sufficient to do the trick. In the case of the Federal Reserve Board we neither know whether the projected rate of inflation is believed to be acceptable of if further changes in interest rates are believed to be required to generate this expected outcome.

Vagueness Over Objectives Damages Transparency of U.S. Monetary Policy

The Bank of Canada has an explicit inflation target of 2 per cent. The Federal Reserve Board, on the other hand, has never given a specific view on its objective. Some insight can be gained as to their objective by examining their outlooks. First, the objective they have in mind is certainly in terms of the deflator for consumer expenditures rather than the CPI. Since the FOMC added a second year to its semi-annual publication of its forecasts in July 2004, the central tendency outlook has never exceeded

CENTRAL TENDENCY PROJECTIONS OF THE FEDERAL RESERVE GOVERNORS AND RESERVE BANK PRESIDENTS FOR PCE PRICE INDEX EXCLUDING FOOD AND ENERGY*

	YEAR 1	YEAR 2
July 2004	1 3/4 - 2	1 1/2 - 2
February 2005	1 1/2 - 2	1 1/2 - 2
July 2005	1 - 2	1 - 2
February 2006	About 2	1 - 2
July 2006	2 1/4 - 2 1/2	2 - 2 1/4

* Change from average fourth quarter of previous year to average for fourth quarter of year indicated

Source: Federal Reserve Board

2 per cent until this July. As FOMC members are instructed to form their outlooks on the basis of their judgement of "appropriate monetary policy", it seems reasonable to conclude that they at least implicitly assume the interest rate pattern that is necessary to ultimately drive inflation into their acceptable range. With the July 2004 and February 2005 FOMC central tendency inflation outlooks being 1 ½ - 2 per cent over the second year and the July 2005 and February 2006 outlooks showing 1 – 2 per cent, it seems reasonable then to assume that the acceptable range of inflation as measured by the core personal consumption deflator has 2 as an upper range. So the fact the central tendency in July 2006 is 2 – 2 ¼ per cent is troubling.

The higher inflation outlook raises a couple of possibilities and questions. It could suggest that the FOMC is now prepared to accept inflation a bit stronger than 2 per cent. There is really no other corroborating evidence to support this against the weight of previous outlooks which had 2 per cent as the upper limit. The question is why the FOMC members didn't implicitly base their outlooks on a higher interest rate profile that would further weaken growth and drive inflation back within their acceptable range. This leads to the second possibility. The time horizon for the outlook may be too short to fully capture the lags from interest rate changes to inflation. After all, inflation in that second year is measured as the change in the price level less than 6 months from now to the level less than 18 months from now. Indeed, in Bernanke's testimony, he notes that inflation is expected to fall over the medium term, which economists typically characterize as two years into the future, slightly beyond the 18 months covered by the central tendency forecasts.

Ultimately there are simply too many unknowns to drive precise policy inferences from the FOMC's outlook. The time period is too short and we do not know what interest rate profile they are assuming. In contrast, the Bank of Canada extends its projection into 2008 as would seem appropriate in view of the monetary policy lags. As they too have a free hand to choose the interest rate profile underlying the forecast there is really no option other than to show inflation by 2008 at their target.

The degree of similarity in recent pronouncements of the Bank of Canada and the Federal Reserve Board is perhaps surprising given that their official mandates are quite different. The Bank of Canada objective function is square focused on keeping inflation at 2 per cent whereas the Federal Reserve Board has dual objectives on growth and inflation. Nevertheless, both central banks have recently concentrated their remarks on the inflation front. For the Federal Reserve Board's part that may simply reflect a logical assessment that inflation rather than growth is the most pressing issue at this time. But there seems to be more to it than that. The Federal Reserve Board has been becoming more explicit over time on its inflation tolerance function. It is well known that Chairman Bernanke is a proponent of establishing a firm, quantitative target for inflation. A bit more precision and a one-year extension of the FOMC outlook horizon would add the missing transparency and make the Federal Reserve Board's operation of monetary policy quite similar to the Bank of Canada's.

Vagueness Over Interest Rate Assumptions Usually a Common Trait, but Not Now

The Federal Reserve Board and the Bank of Canada typically provide outlooks for growth and inflation without specifying what their interest rate assumptions are. We do not know whether the expected pace of inflation through 2007 in the FOMC central tendency is based upon the current rate of interest rate prevailing or whether further hikes are explicitly or implicitly embedded in the forecast. Without that information the forecast provides very little insight. Bank of Canada forecasts typically suffer from the same practice. However, the statement in the July Update that "the current level of the policy interest rate is consistent with achieving the 2 per cent inflation target" seems like a powerful clue that the Bank's forecast is generated under the assumption that interest rates remain unchanged. As such, the forecast provides considerable guidance.

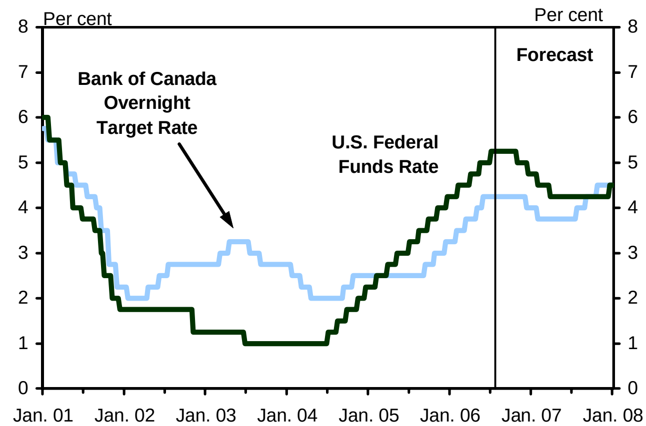
Conclusion: Lack of Transparency Makes the Federal Reserve Board a Harder Read

Despite all the similarities in approach, the interpretations of the intentions of the central banks must ultimately differ. Through its transparent steps, the Bank of Canada has clearly signaled its intent at this time to put a halt to the interest rate hikes. That does not mean there is no chance that rates could rise further. The intent to halt is clearly conditional on the world unfolding as per the Bank of Canada's forecast and the emphasis upon "at this time" is an off ramp should the Bank's thinking evolve. As they acknowledge, there are inflation risks (although balanced against some downward pressure). And if these risks materialize, the Bank will respond accordingly.

The Federal Reserve Board has clearly indicated that it believes it is near the end of the tightening cycle. The minutes released from the June 29th meeting noted as much, with one member noting that the decision to raise rates to 5.0 per cent "was a close call". But its lack of transparency precludes any firm conclusion as to whether they are contemplating, at this time, any further rate hikes. The key missing ingredients, relative to the situation in Canada, are a statement on the acceptable rate of inflation and a longer-term forecast horizon. Through the back door, we may well get a more precise reading on this at their next decision date August 8th. If they raise the interest rate again that might be a sign that they think 2 to 2 1/4 per cent inflation through 2007 is above their comfort zone. Of course, one would have to be careful that the FOMC is not just playing a strategy around risk – ie buying "insurance" that inflation will come down as they project. On the other hand, if they do not raise the interest rate, that may be a sign that they are comfortable with inflation at the projected pace. But again we can't go too far with these interpretations because the FOMC may well think that even without further interest rate increases inflation may fall further in 2008.

Given the ambiguity, it is not surprising that economists and markets are split in their views as to whether the Federal Reserve Board will pull the trigger again on August 11th. Perhaps the FOMC itself is undecided in which case, despite the brave words about being forward-looking, they might be heavily influenced by data still to come.

BANK OF CANADA RATE AND FED FUNDS RATE



Actual data to July 19, 2006; Forecast by TD Economics as at June 2006;
Source: Bank of Canada, U.S. Federal Reserve Board

The key piece will be release of June's deflator for consumer expenditure on August 1st. If the core rate repeats May's 0.2 per cent increase or is even lower, that may be enough to sway the FOMC to stay their hand. On the other hand, a match to the core CPI increase of 0.3 per cent may sufficiently raise their concern over inflation pressures becoming persistent that they will raise the interest rate again.

The TD Economics view has been that the Federal Reserve Board will not hike the rate on August 8th but rather their next move will be a cut to rates before the end of the year. That view is heavily predicated on our forecast showing more softening in the U.S. economy and hence more downward pressure on inflation than either the Federal Reserve Board or the Bank of Canada feature in their outlooks.

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