

“A Monetary Policy Framework for a Volatile World”

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Bank of Canada

Comments by
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**MAX BELL SCHOOL
of PUBLIC POLICY**

This is a very nice paper.

1. Well motivated by current geopolitical/economic context.
 2. Clearly written.
 3. Nice modelling exercise with clear/intuitive results.
- ➔ Concludes that the current system of Flexible Inflation Targeting is adequate for a future with greater volatility.
4. I agree with this conclusion.

Outline of My Comments

1. Review of some basic principles
2. Discussion of central results
3. My one big question

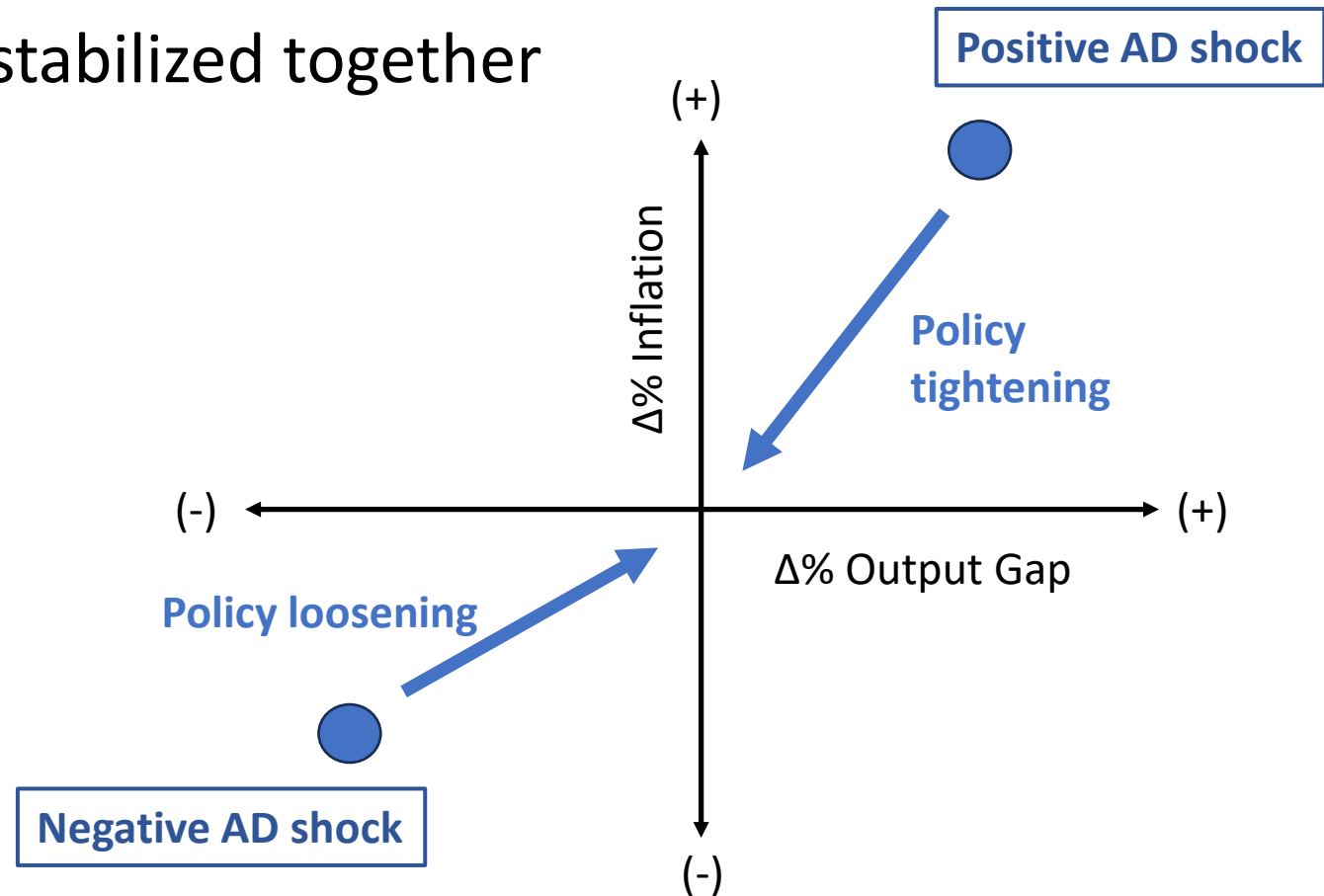
Basic Principles for Monetary Policy

1. Monetary policy is fundamentally a demand-side policy tool.
 - control of interest rates (and money supply) has some supply-side impacts, but the dominant and sustained impact is on aggregate demand.
2. The economy is exposed to both demand-side and supply-side shocks, of varying sizes, signs, and duration.
3. Monetary policy has always faced a challenge with supply shocks.
 - tradeoff between output and inflation stability

Basic Principles for Monetary Policy (2)

4. When faced with **AD shocks**, inflation targeting benefits from the divine coincidence.

- output and inflation are stabilized together

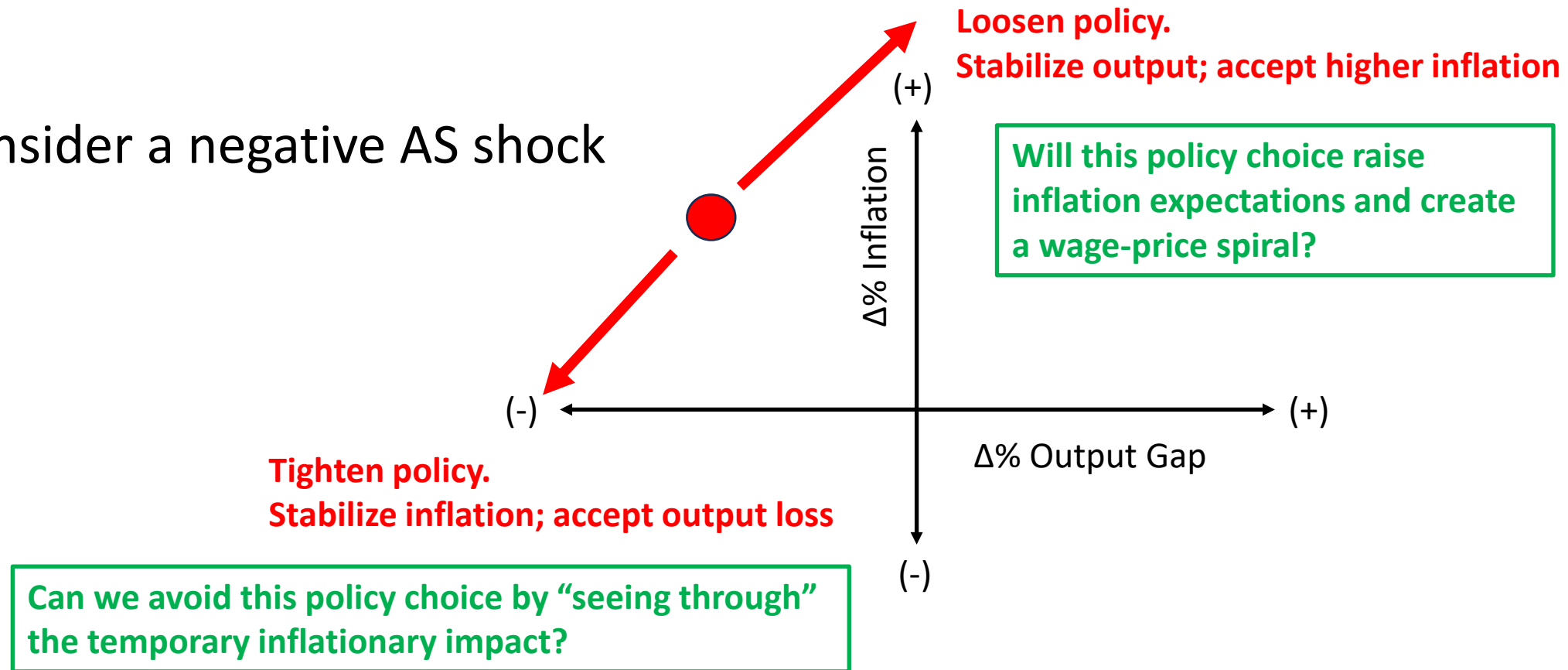


Basic Principles for Monetary Policy (3)

5. But for **AS shocks**, this divinity evaporates:

- the central bank faces a tradeoff

Example: consider a negative AS shock



Basic Principles for Monetary Policy (4)

6. We long believed that monetary policy (and especially IT) was a good tool for macro stabilization because AD shocks were more common and more serious than AS shocks.

But is this still true?

Is it likely to be true for the next several years?

If not, does the Bank of Canada need a new policy framework?

Review of Central Results

Paper's central question:

Can the current IT framework deal successfully with the nature of current and coming shocks?

- deglobalization (tariff policies)
- decarbonization (carbon pricing)



I will focus my comments on these

- + climate-related risks (flooding, fires, etc.)
- + demographics (impact on neutral rate, r^*)
- + digitalization (impact on productivity growth)

Or, will the current IT framework require greater “flexibility”?

Review of Central Results (2)

Useful to think about these phenomena as combinations of AD and AS shocks.

If the dominant/net effect is a negative AS shock, then monetary policy faces the usual tradeoff.

How big are these shocks?

How bad are the associated tradeoffs?

Review of Central Results (3)

Deglobalization

Three scenarios:

1. US tariffs on Canadian exports:

- mostly a negative AD shock for Canada
- but also a negative AS shock due to higher (imported) input prices

2. Canadian tariffs on US exports:

- mostly a negative AS shock through higher prices (final vs. intermediate goods)

3. Bilateral tariffs

- net effect of #1 + #2 is a negative AS shock

Review of Central Results (4)

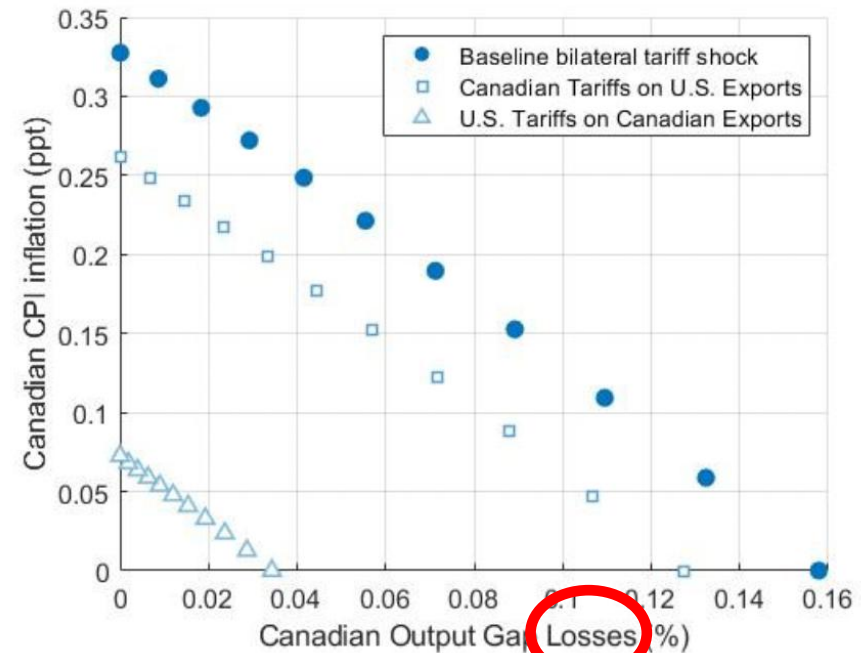
FINDING

The Canadian tariffs generate a larger problem for monetary policy than do the US tariffs, but even the worst case is quite manageable.

My Thoughts

1. Intuitive: US tariffs are an AD/AS shock; but Canadian tariffs are mostly a negative AS shock.
2. Less intuitive: Surprised at small size of these effects.

Chart 1: Canadian inflation-output trade-off following a rise in bilateral costs with the United States



Notes: Inflation shows the two-year average year-over-year CPI response (in percentage points), while the labor gap losses reflect the two-year average deviation of employment from its flexible-price level (in percent).

Review of Central Results (5)

What are the caveats in these results?

1. Ignores Canadian tariff revenue (and associated spending).
 - likely not a big problem since these have been largely repealed.
2. Ignores effect of tariff wars on inflation expectations.
 - likely OK if monetary policy is well communicated.
3. Ignores trade diversification that may soften the output losses.
 - likely OK because not much of this will happen anyway!
- 4. Ignores the effect of tariff uncertainty on investment.**
 - leads to a bigger (AD) shock, but doesn't make the tradeoff worse

Review of Paper's Central Results (6)

Carbon Pricing

1. Carbon pricing itself is both a negative AD shock and a negative AS shock.
2. If all the revenue is returned in rebates, then it becomes mostly an AS shock.
3. The effect on exports depends crucially on the details of the OBPS.
4. But it is not clear how #2 and #3 are dealt with in the model.

Review of Central Results (6)

FINDING

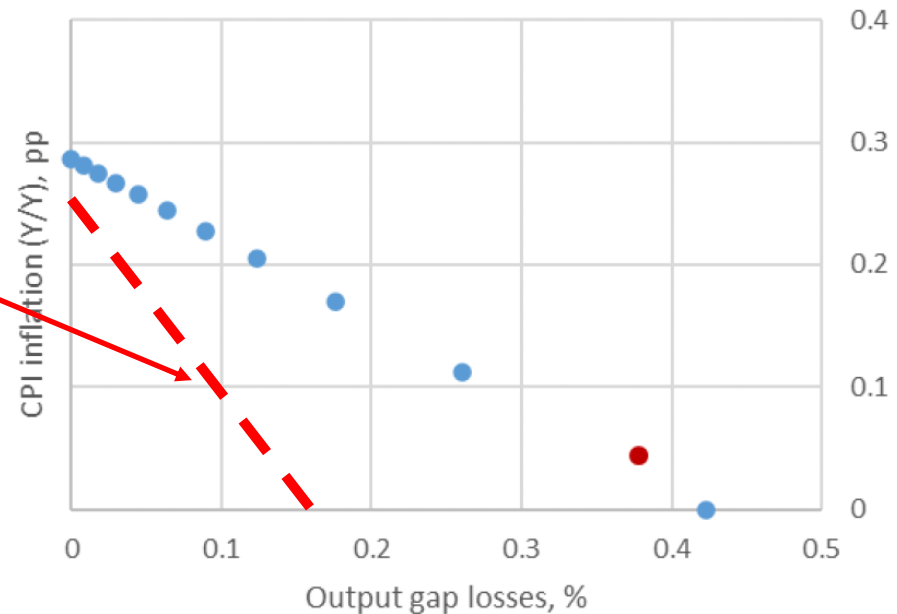
The policy-induced drive to net zero (2030) sees a worse tradeoff than the bilateral tariff scenario (-----) – but still quite manageable.

My Questions

1. Why are employment losses so much worse under carbon pricing?
2. How high is this carbon price going?
3. What is happening with the carbon-pricing revenue?
4. Is this still the relevant modelling exercise for Canada?

The results for deglobalization

Chart 3: Canadian inflation-output trade-offs on the way to net zero



Notes: The blue dots are obtained as the average of the 8-quarter moving average of the deviation of CPI inflation (y/y) from target (percentage points) and the output gap losses (percent) over the period from 2019 (start of the scenario analysis) until 2030. The red dot shows the corresponding values under the historical monetary policy rule.

My One Big Question

Are we really entering a more volatile world in which negative AS shocks will be more common than before?

If so, then this paper is doing the right modelling exercise and its results suggest that the current IT framework is up to the task.

My One Big Question (2)

Or, are we currently living through a bunch of large changes that will soon stop as we settle into our “new normal”:

- more tariffs, less trade
- more climate policies
- more digitization

If so, then maybe the analysis in this paper is not really relevant.

Instead, we need to ask whether Canada's IT framework is adequate to deal with a modified economic structure – even with unchanged volatility.

And I see no reason not to think that our IT framework could easily adjust to a different path for Y^* or r^* or U^* or other key structural macro variables.

Thanks very much.