

Bank of Canada Monthly Research Update

October 2016

This monthly newsletter features the latest research publications by Bank of Canada economists. The report includes papers appearing in external publications and staff working papers published on the Bank of Canada's website.

STAFF WORKING PAPERS

Richards, Simon & Matthieu Verstraete, “Understanding Firms’ Inflation Expectations Using the Bank of Canada’s Business Outlook Survey”, CESifo Working Paper No. 6090

Kuncl, Martin, “Fragility of Resale Markets for Securitized Assets and Policy of Asset Purchases”, Bank of Canada Staff Working Paper 2016-46

ABSTRACTS

Fragility of Resale Markets for Securitized Assets and Policy of Asset Purchases

Markets for securitized assets were characterized by high liquidity prior to the recent financial crisis and by a sudden market dry-up at the onset of the crisis. A general equilibrium model with heterogeneous investment opportunities and information frictions predicts that, in boom periods or mild recessions, the degree of adverse selection in resale markets for securitized assets is limited because of the reputation-based guarantees by asset originators. This supports investment and output. However, in a deep recession, characterized by high dispersion of asset qualities, there is a sudden surge in adverse selection due to an economy-wide default on reputation-based guarantees, which persistently depresses the output in the economy. Government policy of asset purchases limits the negative effects of adverse selection on the real economy, but may create a negative moral hazard problem.

Understanding Firms’ Inflation Expectations Using the Bank of Canada’s Business Outlook Survey

Inflation expectations are a key determinant of actual and future inflation and thus matter for the conduct of monetary policy. We study how firms form their inflation expectations using quarterly firm-level data from the Bank of Canada’s Business Outlook Survey, spanning the 2001 to 2015 period. The data are aggregated to construct an inflation expectations index. Results based on the index suggest that expectations are not consistent with the rationality assumption but are, still, more complex than purely adaptive expectations. Firms’ own unique experiences, such as the dynamics of the prices they expect to pay (wages/inputs), significantly influence aggregate expectations. Expectations are also found to be significantly and positively correlated with movements in oil prices. Most of the preceding results

hold at the firm level. The estimation of structural shift specifications suggests that inflation expectations in Canada have drifted downward since the Great Recession. However, the data do not suggest that Canadian businesses' expectations have become unanchored.