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The Bank of Canada and Crisis Management

COVID-19 and Beyond

Scott M. Aquanno

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ABOUT THE AUTHORS

Scott M. Aquanno is an Assistant Professor in the Political Science Program at Ontario Tech University in Oshawa, Ontario. Dr. Aquanno holds a Ph.D. in political science from York University.

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Executive Summary

The COVID-19 crisis has caused a tectonic shift in Canada's public finances. On April 1, the Bank of Canada (BoC) began a major bond-buying program, following the tracks of the U.S. Federal Reserve and other central banks around the world. This sudden and dramatic shift in bank operations and strategy is the latest stage in the BoC's relationship with government debt, financial markets, and the day-to-day lives of all Canadians. The current moment demands an understanding of the bank's powers, and its history, and a reinvigorated debate about its evolving responsibilities.

The BoC has exercised its far-reaching powers to shape the economic evolution of Canada through three distinct eras. From 1938 to 1974, the bank purchased large amounts of government debt, thus creating the money needed to finance federal spending on the physical infrastructure and public programs that laid the foundation for Canada as we know it today. Following 1974, as governments around the world moved to weaken labour protections and reduce support for public services as a strategy to boost business profits, the bank forced governments to fund debt through private channels, with the result that public debt rapidly outpaced economic growth. Following

the financial crisis of 2008-09, the bank adopted a more flexible approach, closely observing innovative moves by central banks around the world. These innovations added new tools to the bank's policy toolkit.

In 2020, for the first time since the 1970s, large-scale purchases of government bonds are once again central to BoC operations. And while the bank itself is, by statute, politically independent from government, its policy decisions are far from politically neutral in their impacts. Through its recent actions, the bank has helped meet the urgent needs of vulnerable workers, businesses, students, and provincial governments.

As the COVID-19 epidemic abates, the Bank of Canada's ability to continue on this course will be called in to question. Canadian governments will be forced to contend with unprecedented budget shortfalls and the presumed need to finance debt through private borrowing. Without innovative action, such conditions could produce a new age of austerity: even if public debt markets are vastly different following the pandemic, governments will, nonetheless, face pressure to reduce spending and limit debt. The same conservative forces that proudly restrained public investment following the 2008 financial crash—and used necessary stimulus spending as an excuse to reduce public spending—will once again make their voices heard.

The bank would be wise to consider innovative financing mechanisms to give governments policy alternatives beyond austerity. Austerity brings about suffering at the community level. It erodes the ability of government to support strategically important sectors of the economy. It impedes bold efforts to confront the climate crisis.

For the BoC to help governments steer away from austerity will require innovative thinking and unconventional polices that further reimagine its relationship to private and public markets. A logical next step is to provide more comprehensive support to provincial and local governments, given that they will soon face unheard-of budget shortfalls and lack the revenue tools available to the national government.

A more ambitious strategy would involve the development of a new public bank, backstopped by, but independent from, the BoC, to support public investment and give governments access to cheap credit over the long-term. This would address two central constraints facing the BoC. First, such a bank could be democratically organized, with local branches across the country, linked to regional and national offices and capable of coordinating decisions and targeting investment in Canadians' priorities. Second, it would steer around the perceived limits on monetary financing created by the international monetary system and by the bank's need to maintain credibility. Needless to say, a public investment bank of this nature could play a key role in the decarbonization of the economy, as it could support projects typically underfunded by private investors.

Even though the return of austerity politics is far from certain, the COVID-19 crisis has demonstrated the important role that governments play in the economy. It has provided an x-ray of the precarious and vulnerable working conditions underpinning economic growth and exposed the socio-economic fault lines produced by years of cutbacks and "market-friendly" policies. At the same time, however, it has also created openings for political alternatives, in part because it has demonstrated the feasibility of innovative spending programs backed by activist central bank policy.

As Canadians face an uncertain future together, an ambitious extension of the BoC's responsibilities is the most practical option.

Introduction

As Canadian policy makers continue to contend with the COVID-19 pandemic, and its economic ramifications, it is necessary to reinvigorate debates about the Bank of Canada's evolving responsibilities. This means acknowledging the bank's penchant for policy innovation and considering how to marshal this towards a more sustainable future. Yet it also means recognizing that, in terms of the bank's progressive potentialities, the sky is not the limit: it faces real constraints due to its organizational design and the free movement of capital around the world. This article offers a broad overview of the Bank of Canada's institutional flexibility and changing agenda. It concludes by examining the bank's current policies and the potential dangers these impose, and by suggesting what a more ambitious application of its wide-ranging powers might realistically entail.

Institutional Development and Capacity Building: 1938–2020

The institutional powers of the Bank of Canada (BoC) have long been a principal point of concern for progressive economists and policy analysts. The bank has important monetary and financial system responsibilities, and "far-reaching powers" that can "wield a heavy (if indirect) influence on people's day-to-day lives," yet it lacks the democratic accountability of other policy institutions (Berg 2018: 2). The bank's "independence" means that the government sets its basic priorities, but does not interfere in day-to-day operations. As a result, the bank's six-member Governing Council essentially controls the decision-making process.[1] Particularly problematic is that the Bank of Canada Act, the statute governing the bank's operations, provides a wide interpretation of its central authorities: the bank is responsible for regulating currency and credit in a way that "protects the external value of the national monetary unit" and "promotes the economic and financial welfare of Canada." This cross-section of variables—the bank's independence, market power, and institutional adaptability—means that it is not an innocuous arbiter of credit and liquidity, but rather a key source of economic authority.

The flexibility provided by the Bank of Canada Act has been a key source of the BoC's organizational plasticity, since it provides space for institutional learning and trial-and-error experimentation, and allows adaptation to changing policy ideas as well as wider economic shifts. The bank's development following nationalization in 1938 can be separated into three distinct periods. From 1938 to 1974, the bank tended to accommodate fiscal policy expansion by purchasing a relatively large share of government treasury bonds (Ryan 2018).[2] This prevented private financial markets from fully disciplining public borrowing through high interest rates, and allowed the government to fund its obligations cheaply, thereby setting the conditions for the development of social citizenship rights through the post-war expansion. During this period, the bank associated inflation with variations in aggregate demand and often utilized the Philips curve, which predicted an inverse relationship between inflation and unemployment, to make policy decisions: "the predominant view...was that a focus on the demand side of the economy was entirely appropriate for understanding aggregate fluctuations and changes in inflation" (Ragan 2011; Crow 2009).

This changed following 1974, amid the gradual development of a new international monetary framework stressing the removal of post-war financial and monetary constraints, and the rise of new economic ideologies and political coalitions which aimed to liberate the economy from government intervention and saw Keynesian demand policies as a barrier to free market prosperity.[3] Like other central banks, the BoC gradually adopted a quantity theory approach to inflation and began targeting money supply growth.[4] As the bank forced governments to fund debt through private channels and no longer passively absorbed treasuries by issuing money, government debt rapidly outpaced real output growth (Protopapadakis and Siegal 1986). While the bank stopped monetary targeting in 1982, marking the end of monetarist experimentation, this helped set the stage for its commitment to price stability in 1988 and the development of its inflation targeting regime three years later. The period from 1975 to 2007 thus marked the bank's so-called "modernization," defined by its acceptance of orthodox economic theory, and its commitment to maintaining inflation at or near two per cent.[5]

The period following 2008 heralded another qualitative shift in the bank's institutional development. Following the financial crisis, with market conditions changing rapidly and the threat of disinflation, or even deflation, the bank slightly reset the terms of its inflation targeting approach by making it more "flexible" and "symmetrical." This involved softening its low inflation objective by accepting a longer inflation targeting horizon and expressing equal concern about the inflation rate falling below two per cent.[6] More importantly, as interest rates fell to nearly zero in 2009, and thereby blunted the impact of conventional monetary policy, the bank searched for new ways to influence market outcomes and closely monitored the innovative practices being developed elsewhere.[7] With interest rates remaining persistently low in the post-crisis period, the bank signalled its intent to use these crisis-era innovations in the future when it renewed its inflation targets in 2016. These innovations effectively added new programs, such as large-scale asset purchases and funding for credit, into the bank's policy toolkit.[8]

As much as these programs fit within the bank's lender-of-last-resort responsibilities, and remained focused on supporting the orderly function of financial markets through temporary purchases, this move towards unconventional policy involved the development of new institutional capacities and a high degree of policy learning. This occurred as the bank observed changes taking place at the U.S. Federal Reserve, the Bank of England, the Bank of Japan, and the European Central Bank, and therefore reflected (and followed) wider shifts in monetary policy and financial management. Moreover, although such programs were forward looking, they can be read as an adjustment in the bank's relationship to the financial system, for they entailed new ways of transmitting credit and liquidity to private markets and new modes of interaction with key financial institutions. For example, funding for credit requires using private institutions to transmit credit to *specific* sectors of the economy, and large-scale asset purchases involve increasing the price and reducing the yield on key *private* assets, such as mortgage backed securities and corporate bonds.

Thus, while the transformation of the bank's policy tools and goals over the past decades is more complicated than described here, it can be summarized as both cautiously innovative and far-reaching. As the bank adapted to changing circumstances from the 1970s through to the present, it developed new institutional capacities to manage (and protect) increasingly complex financial processes, and altered the terms of its relationship to private and public financial markets in the process. Whether deliberately or not, this helped set the conditions for the financialization of Canadian capitalism, the process whereby financial markets and financial institutions have become "increasingly central to the workings of the economy" (Davis and Kim 2015: 205). According to a number of different studies, this has led public policies "to become more accommodating to both domestic and foreign investment," and has increased levels of inequality and decreased social mobility (Davis and Kim 2015: 2017; Stockhammer 2004; Lazonick and O'Sullivan 2000).

Putting aside these wide-ranging impacts, what is primarily notable about the bank's most recent policy shifts is that they have potentially important distributive consequences. The bank trivializes the impact of its policies on specific groups when it measures them solely in terms of overall economic performance. According to the BoC's own analysis, in fact, low inflation targets favour the interests of lenders over borrowers (Bank of Canada 2016: 15). This is consistent with a wider body of political science research which shows that inflation shifts resources between groups, even if it does not affect "the real performance of the aggregate economy," and subsequently has differential impacts on social actors depending on their location in the political economy (Kirshner 2001: 58).[9] The large-scale asset program also shows clearly the distributive consequences and non-neutrality of central bank policy. This strategy aims to push investment out along the risk curve by "encouraging" the acquisition of a broad range of financial products, and therefore attempts to improve financial conditions by boosting asset values and thus reducing longer-term interest rates (Bank of Canada 2015: 2). Such "rebalancing" of private portfolios may provide credit access to certain borrowers, but it appeals to wealthy households as well, as asset inflation disproportionally favours those with large concentrations of financial wealth (Bank of Canada 2015: 2). Since many middle and lower income households are asset poor, this may exacerbate existing patterns of wealth inequality over the long term (Montecino and Epstein 2015).

All this cautions against associating the political independence of central bank policy with the political neutrality of its policy decisions, and speaks to the ease with which the bank's evolution under neoliberalism could be seen as reflecting the "institutional victory" of "certain groups and coalitions over others" (Kirshner 2001: 58; Blyth 2016). It is important to acknowledge the real constraints on the Bank of Canada stemming from the international monetary system and be practical about the limits these impose on policy development: privatized currency markets and the global mobility of capital link Canada's economic well-being to financial and monetary stability and to the bank's credibility in fighting inflation. Yet neither these constraints, nor the dangers of high inflation, prevent the bank from developing innovative funding measures that pay greater attention to the needs of marginalized groups and support public investment. This requires having a wider, less defensive vision of the bank's role in the economy and focusing more on the root causes of financial risk and instability.

Monetary and Financial Policy in the COVID-19 Era

The COVID-19 crisis has caused a tectonic shift in Canada's public finances. On April 1, the Bank of Canada began a major bond-buying program, following the tracks of the U.S. Federal Reserve and other central banks around the world. Reminiscent of the bank's post-war investment strategy, this program provides at least $5 billion per week (and certainly upwards of $200 billion in cumulative total, depending on how long the program lasts) to support the federal government's recent spending plans. On top of this, it has increased the share of treasury bills it acquires at primary auctions to 40% and created new purchase programs to support provincial and corporate debt markets.[10] It is perfectly clear that these policies have improved market function, suppressed interest rates, and allowed governments to pursue the aggressive health, income, and business support policies needed to combat the pandemic.

Yet while the bank has made it easier for governments to fund deficits and lowered the cost of this debt, there is, at this point, a major contradiction in its rescue strategy: the thrust of the bank's policies has aimed at supporting credit conditions in the *near term*, but the deficits governments accumulate now will have *long-term* political implications, especially since the additional debt load will not build new productive capacity. The bank has not committed to any form of yield curve control[11] to ensure that government funding costs remain low in the years following the crisis, nor provided forward guidance regarding provincial debt markets, despite provinces having broad responsibility for health, education, and social services. This is consistent with the actions of other central banks who have framed similar interventions as "temporary short-term source[s] of additional funding" and explicitly rejected using monetary financing in the long term (Elliot 2020; Bailey 2020).[12]

As the health crisis abates, then, Canadian governments will be forced to contend with unprecedented budget shortfalls and the assumed need to use private markets as their main source of financing. Without innovative action, such conditions could produce "a new…age of austerity": even if public debt markets are vastly different following the pandemic, governments will face pressure to reduce spending and to limit debt (Foroohar 2020). They will encounter the same conservative forces and logics that proudly restrained public investment following the 2008 financial crash and used stimulus spending as an excuse to reduce the size and scope of government intervention in the economy. It is not the bank's responsibility to influence public attitudes towards the issue of austerity, nor should technocrats be at the centre of these debates. However, the bank would be wise to consider innovative financing mechanisms to limit the potentiality of these outcomes and give governments different policy alternatives. One reason is that many of the workers required to sacrifice their health and safety to provide "essential" services during the crisis will bear the brunt of these cutbacks, should they occur.[13] Another is that austerity undermines the basis for sustainable economic development by further reducing social mobility and economic equality. It also tragically erodes the public planning capacities which allow governments to coordinate the distribution of labour and scare resources to strategically important sectors of the economy, monitor community and environmental needs, and develop key productive capacities. While the bank's hard and fast distinction between economics and politics tends to omit these considerations, they nevertheless pose significant financial risks and have strong bearing on Canada's economic welfare.

For the bank to move in this direction would require more innovative thinking and unconventional polices that further reimagine its relationship to private and public markets. A logical starting point is to provide more comprehensive support to provincial and subnational governments, given they face unheard-of budget shortfalls and lack the revenue tools available to the national government. As Harold Chorney once suggested, no doubt aware it was one of the goals in creating the Bank of Canada, this might entail "allowing the provinces access to their relative share of the central bank's debt acquisition capacity" (Chorney 1999:199). A similar platform could be developed to support municipalities, although this is more complicated in light of their precarious constitutional status as agents of provincial governments.[14]

A more ambitious strategy involves the development of a new public bank, backstopped, but independent from, the BoC, that aims to support public investment and give governments access to cheap credit over the long-term.[15] This would address two central constraints facing the BoC. First, such a bank could be democratically organized, with local branches across the country, linked to regional and national offices capable of coordinating decisions and ensuring investment is efficiently allocated to projects Canadians truly prioritize. Second, it would avoid the potential or perceived limits on monetary financing created by the international monetary system and by the bank's need to maintain credibility. Needless to say, a public investment bank of this nature could play a key role in the decarbonization of the economy and in addressing the environmental crisis more generally, for it could support projects typically underfunded by private investors.[16] It could also support other kinds of publicly mandated investment in strategic industries and invest in equities with the aim of influencing corporate governance strategies. The point is not that such a reorientation of concerns should be haphazardly applied, only that it is hardly unreasonable in light of the bank's adaptability and *de facto* non-neutrality.

Even though the return of austerity politics following the crisis is far from certain—to be sure this remains an open political question—the crisis has demonstrated the important role that governments play in the economy and the many-sided limitations of neoliberal programs. It has provided an x-ray of the precarious and vulnerable working conditions underpinning economic growth and exposed the vast socio-economic fault lines produced by years of cutbacks and market friendly policies. But it has also created openings for political alternatives, in part because it has provided powerful evidence about the feasibility of innovative spending programs and put central banks "in the political crosshairs" (Politi 2020). This all seems to suggest that an ambitious extension of the BoC's responsibilities is in fact the most practical option at this juncture.

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Notes

1 The Bank of Canada is a crown corporation owned by the national government. However, it operates at arm's length and is relatively insulated from political intervention. The Minister of Finance appoints the members of the bank's Board of Directors and is represented on the board by the Deputy Minister of Finance (as a non-voting member). Subject to the approval of Cabinet, the board selects the bank's Governing Council, which "sets monetary policy and strategic direction" (Berg 2018: 3). While Cabinet also has the power to dismiss the bank's directors and governors, this cannot be done for political reasons.

2 This period could be further divided. For example, the bank's activities from 1938 to 1950 were more focused on keeping interest rates low and shaped by the currency restrictions established by the Bretton Woods system in 1944. The government of Canada moved to a flexible exchange rate system in 1950 and removed important controls on foreign investment and foreign exchange (Thiessen 2000).

3 Mark Blyth describes the policy transformations that started in the 1970s as a movement from a "debtors paradise into a creditors paradise" (Blyth 2016). He argues that inflation targeting and price stability aimed to "restore the value of debt" and "discipline labour through unemployment," and underpinned the "market friendly revolution" that led to growing inequality and labour's declining share of income (Blyth 2016).

4 The bank's program of monetary gradualism involved using interest rates "to generate a progressive slowing in monetary expansion and overall spending in Canada" (Crow 2009: 299).

5 The bank also established a "control range of 1 to 3 per cent around this target" (Bank of Canada 2016: 2).

6 This is the time period for returning inflation to two per cent. According to the bank's 2016 inflation targeting report, "different interest rate paths could be broadly consistent with achieving the inflation target over a reasonable horizon" (Bank of Canada 2016: 3).

7 Typically, the Bank of Canada influences economic output by adjusting its policy rate. This impacts the price of short-term credit and alters spending habits in the economy. At zero (or near zero) interest rates, the bank no longer has the same capacity to stimulate the economy, since consumer rates cannot drop below zero. The bank refers to this as the effective lower bound (ELB).

8 For all practical intents and purposes, this foreclosed on other antidotes to the problems of the effective lower bound, such as targeting higher levels of inflation.

9 Beyond this, a 2018 report prepared by the Library of Parliament found "evidence that lowering inflation may disproportionately increase female unemployment rates" (Berg 2018: 2).

10 In addition to these unconventional measures, the bank has reduced its policy rate 150 basis points.

11 Yield curve control involves targeting a specific longer-term rate on the yield curve. This is typically accomplished through forward guidance (see below) and bond purchases, and involves central banks purchasing whatever volume of bonds is necessary to achieve the target rate. Conventionally, the Bank of Canada influences economic conditions by setting short-term interest rates in the overnight market. Forward guidance involves communicating the anticipated future course of monetary policy with the aim of influencing market/public action.

12 Monetary financing often refers to the process whereby central banks purchase government debt to fund deficits and support government programs.

13 Though important politically, this is unlikely to impact the bank's decision making, even if it expands its viewpoint.

14 According to the Federation of Canadian Municipalities, the pandemic has led to "plummeting revenues" and created a "fiscal crisis" at the municipal level across Canada (FCM 2020).

15 This could also involve altering and expanding the mandate of the Canada Investment Bank. While the CIB focuses on long-term economic growth, is not democratically organized and is severely limited in terms of its financing and lending capacities.

16 To the extent that the current pandemic can be tied to biodiversity loss, this would further support the Bank of Canada's legislative mandate.

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