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The Recession and the World Financial Crisis Bring Challenges and Change to Canada's Central Bank

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"The financial system is the economy's plumbing. And like the plumbing in a house, it is taken for granted when it works, but when it doesn't, watch out."

—BIS 79th Annual Report , June 2009.

The Changing Environment for Central Banks

The central bank is the key stabilizer in a country's financial system. And in recent decades Canada's and other nations' financial institutions have become vastly more complex. What was once the special area of banking has been broadened through a variety of new channels and financial instruments.

The payments system that was once dominated by paper cheques is now primarily an electronic payments clearing system. Many individual payments are cleared through credit cards (issued by banks and by others) and by electronic transfers via debit cards. Employers often directly deposit employees' pay into bank accounts via electronic "pay-cheques."

The lending sector has also become more complex, with asset-backed commercial paper competing with bank loans, and the securitization of mortgages and other debt instruments. There has been an explosion of sophisticated derivitive securities, along with insurance schemes, to pass risk from one investor to another; these are called credit default swaps. New financial businesses have also arisen, such as hedge funds and private equity groups.

In recent weeks, the Obama Administration has proposed a much enlarged regulatory role for the U.S. Federal Reserve. This will constitute a further challenge to Canadian monetary policy, legislation, and regulation. Should Canada follow the U.S. lead, or is there a better alternative?

In this complex and hectic environment, one can reasonably ask whether our central bank and regulatory institutions are up to the new and developing challenges.

Recent Developments and Central Bank Reactions

The past two years of financial crisis has triggered a complete re-thinking by governments and the public of how monetary policy should operate. Also, in response to that crisis, monetary policy and financial regulation have had to operate in vastly different ways than in the past. In the U.S., the U.K., and in some European countries, it has been necessary not only to rescue commercial banks, but also to come to the aid of some large investment banks and insurance companies. Traditionally, these non-banks were largely ignored by central banks, since these kinds of institutions were not regarded as essential to the health of the financial system.

In addition, as a result of the financial crisis, central banks in the industrially-advanced countries have expanded their lending operations through a mixture of more types of credit and collateral, longer terms, and interventions in corporate borrowing markets. An example would be the U.S. Federal Reserve's lending directly to investment banks. The European Central Bank (ECB) has guaranteed unlimited funds for up to six months instead of the usual one week. Some have gone much further. The Bank of Japan has bought equities and the Swiss National Bank has intervened in the currency markets.

All of these changes came about because traditional monetary policy-makers failed to recognize the massive expansion of the largely unregulated shadow banking system, and the huge non-bank financial conglomerates that have also sprung up. The large, new financial conglomerates were honeycombed with conflicts of interest and lack of transparency that interfered with honest and effective credit allocation.

The Changes Brought About by the Financial Crisis

Now it is seen as essential to recapitalize banks and other conglomerates deemed "too big to fail." And as the financial system was crumbling, widespread changes were necessary in how central banks operate. In short, central banks have moved sharply away from the broadly neutral role they always held with respect to intervening in non-banks and financial markets.

U.S. economic guru Henry Kaufman has observed, "The (U.S.) Federal Reserve has been hobbled by at least two major shortcomings that were primarily responsible for the current (credit crisis) and several previous credit crises. Its failure to spot the importance of changing financial markets and its commitment to *laissez faire* economics were big mistakes and justify a fundamental overhaul of the Fed." (Henry Kaufman, Financial Times web site, April 27,2009)

In Canada, the central bank has also been forced to shift into a brand new terrain, even though our chartered banks are far healthier than their American and British counterparts. The new scenario includes a central bank rate of only one-quarter of one per cent, or nearly a zero interest rate, for the first time in Canadian history. As well, because of the deep recession, Canada's rate of inflation is also approaching zero.

As John Murray, Deputy Governor of the Bank of Canada, observed in a recent wide-ranging speech, the Bank of Canada's shift into an unconventional monetary policy direction includes three new instruments of policy.

The first is to try to jaw-bone down longer-term interest rates by telling the markets that short interest rates will be held close to zero for about a year unless there is a major inflation spike; the second is to employ quantitative easing policies, if necessary; and the third is to engage directly in private sector credit-easing policies.

The last two new approaches are not easily understood. As Murray explains, quantitative easing is simply an increase in the reserve base of the central bank, which leads to an expansion of deposits at the banks and in the money supply.The expansion of the central bank reserve base is not restricted to traditional short-term treasury bills.

> "Quantitative easing occurs whenever a central bank purchases private or public sector securities by expanding its reserve base. These purchases directly affect the yields of the securities that are bought, putting downward pressure on their interest rates and upward pressure on their prices. They also inject additional central bank reserves into the financial system, which deposit-taking institutions can use to generate additional loans…. Credit easing is the third mechanism, and is a term reserved exclusively for central bank purchases of private sector assets in segments of the market where dislocations and credit constraints appear to be most severe. It is designed to ease credit conditions by stimulating more active trade in certain assets and through a process of portfolio substitution." (Speech by John Murray, Deputy Governor of the Bank of Canada to the Global Interdependence Center, Philadelphia, Pennsylvania, 19 May 2009)

Inflation Targeting is Insufficient, and Additional Priorities Are Needed

Despite these new initiatives by Canada's central bank, there is still an important missing ingredient in the Bank of Canada's approach for dealing with the credit crisis and the steep recession. The missing ingredient relates to broadening the main objectives of Bank of Canada policies.

For too long now, Canada's central bank has pursued a policy directed almost solely at inflation targets. Indeed, the Bank of Canada was one of the first central banks to adopt explicit inflation targets. For example, in an August 25 speech to the Canadian Association for Business Economics, Timothy Lane, Deputy Governor of the Bank, stated: "The Bank of Canada has important responsibilities in supporting a stable and efficient financial system, which is critical to long-term growth." But he then went on to emphasize the inflation target as the key policy objective of the Bank.

Since the early 1990s, the inflation target, which was set in conjunction with the Minister of Finance, allowed for an acceptable inflation range of 1% to 3%, with the effective target of 2%. The Bank argues that, by focusing primarily on inflation, it will improve the overall welfare of the economy.

Even after the recent financial crisis, the Bank of Canada stated in its April 2009 "Monetary Policy Report" that "low, stable, and predictable inflation is the best contribution that monetary policy can make to the economic and financial welfare of Canadians."

The objective of controlling inflation, however, looks solely at measures that affect consumer prices, particularly the Consumer Price Index. This approach ignores the inflation of asset prices and the dire effects that asset price "bubbles" have on the economy. For example, it is clear that the exceptionally easy U.S. monetary policy after 9/11 that also targeted low price inflation was an important contributing cause of the price increases in the U.S. housing sector and in the U.S. stock market, and the subsequent bursting of these "bubbles." In Canada, an easy monetary policy in a period of low inflation also contributed to an increase in domestic asset prices.

In other words, a further objective of monetary policy should be to avoid creating "bubbles" in asset prices. As Jaime Caruana, General Manager of the Bank for International Settlements, stated at that bank's June 29, 2009 annual meeting, "We need to explore how to incorporate credit and asset price booms and the associated risk-taking more meaningfully in monetary policy frameworks."

In our view, there are still other missing pieces in this picture that relate to goals for the real economy, including the concept of full employment or a low rate of unemployment, rapid economic growth, or even the trading value of the Canadian dollar.

Central Bank Policies and Canada's Exchange Rate

One question that has been raised is the effect of central bank policies on the Canadian dollar. In the past, Canadians have seen the Bank of Canada stand by while high short-term interest rates forced the Canadian dollar to higher levels, and that caused recessions to become even more severe. That was because the Bank of Canada was seeking to reduce inflationary pressures rather than ameliorate the effects of recession.

It is interesting that inflation targeting can have very different effects on the Canadian dollar. If inflation is seen as too high, the Bank of Canada has in the past increased short-term interest rates, and that has had the immediate effect of increasing the Canadian dollar exchange rate. Now, however, the inflation rate is well below its target range. In such circumstances, it would be appropriate to reduce policy interest rates and help produce a lower-valued Canadian dollar. But the central bank's policy rate is now effectively zero. There is, therefore, a clear dilemma for the Bank of Canada.

In a considerable departure from the central bank's usual reluctance to talk about the future value of the Canadian dollar, the bank has recently been involved in "talking the Canadian dollar down." Most recently, Timothy Lane, Deputy Governor of the Bank, speaking to the Canadian Association for Business Economics, stated: "If a stronger dollar were to alter the path of projected inflation relative to that presented in our July *Monetary Policy Report*, we would need to take that into account." And he further stated, "…we retain considerable flexibility through the use of unconventional monetary policy instruments, including quantitative easing."

It is interesting, however, to note that the Deputy Governor raised the question of the exchange rate (the external value of the Canadian dollar) primarily in terms of achieving the inflation target. As the Canadian dollar increases in value, it brings with it lower prices for imported goods. A much more important objective of a lower-valued Canadian dollar would be to stimulate growth in the economy and reduce the already high rate of unemployment.

Thus the central bank's rationale for lowering the Canadian dollar is based primarily on increasing Canada's inflation rate into the one-to-three per cent range from the roughly zero current inflation rate. This seems a rather peculiar objective for the Bank when previous Bank Governors have strongly proposed a goal of zero inflation. The question remains, however, as to what particular "unconventional monetary policy instruments" the Bank of Canada might use to affect the exchange rate.

The usual course of action for the central bank to use to affect the Canadian dollar's value would be to lower short-term interest rates. That course of action, however, is now not open to the central bank as short-term policy rates are close to zero.

There is a general consensus among economists that the most persistent factors affecting the external value of the Canadian dollar are resource prices, particularly the price of crude oil. Would the Bank enter into the forward market for crude oil? But if it did, that would also affect Canada's inflation, reducing inflation (by lowering gasoline prices) when the Bank is seeking to raise inflation back to its target level.

The same perverse situation would exist if the Bank sought to use quantitative easing by buying large amounts of Canadian government bonds in order to lower medium- or long-term interest rates. Lower long and medium interest rates would bring lower mortgage rates, which would also reduce measured inflation. It is even a question whether or not the Bank's purchase of Canada Bonds could be large enough to affect interest rates sufficiently to bring about a lower-valued Canadian dollar.

Another possibility would be for the Bank to use quantitative easing to purchase U.S. dollars or U.S. dollar securities. In Canada, that has always been the prerogative of the Exchange Fund, which, although operated by the Bank of Canada, is an instrument in the power of the Department of Finance and the Minister of Finance.

Intervention into the foreign exchange market would not be new for Canada, but it has been unused for many years now. It also has serious problems. Would the Bank and the Government want to buy large quantities of U.S. dollar assets, and could they really buy enough to affect the Canadian dollar exchange rate? The quantities of foreign exchange traded each hour are so huge that one wonders how effective such an intervention might be, and how long its effect would last.

It will be interesting to see what method the Bank of Canada tries, if any, and what effect its intervention or quantitative easing has on the Canadian dollar, on the growth of the Canadian economy, or whether it has any effect on Canada's inflation rate in the short term or in the long term.

Are New Powers for Central Banks Needed?

As mentioned earlier, the U.S. Administration has proposed new regulatory powers for the U.S. Federal Reserve. This proposal, if passed by Congress, would give the Federal Reserve the powers and responsibility for major players in the financial system in the United States, removing powers from the present state and federal institutions now responsible for overseeing those very large institutions.

The question for Canada is whether or not to move in that same direction and give the Bank of Canada regulatory and oversight powers over Canada's very large financial institutions.

Canada has assigned the operation of monetary policy to the Bank of Canada, and the regulation of financial institutions to the Office of the Superintendent of Financial Institutions. This division of responsibility has worked well, and indeed has been commented upon favourably by other jurisdictions. Thus the question for Canada is whether to follow the U.S. model or to retain the Canadian one, with both the Bank of Canada and the Superintendent of Financial Institutions given additional powers.

When answering a question on this issue at the recent meeting of the Canadian Association for Business Economics, Deputy Governor Timothy Lane said he agreed that Canada's system has worked well and should be retained. We also feel that the present system should be retained.

Conclusion

The Bank's approach of focusing solely on a target of 2% inflation is far too rigid, and could hurt our economic progress, particularly in the current volatile times.

In our view, the Bank of Canada needs to broaden its formal economic policy objectives. This would include adjusting its policy measures to avoid future asset price "bubbles." And the central bank must have a broader view of the economy and include employment and economic growth along with inflation as near-term objectives.

But the separation of the regulatory function from the monetary policy function appears to have worked well for Canada. The needed changes for Canada's financial system and institutions are the inclusion of all financial institutions into the federal orbit.

The central bank should be able to deal with any and all financial institutions that impinge on monetary policy. It also means that the coordination of monetary policy and regulation of financial institutions must receive priority and careful organization.

Legislation should make explicit the broadening of the role of the central bank to deal with "asset bubbles" and to include other economic objectives beyond merely inflation targets.

The present consultative committee of the Deputy Minister of Finance, the Chairman of the CDIC, the Superintendent of Financial Institutions and the Bank of Canada should be made more formal. It would be very useful to have a report of these meetings made public, even if that were to be after a certain set time.

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