This is a job for ... the Bank of Canada

By William Robson
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Even if the most acute phase of the credit crisis has passed, another jarring drop in equity markets last week showed how severely the deepening economic slump has rattled investors. A clamour for government help is building. Around the world, political leaders are talking bailouts, regulations — even new global financial architecture. Here in Canada, Finance Minister Jim Flaherty is under pressure to deliver fiscal stimulus in his fall update.

Before rewriting rulebooks and cranking up government spending, Canadians need to recall that central banks — including the Bank of Canada under Governor Mark Carney — are far and away our best hope to cushion the downturn and hasten the recovery. Recent worries about deflation are a timely reminder that modern central banks are made to order for this purpose. It was the need to mitigate past financial panics and recessions that inspired their capacity to create virtually unlimited amounts of money, in which all counterparties have confidence, and to do it quickly.

Central banks are not only fast and powerful. Their operational independence and place at the core of national payments systems mean they can act evenhandedly among sectors and regions. Moreover, they can reverse course as effectively when the emergency has passed.

These virtues of central-bank action — speed, power, neutrality and reversibility — contrast strikingly with many other actual and proposed interventions around the world. Guaranteeing deposits and loans is powerful, but politics tends to favour some creditors and debtors over others and makes withdrawing guarantees painful. Governments buying bank assets and shares, or forcing mergers or takeovers, is worse — look how markets tanked while U.S. Treasury Secretary Henry Paulson flip-flopped on the U.S. rescue plan. Temporary regulatory relief from mark-to-market rules — which require companies to record regularly the current market value of assets and liabilities — may be necessary, but abandoning the principle would allow opaque, leveraged assets and liabilities to poison balance sheets into the indefinite future. And French President Nicolas Sarkozy's expansive talk promises months of wrangling and grandstanding over international regulation of borrowing and lending. Nothing there to promote recovery.

Here at home, eyes are on federal and provincial governments. But would new fiscal spending or transfer payments be as fast, powerful, neutral and reversible as central-bank action?

Most things governments can do speedily are, in fact, unlikely to help much. Quick one-offs such as sales-tax relief or cheques to households are ephemeral. Canada had the former, the U.S. the latter, earlier this year — neither had measurable impact. New infrastructure is likelier to do lasting good, but such projects take months to design and years to roll out. Hopes for old-textbook-style stimulus are overblown, in any event. Canadians already know what Americans are rediscovering — that worries about unsustainable fiscal policy can hurt confidence more than new spending helps it.

As for neutrality, the adage that governments pick winners badly but losers pick governments well applies doubly when governments act in haste. The queue for handouts — provinces badgering the feds, cities badgering both; hundreds of businesses suffering genuine hardship — will be long. Every choice of one interest over another will distort Canada's economy during the recovery.

And for years afterward — because fiscal moves are hard to reverse. Special breaks build instant constituencies. As underlined by the mushrooming price tag of the package being prepared by the incoming Obama administration south of the border, governments respond all too readily to our desire to consume — to get more here and now by running a tab against tomorrow. That is why deficits are so tempting and so persistent. The roots of today's crisis lie in too much shopping and borrowing, in too many demands on human and natural resources. Deliberately dissaving more through the public sector is no prescription for sustainable expansion in the years ahead.

The flaws of fiscal and other interventions proliferating around the globe highlight the virtues of smart monetary policy — the tool that can ease the crisis soonest and forestall less helpful or even harmful responses. The Bank of Canada normally sets interest rates every six weeks. Its next decision is no further away than early December. The target for the overnight interest rate is currently 2.25 per cent. The central bank can cut by 25 basis points, or 50 — or more if needed — by flooding the payments system with fresh Canadian dollars. If banks need recapitalizing, easy money is a potent, neutral way to do it.

The Bank of Canada can also foster the flow of that fresh money through the financial system to the broader economy. It can buy different securities from different issuers, and at longer maturities. By making its facilities available on similar terms to all, it can avoid the appearance or the fact of favouring any particular business or region. And because the bank operates at arm's length from government and has a mandate to keep inflation at 2 per cent, neither economic nor political obstacles will stop it unwinding those operations when the time is right.

The upcoming federal fall update and policy hyperactivity abroad have fostered too much talk about mitigating the crisis through government budgets and regulations. If Canada's financial and economic outlook continues to be bleak, an overnight rate of 0.5 per cent would be a better tonic than anything in fiscal or regulatory toolkits. Finance ministers, Washington heavyweights and French presidents are the wrong people to turn to for help working through the slump that now threatens Canada's economy. For that, the Bank of Canada Governor is our man.

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