Bank of Canada exploring closer ties with Ottawa to counter future economic slumps

By Barrie McKenna
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The Bank of Canada is exploring the possibility of working more closely with Ottawa to co-ordinate interest rate relief with government spending to counter future economic slumps.

The proposal comes as the central bank lays the groundwork for the next scheduled five-year renewal of its 2-per-cent inflation target in 2021.

The Bank of Canada is facing a series of emerging risks that could make monetary policy less effective when the next shock hits, deputy governor Lawrence Schembri warned in a speech Thursday to the Manitoba Association for Business Economists.

Higher levels of household and government debt, a long-term decline in interest rates and slow growth are all making the job of central banks more difficult, Mr. Schembri pointed out. Real – or after-inflation – interest rates have slumped to near zero from more than 6 per cent in the early 1990s.

Among the options on the table to strengthen the bank's "monetary policy framework" is to have "more explicit" co-ordination of interest rate moves with government spending plans, he said.

"The experience during the crisis, when both aggressive monetary and fiscal stimulus were used, highlighted the benefits of simultaneous policy action," Mr. Schembri explained.

"Countercyclical fiscal policies, such as automatic stabilizers, and discretionary policies, such as infrastructure spending, are highly effective."

Government stabilizers are programs such as employment insurance, which automatically prop up the economy when slumps lead to higher joblessness.

Mr. Schembri acknowledged, however, that the prospect of the independent central bank working more closely with the federal government raises "governance issues" for both Ottawa and the bank.

The Bank of Canada has stuck with an inflation target since 1991 as the centrepiece of its monetary policy framework. The bank lowers its benchmark rate when growth is weak and inflation appears to be falling below the roughly 2-per-cent target. On the other hand, when the economy is growing at a healthy clip and inflation is starting to perk up, the bank can raise rates to cool things down.

Among other options on the table is an adjustment in the 2-per-cent target, the use of explicit "forward guidance" on where its benchmark rate is headed, large-scale purchases of government bonds and other assets as price-level targeting.

Mr. Schembri's remarks did not touch on the timing of the next rate move by the Bank of Canada, which has raised its key rate three times since last June to 1.25 per cent.