More co-ordination between BoC and federal government must respect bank's independence

By Craig Alexander

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Last week, Bank of Canada deputy Governor Lawrence Schembri gave a speech suggesting that greater co-ordination of monetary and fiscal policy might be needed in the future. He is right. The key to successful co-ordination, however, is two-fold: maintaining the Bank's independence and choosing the most appropriate co-ordination tools.

Let's start with the case for greater co-ordination. Structural changes in the Canadian economy mean that the long-term average level of interest rates will likely be lower than they have been in the past. An aging population and weak productivity growth mean that the trend rate of growth in the Canadian economy will likely be slightly less than 2 per cent annually over the decades to come. Consequently, the neutral level of the Bank of Canada benchmark overnight rate is likely around 2.75 per cent. That is well above the level today, but significantly below the 4.50-per-cent neutral level in the 1990s.

This creates a challenge for monetary policy. When a recession occurs in the future, the scope to lower interest rates will be limited. As monetary stimulus is applied to bolster the economy during a downturn, it would be easy to rapidly approach the zero threshold. Beyond cuts in interest rates, the central bank can deploy non-traditional measures to provide stimulus, such as forward guidance on interest rates and quantitative easing through bond buying, but these have limitations and drawbacks.

Given this reality, a prudent approach would be to have fiscal policy complement monetary policy when the economy needs a boost. There are, however, two key complications.

First, co-ordination cannot be allowed to jeopardize the independence of the Bank of Canada. Politicians should not be involved in setting monetary policy because political goals could supersede economic goals. Indeed, the governing council of the Bank of Canada sets monetary policy without consulting the government for this reason. But co-ordination need not undermine independence so long as the co-operation is done at arm's length. There have been examples in the past when monetary and fiscal policy has been synchronous. The challenge is how to formally structure greater co-operation, and that is not clear.

Second, one should be mindful that fiscal policy often cannot be deployed quickly. Government spending and investment measures can take time to be implemented. As a result, the impact of fiscal stimulus can often be felt after a recession ends, which makes policy pro-cyclical rather than the desired countercyclical. There can also be a tradeoff between speed and impact. For example, the government infrastructure spending in the wake of the 2008-09 recession was focused on so-called shovel-ready projects. These were projects that could be done quickly, but often did not offer the greatest potential economic benefit. More recently, the federal government committed to large-scale infrastructure spending two years ago, but a large portion of the money has been slow to get out the door and provide economic gains.

So, co-ordination of monetary and fiscal policy would be beneficial to stabilizing and/or bolstering economic growth, but it might still pose challenges. One option would be to expand the use of economic policies and programs that are designed to offset fluctuations in the economy, which are often referred to as automatic stabilizers. For example, one could expand employment insurance (EI) so that it covers more workers and increases income support when the labour market weakens. Modernizing EI would also be beneficial because the existing system is designed to serve the needs of traditional full-time workers who experience a temporary job loss. It is not really designed for the precarious workers of today who have contract, part-time or self-employed positions – which is the reality for an increasing number of workers. Other options include wage subsidies to help support employment in bad economic times or a basic income program to provide income security. The expansion of automatic stabilizers can also help the economy quickly without political judgments or considerations.

Again, the call for greater co-ordination of monetary and fiscal policy has merit. And there is already good co-operation between the central bank and the federal government. I also believe that a sustained modest economic growth environment puts limitations on monetary policy. Greater policy co-ordination is called for in the future, but we need to ensure that the Bank of Canada stays independent and fiscal policy stimulus is deployed in the most effective manner possible.

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