Three moves Poloz can still make to stimulate the economy

By David Parkinson
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Minutes after the Bank of Canada slashed its key policy interest rate for the second time in nine days on Friday – with quite likely more cuts to come – Governor Stephen Poloz was asked in a press conference what more he could do to stimulate a threatened economy, with rates rapidly approaching zero.

He assured Canadians that the key rate – cut by half a percentage point on March 4 and by the same again on March 13 – wasn't the only weapon the bank has to help the economy weather the fast-growing COVID-19 storm.

"We have a variety of other tools in the tool kit," he said.

It's a legitimate concern when the Bank of Canada is running low on its most powerful and best-understood mechanism for aiding the economy – and will almost certainly soon be running even lower. The bank's key rate now sits at 0.75 per cent; with the U.S. Federal Reserve slashing its rate to near-zero in a surprise emergency cut late Sunday, it seems inevitable that Canada's central bank will head down the same path, and likely won't wait until its next scheduled rate-setting decision in mid-April to do so. Another half-point cut would bring the rate to 0.25 per cent, matching its all-time low set in the 2009 financial crisis.

Anything beyond that is uncharted monetary policy territory.

Fortunately, central bankers learned some very helpful lessons a mere decade or so ago, when the financial crisis forced them to experiment with new ways to provide monetary stimulus when interest rates in many countries ran dry. From this experience, we can confidently identify three key tools Mr. Poloz could put to work if necessary – what is referred to as "unconventional" monetary policy. We also know that Mr. Poloz doesn't warmly embrace any of them.

Forward guidance

The Bank of Canada itself was a global pioneer in developing and implementing this tool, under Mr. Poloz's predecessor, Mark Carney. This involves a central bank explicitly stating a time period under which it will maintain interest rates at a certain level, and/or the specific conditions that would need to be in place before it would change rates.

The certainty provided by forward guidance has proven remarkably powerful in promoting economic and market stability, something the Bank of Canada experienced first-hand following the financial crisis.

Yet Mr. Poloz found forward guidance to have lingering and problematic side effects when he took office in 2013. He believed that the markets had come to rely on the central bank to tell them what to think and when, and had stopped thinking for themselves – thus distorting the healthy functioning of trading. In 2014, he dropped the use of forward guidance, saying that the bank should only resort to it in times when the policy interest rate was at or near zero. By his own definition, we are headed toward prime forward-guidance territory now.

Quantitative easing

Quantitative easing (QE) was the U.S. Federal Reserve's tool of choice when its interest rates effectively reached zero in the aftermath of the financial crisis. It involves the central bank buying assets on the open market (usually government bonds, though not limited to that) in order to increase the supply of money in the financial system and the broader economy.

While other central banks have also turned to QE, the Bank of Canada has never done so. In a speech just last month, senior deputy Governor Carolyn Wilkins acknowledged that QE "prevented far worse economic outcomes" following the financial crisis. Nevertheless, she said, central banks still don't fully understand the long-term effects of QE. It's a tool that the bank would use with caution.

Negative interest rates

We have learned in the past several years that zero is not, in fact, the lowest point for interest rates. The European Central Bank, for one, has taken rates into negative territory – meaning, in effect, that financial institutions actually pay a small amount for the central bank to hold their deposits. The idea is to create a compelling incentive for banks to lend.

In 2015, the Bank of Canada published a research paper that estimated that it was practical to consider the true bottom of the Bank of Canada's policy rate to be roughly negative-0.5 per cent. But in Friday's press conference, Mr. Poloz made it clear that he sees negative interest rates as a last resort – and an unpalatable one at that.

"I don't think I'm alone amongst central bankers – we don't like the idea that much," he said. "It's not a happy place for the banking system."

Mr. Poloz suggested that negative rates are only a practical option in countries that have run out of "fiscal firepower" – the capacity of governments to spend more to provide economic stimulus. His argument – with Finance Minister Bill Morneau sitting beside him at Friday's press conference, nodding in agreement – is that Canada has room on the government balance sheet to deliver that fiscal boost, so that the Bank of Canada shouldn't have to resort to such desperate measures.

That really is Mr. Poloz's true tool of choice – a co-operative federal government prepared to spend. Which is why Friday's press conference, with government and central bank making a very public display of working literally side by side, was such a big deal. With the central bank fast approaching its limits on conventional rate-cutting, Mr. Morneau must pick up the torch from here – lest Mr. Poloz be forced into monetary policy options that he'd rather avoid.