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It's about balance. When money's tight, fear rules. Loosen the money, ease the fear.; Counterintuitive as it seems, more of what got us in trouble is what's needed to right the economic balance

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To many Canadians, some of the proposed responses to the global financial crisis may sound somewhat perverse. Interest rates that were too low for too long - fostering the housing bubble, commodity price spikes and inflation - were a key cause of the meltdown, so for the Bank of Canada to slash interest rates further sounds like more of the same.

Another major contributor to the crisis was actual or implied government guarantees - not just of deposits and mortgages, but implicit backstopping of financial institutions that were "too big to fail." For the federal government to guarantee interbank lending, as it appears poised to do, might also seem a doubtful cure. These fears, however, are misplaced: If the government delays remedial action, the crisis will inflict unnecessary damage on the economy and Canadians' wealth. Cheap borrowing and what appears to be low-risk lending are indeed dangerous when expectations about the future are buoyant. But now that irrational exuberance has given way to terror, cheap borrowing and apparently low-risk lending are vital to prevent a painful economic contraction.

Rapid action matters because the relationship between expected income growth and the cost of borrowing is key to the financial system's impact on the economy. We are used to focusing on the level of interest rates; it's changes in the overnight rate, the chartered banks' prime business lending rate, and other interest rates that make headlines. Whether a given interest rate supports or retards borrowing and spending, however, depends on how households and businesses feel about the future.

Individuals who expect salary increases, or the value of their houses to appreciate, will find even high interest rates affordable. Likewise, business owners who expect sales growth and healthy profits will borrow, even at rates that look expensive. By contrast, individuals in households fearing unemployment or a collapse in housing prices, like businesses losing customers and facing losses, will hesitate to borrow, even if interest rates look low.

The loss of wealth created by the crisis - and the torrent of bad news about spending, hiring and investment - has turned everyone sharply pessimistic. Many forecasters are now calling for real output in Canada to fall in 2009. If the resource boom that boosted prices and incomes over the past four years turns to bust, Canadians' aggregate income could fall, in dollar terms, for the first time since the 1930s.

Under those circumstances, household and business expectations of future income growth are bound to decline further.

As for interest rates, central banks are cutting their policy rates, and yields on very high quality securities, such as treasury bills, have fallen sharply. Yet, consumer and business lending rates have come down much less, and many would-be borrowers cannot get loans at the posted rates, or at all. Fear of defaults, even among the largest and most secure financial institutions, has caused the spread between yields on government-backed assets and other securities to spike upward.

Absent action to bring those spreads back down, Canadians fearful of the future will find loans expensive. If the prime rate stays where it is through 2009, the gap between it and changes in income will be 5 percentage points or more, threatening continued financial paralysis and economic decline in 2010 and beyond.

So, notwithstanding that in the runup to the crisis interest rates were too low, and borrowing and lending were too reckless, what Canada needs now is lower interest rates, and borrowing and lending unconstrained by fears of large-scale defaults.

Further cuts in the overnight-rate target by the Bank of Canada will help lower the cost of high-quality credit. Constricted lending volumes and high spreads in credit markets mean, however, that a lower overnight rate will not be enough. Elsewhere in the world - most notably, Europe and the U.S. - governments have extended retail deposit insurance, guaranteed interbank lending, and shored up the balance sheets of their financial institutions, sometimes through actual or prospective equity stakes. While Canadian financial institutions are among the world's soundest, these steps by other governments threaten to leave them looking relatively risky and, therefore, unattractive as partners in credit-market and other transactions - meaning that quantity limits and high spreads might affect Canada disproportionately. So Canada should act in this area, as well.

Some moves abroad are highly problematic. Retail deposit insurance, once extended, is politically very hard to take away, so the extra moral hazard associated with inattentive depositors will cast a long shadow into the future. Equity stakes in banks are also hard to unwind, and raise horrendous

governance problems. Guarantees of interbank funding, by contrast, are relatively easy to extend - and to narrow, to charge fees for, and to withdraw as the crisis eases. Such a move would help ensure that easier terms for loans from the Bank of Canada translate faster and more completely into easier terms for loans to consumers and businesses.

Importantly, actions to give the Canadian economy a monetary and financial boost should be quick and decisive. If pessimism about jobs, incomes and sales in 2009 and beyond continues to engulf Canadian households and businesses, even borrowing rates of zero could begin to look expensive.

Concerns about easy money and moral hazard are understandable. But right now, money is tight and fear rules. A quick return to economic growth and stability is the critical task.

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