Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Bank of Canada Watchers

Date: March 13, 2020

Re: **The COVID-19 Monetary Policy Problem**

The Bank of Canada was right to cut interest rates last week, but 25 basis points rather than 50 would have kept valuable firepower in reserve in case, as seems likely, it's needed in coming weeks.

Given the complexity of COVID-19, a cut of at least 25 basis points was likely the right call. The key was to move swiftly and decisively, which the Bank did by following the US Federal Reserve's 50-point reduction last Tuesday.

These moves by the Fed and the Bank of Canada appear to be part of a co-ordinated series of central bank actions around the world to fend off the possible negative economic effects of COVID-19. This initiative has been criticized in some circles, so the macroeconomic effects of the COVID-19 shock and the best response of domestic monetary policy require unpacking.

We think of the negative shock as having three main components.

First, it is a negative demand shock originating abroad. Chinese demand for US and Canadian exports has already fallen and things may get worse. Some sectors of the Canadian economy will feel the impact more than others. Travel and tourism are likely to be severely hit. The correct response for a central bank to a negative demand shock is a cut in the overnight rate to encourage spending both domestically and from abroad. Growth in foreign demand will be determined by both the impact of a rate cut on the exchange rate and the degree to which COVID-19 continues to disrupt economic activity abroad.

Second, it is a negative supply shock. Canadian firms' supply chains have suffered disruptions that may well get worse before they get better. Supply chains for some goods are quite complex and can cross many international borders, and Chinese manufacturers are important links in many of these chains. Falling supply as a result of these disruptions will tend to raise prices. In this instance, the best response of monetary policy might actually be to leave the overnight rate untouched.

However, to the extent that these supply-chain disruptions lower productivity, they cause the so-called neutral rate of interest to fall. The neutral rate, which is linked to capital's productivity, is the rate at which overall saving in the economy equals investment. If capital becomes less productive, investment falls relative to savings, and the real interest rate must fall to encourage firms to invest more and households to consume more and save less. In this context, keeping the overnight rate constant would be tantamount to tightening monetary policy. So, this consideration also calls for a rate cut.

Third, the heightened uncertainty induced by the virus has caused a flight to safety. The demand for safe and liquid assets, including cash, has increased sharply. Central banks typically respond to this kind of situation by pumping liquidity into financial markets, or at least announcing that they stand ready to do so. Indeed, the Bank of Canada's website features the COVID-19-related "Statement of G7 Finance Ministers and Central Bank Governors," in which they promised to continue "supporting price stability and economic growth while maintaining the resilience of the financial system." This statement was short on detail, however, so a complementary rate cut was very much in order.

The last time the Fed cut rates by more than 25 basis points was in December 2008, when it cut by 75 basis points – the Great Recession was already well underway. The Bank of Canada's record includes one 75-basis-point cut in 2008 and five 50-basis-point cuts between March 2008 and March 2009. Unfortunately, the Fed had held the fed funds rate constant between May and October 2008 because of a spike in inflation due to rising oil prices. This prevented it from acting in a more proactive way and helped turn what could have been a milder recession into a major crisis. This time round, the Fed's 50-basis-point cut suggests it is trying to get out in front of a potentially deteriorating situation. The Bank of Canada is doing the same. We would suggest, however, that for Canada, a 25- basis-point cut would have achieved the same outcome, thus holding on to more ammunition should things get worse – a critical consideration when the overnight rate is already starting from a low base.

The size, severity and persistence of these three components is highly uncertain and can be debated. What is clear, however, is that all three components of the negative shock pointed to the need for a cut.

Steve Ambler is David Dodge Chair in Monetary Policy, C.D. Howe Institute, and Professor of Economics, École des sciences de la gestion, Université du Québec à Montréal. Jeremy Kronick is Associate Director, Research, C.D. Howe Institute.

To send a comment or leave feedback, email us at blog@cdhowe.org.

The views expressed here are those of the authors. The C.D. Howe Institute does not take corporate positions on policy matters.