Intelligence MEMOS

From: Martin Eichenbaum

To: The Bank of Canada

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Re: **Planning for the Next Big Recession**

The Bank of Canada normally responds to the threat of a large recession by aggressively cutting interest rates. It won't be able to use this strategy the next time around: short-term interest rates would hit zero before the job is done.

Instead, the bank will have to rely on large-scale purchases of long-term financial assets (quantitative easing) and a big depreciation of the dollar. While helpful, these policies are unlikely to be as effective as the bank's traditional strategy.

Its benchmark interest rate is now only 1.75 percent, well below the 4.5 per cent on the eve of the 2007 financial crisis. Long-term interest rates are even lower. There is no reason to expect that these rates will rise substantially in the foreseeable future.

So what happens the next time the Bank of Canada is called on to combat a big recession? Last time, it dropped its policy rate by 4.25 percentage points, but no one thinks there could or should be a cut from 1.75 percent to negative 2.5 percent. Economists refer to this problem as "the effective-lower bound" constraint on interest rates.

The Bank of Canada is currently reviewing alternative long-term strategies to deal with the effective-lower bound problem. The set of alternatives should be expanded to include allowing for wider swings in inflation over time in an effort to fight incipient downturns.

The latter strategy would entail the bank lowering the threshold for the risk of a downturn that causes it to cut its policy rate. Such a policy shift could temporarily drive inflation above its 2 percent target, but increased risk aversion about an economic downturn is justified given the effective-lower bound problem. If downturns are costlier than they used to be – because they're harder to escape –policy should reflect that fact.

It would take a long time to convince politicians of the wisdom of such a substantial change to the current inflation-targeting regime. It would take even longer to credibly communicate it to the public. We may not have the luxury of time before Canada faces the prospect of a severe recession. The much-discussed list of things that could go wrong is long and daunting.

What should the bank do in the face of this challenge?

First, it needs to decide what to do if there is a severe recessionary shock before any new long-run strategies are in place. In 2015, the Bank updated its general framework for conducting policy in a low interest-rate environment. That framework involves a discussion of the general tools at its disposal. It would be good for the bank to articulate its strategy, as concretely as possible, of how and when it would use these different tools.

As the Federal Reserve, the European Central Bank and the Bank of Japan have done in the past, the Bank of Canada will almost certainly want to engage in large-scale purchases of long-term financial assets ("quantitative easing") to drive long-run interest rates down. But which assets should they purchase? Government debt? Mortgages? High-quality corporate debt? Stocks (as in Japan)? Canada is only one of the many players in global markets. In making its choices, the bank needs to ask the hard question: what yields can it have a substantial impact on?

Second, the bank needs to communicate its strategy to the public. Critically, it needs to manage expectations about what it can accomplish with various programs.

Third, during a severe recession the bank should allow a substantial depreciation of the Canadian dollar, which would encourage an increase in net exports and the net demand for products produced by Canadians, which is just what we need in a deep recession.

One can also foresee that exchange rates will probably depreciate more in future recessions for at least two reasons. First, the bank's new tools probably won't be effective as its old tools, which means recessions will be larger as will the depreciation of the Canadian dollar. Second, quantitative easing will directly contribute to that depreciation as some investors redirect their investments towards foreign assets.

Because of its dependence on commodity exports, the Canadian economy is particularly sensitive to global downturns. That means the Bank of Canada is particularly exposed to the effective-lower bound constraint on short-term interest rates. It is incumbent on the bank to communicate its strategy for dealing with that problem. Canadians need to be prepared for the bumpy road ahead that we will almost certainly be travelling.

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