Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Governing Council at the Bank of Canada

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Re: **The Path Forward for the Bank of Canada**

As economists, rather than epidemiologists, infectious-disease doctors or tea-leaf readers, we cannot tell readers whether this pandemic will end in three weeks, three months, or later. But it will end, and if central bankers and fiscal policymakers continue on the path of responding to this crisis with the urgency they have, it should have the V-shaped recovery economists talk about.

Judging by the downward gyrating of world stock markets, however, more is likely needed from policymakers, both fiscal and monetary.

What is missing from a monetary policy perspective is a clear outline of the path forward, the steps that can be taken in the short, medium and long term.

First, the short term. The Bank of Canada has already lowered the overnight rate target by 100 basis points in less than two weeks, and it now sits at 0.75 percent. It appears very likely that the rate will fall further in the near future.

We have **written** on the need for a cut to stimulate demand during this crisis, even if the coronavirus shock is a supply shock arising from disruption to firms' supply chains.

However, if restaurants, bars, cinemas, stadiums and arenas, concert halls, etc., are shut, and travel is severely restricted by decree, it is hard to see how making it cheap to borrow to spend will have much of an impact. In the current situation, both firms and households are likely to be facing severe liquidity crunches, and banks' loan portfolios have suddenly come to look much more risky. This will likely hamper banks' willingness to lend to each other in overnight markets. This is why the bank's well thought-out plans to provide liquidity to financial markets is likely to be more beneficial than its rate cuts in the short term.

Second, the medium term. If the Bank of Canada lowers the overnight rate to zero (or near zero), the question becomes what tools does it have if more support is required. While zero is no longer the lower bound, negative rates in Canada are yet to be tried, and their success abroad is mixed at best. Canada was successful with forward guidance – the art of convincing markets you will leave the overnight rate at zero for as long as necessary – during the 2008 financial crisis. This should be the first step the Bank of Canada takes in terms of unconventional monetary policy.

If forward guidance proves insufficient, the Bank of Canada has other tools in its toolbox. Most notably, they could turn to quantitative easing (QE). Unlike most other countries, Canada did not have to use quantitative easing (QE) during the crisis. QE involves central bank purchases of government bonds (or other kinds of debt) so as to push down yields on these securities and stimulate borrowing and lending activity as a result. The evidence on the effectiveness of QE is mixed, but as we have written **elsewhere,** the key is for a central bank to credibly establish a firm end point over the medium run for the level of a nominal aggregate, which could be the level of nominal GDP. By committing to a higher path for monetary aggregates, QE can also affect inflation expectations, which has the effect of lowering real interest rates and stimulating spending.

Lastly, the long run. If the economic recovery is in full swing, and the neutral rate (the rate at which the economy is neither overheating or underperforming) returns to its pre-COVID 19 range of 2.25-3.25 percent, the bank will look to bring the overnight rate back up. The bank's job is to hit the 2 percent inflation target, and that will continue to be its focus. But there is no doubt that raising the overnight rate will be more difficult than lowering it. The highest overnight rate since the financial crisis was 1.75 percent, far from the peak of 4.5 percent in July 2007. In our view, the Bank should outline as part of its communication strategy its views on returning the overnight rate to neutral, guided by its 2 percent inflation target.

These are unprecedented times. The future is uncertain. Outlining the path forward might bring some comfort.

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