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It's crunch time, Canada; Getting banks to match the demand for credit in a recession doesn't make much sense. The Bank of Canada has to jolt the economy into recovery or we will fall even further

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September's worldwide credit crunch saw financial institutions become unwilling to lend to each other, on almost any terms, let alone to anyone else. They were trying to strengthen balance sheets and increase liquidity after the shock that the failure of Lehman Brothers administered to a system already weakened by the U.S. subprime mortgage fiasco.

The real slowdown that is now gathering momentum is the crunch's direct consequence. Households and firms that do not borrow do not spend; firms that do not sell do not produce and do not hire, and so on.

Locally, the Bank of Canada has responded by halving its already falling target for the overnight rate to 1.5 per cent from 3 per cent, providing more cash to financial institutions and further strengthening their balance sheets by exchanging treasury bills for private paper. When announcing its latest target interest-rate setting, the central bank cautiously suggested that "money markets and overall credit conditions in Canada are responding to significant ongoing efforts to provide liquidity to the Canadian financial system."

So far so good, perhaps, but neither far enough nor good enough, because accumulating evidence suggests that the financial system is not so much recovering from a credit crunch as heading into an insidiously destructive "credit deadlock." The term belongs to the British economist Ralph Hawtrey and refers to the reluctance of firms and households to borrow in a depressed economy even when financial markets appear otherwise functional, hindering the monetary expansion needed for recovery.

Consider interest rates. Nominal rates are down, but when the overnight rate was 3 per cent in early September, most people probably thought that inflation over the next year or two was likely to run somewhere between 2 and 3 per cent, implying a real rate close to zero. Year-on-year inflation rates have remained above 2 per cent since then, but these are a poor guide to the future in current circumstances. Since September, Canadian consumer prices have actually fallen, while output and labour market indicators have soured. A period of very low inflation, perhaps even deflation, now looks likely.

If Canadians are factoring all this into their expectations, then real interest rates have risen significantly in the past few months. Moreover, with jobs insecure and savings disappearing, consumers are now less willing to borrow at any given level of real interest rates. So too are firms, as product markets contract.

In short, falling nominal interest rates are masking a dangerous tightening of monetary policy's stance at the very time when more monetary stimulus is needed, but it is becoming more difficult for the Bank of Canada to provide enough of it by merely cutting overnight interest rates, or by providing liquidity through purchase and resale arrangements.

These measures leave too much to the initiative of financial institutions, which are interested in expanding their liquidity only to the extent needed to comfortably support the level of business that their customers seem to want with them. That level reflects an already depressed economy, and hence is insufficient to promote its recovery.

At this juncture, there is little point in Finance Minister Jim Flaherty and Bank of Canada Governor Mark Carney exhorting the banks to do better. Rather, the Bank of Canada needs to take the initiative in providing the financial system not with all the liquidity it wants, but with more than that. Only this will push financial institutions into becoming more aggressive lenders, as they dispose of excess cash holdings. The central bank could also enter the open market to buy assets directly from the non-bank public, furthering the goal of getting so much liquidity into the hands of households and firms that they too will increase their spending.

This is where fiscal stimulus fits in. Well designed, it can have immediate and beneficial effects on the sectors toward which it is directed; but more important for monetary policy, it must be financed by the sale of government bonds. If those bonds' initial purchasers are in the financial system, or among the public at large, the Bank of Canada can then actively buy them up, as part of its efforts to force liquidity into the economy; a few intermediate transactions could be eliminated, while achieving the same ultimate result, were the central bank itself to be the bonds' initial purchaser.

These recommendations will horrify anyone who believes that fiscal deficits financed by money creation are an inflationary route to ruin. So they are when the real economy is running near its capacity and financial markets are functioning normally. But when the real economy is depressed, and when deadlocked financial markets seem to be functioning normally, but in fact are providing insufficient

stimulus to support a real recovery, those same policies will encourage the spending needed to restore normality.

In the early 1930s, U.S. policy makers were misled by the false signals of returning financial market normality to which a developing credit deadlock gave rise, and they let it grow into the Great Depression. In the early 1990s, the Bank of Japan made a similar mistake and failed to take advantage of the opportunities for aggressive monetary expansion provided by a fiscal stimulus program, thus helping ensure that the 1990s became a lost decade.

U.S. credit markets are now emitting similar misleading signals, but, to judge from recent announcements, the Fed has seen through them this time. So are Canadian markets, and the Bank of Canada should follow the Fed's example. It is, after all, assigned to keep inflation at 2 per cent, and the way things are now developing, that is going to require quite an expansionary effort over the next year or so.

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