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The Bank of Canada Needs to Nurture those Green Shoots of Recovery

By

David Laidler

- To encourage new growth in the Canadian economy, the Bank of Canada should be actively irrigating financial markets with a growing money supply.
- Recovery needs support from the continued credibility of the Bank's 2 percent inflation target – but there are signs that this credibility is fading over short time horizons, dampening low interest rates' positive effect on spending.
- While money supply growth – a neglected leading indicator of economic performance – has recently recovered from its late 2007 setback, the Bank of Canada should pursue quantitative easing to keep it growing vigorously.

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Perhaps anticipating the arrival of spring, after four months of falling prices, Canada's inflation rate turned positive in February. Still, any green shoots of recovery, like those that Federal Reserve Chairman Bernanke recently claimed to see in the warmer south, are likely to sprout here only if we keep the monetary sprinklers running a while.

The economy's return to a level of performance consistent with hitting the Bank of Canada's 2 percent inflation target will depend heavily on events in the US and elsewhere, but two crucial factors that Canadians can control are the evolution of inflation expectations and the growth of the money supply. Despite falling prices, the Bank of Canada has until recently continued to characterize expectations as firmly anchored to its medium-term 2 percent inflation target.[1] If this is right, expectations of imminently rising inflation will act like spring rain on those green shoots of economic recovery, encouraging firms and households to increase spending while prices remain low, and the economic garden will begin to flourish.

This is how inflation targeting is supposed to work. Unfortunately though, the timely arrival of gentle showers seems uncertain. Canadians' inflation expectations have been declining, particularly at shorter horizons, and show signs of becoming detached from the Bank's 2 percent target.

This e-brief draws heavily on research carried out by Robin Banerjee, who bears no responsibility for the uses to which it is put here. Colin Busby, Ben Dachis, Finn Poschmann and Bill Robson, who commented helpfully on an earlier draft, are also blameless.

1 For example, in its January 22, 2009 *Monetary Policy Report Update.*

The speed of the world economy's slowdown in the final quarter of 2008, accentuated by the failure of Lehman Brothers, surprised policymakers everywhere, not least in Canada, where commodity export prices had remained strong through the summer and dampened the local effects of the world-wide recession's earlier phase. Like every other policymaker, the Bank of Canada has spent the last six months scrambling to catch up with events, and in the interim, inflation expectations have been falling.

Consider:

- Expectations implicit in the yield spread between conventional and real return bonds fell from 2.4 percent from 2008 Q3 to 1.5 percent in February 2009;
- The "consensus forecast" of Canada's inflation rate for 2009 yielded by a regular survey of informed observers declined from 2.2 percent in 2008 Q3 to 0.7 percent in January 2009;
- In the Bank of Canada's own quarterly survey, the fraction of firms expecting CPI inflation of 2 percent or less over a two-year horizon increased from 19 to 78 percent between Q3 2008 and Q1 2009;
- The fraction of firms in a recent Conference Board of Canada survey expecting the prices of their own products to rise over the succeeding six months by less than 2 percent increased from 61 to 89 percent between Q3 and Q4 2008;
- Between October 2008 and this January, the Bank's own base-case forecast for year-on-year CPI inflation for the period ended Q4 2009, fell from 1.6 to 1.1 percent and that for "core" inflation fell from 1.7 to 1.1 percent.[2]

Each of these indicators has its own well-known faults, and is easy to discount in isolation; but when they all give the same message at the same time, we should pay attention. Over a one- to two-year horizon, inflation expectations are no longer firmly anchored at 2 percent. Were the credibility of inflation targeting at longer horizons not still confirmed by the consensus survey's prediction of a return to 2 percent inflation by 2011, further weakening of household and business spending would have to be feared. It remains to be seen how secure that credibility will prove to be as the recession continues.

As it is, low and falling shorter-term inflation expectations have worked to offset the impact of the substantial cuts to short-term nominal interest rates that the Bank of Canada began to engineer in 2007, and whose pace picked up in late 2008.

Consider the chartered banks' prime lending rate, a representative example of the non-bank public's borrowing costs. Since July 2007, this rate has fallen from 6.25 percent to 2.50 percent, but, using the Bank of Canada's year-ahead forecast of core inflation for the relevant adjustments, its real value has fallen only from 4.05 to 1.35 percent (Table 1). Given the collapse of the Canadian economy's real prospects over the same 18-month period – output was growing at

2 The first four pieces of evidence cited here are taken from the Bank of Canada's tabulation of "Indicators of Capacity and Inflationary Pressures for Canada" http://www.bankofcanada.ca/en/rates/indinf/.html. The figures for the Bank's inflation forecasts are averages of those for the last two quarters of 2009 given in Table 4 of its January 2009 *Monetary Policy Report Update*. The core inflation forecasts used in Table 1, below, are, in order, those for the first half of 2008, the first half of 2009 and second half of 2009. They are taken from various Monetary Policy Reports, specifically July 2007, Table 1; July 2008, Table 3; and January 2009, Table 4 (for January 2009, an average of forecasts for the 3rd and 4th quarters is used).

Table 1: Nominal and Real Values of the Prime Lending Rate

Date	Prime Lending Rate	Expected Inflation (Bank of Canada's year-ahead inflation projection)	Implied Real Prime Lending Rate
		Percent	
7/07	6.25	2.2	4.05
7/08	4.75	1.9	2.85
3/09	2.50	1.15 (Jan)	1.35

Sources: Bank of Canada (see footnote 2) and author's calculations.

an annual rate in excess of 3 percent in mid-2007, and is now into its second quarter of contraction at a similar annual rate – the amount of extra monetary stimulus implicit here is modest, perhaps even inadequate.

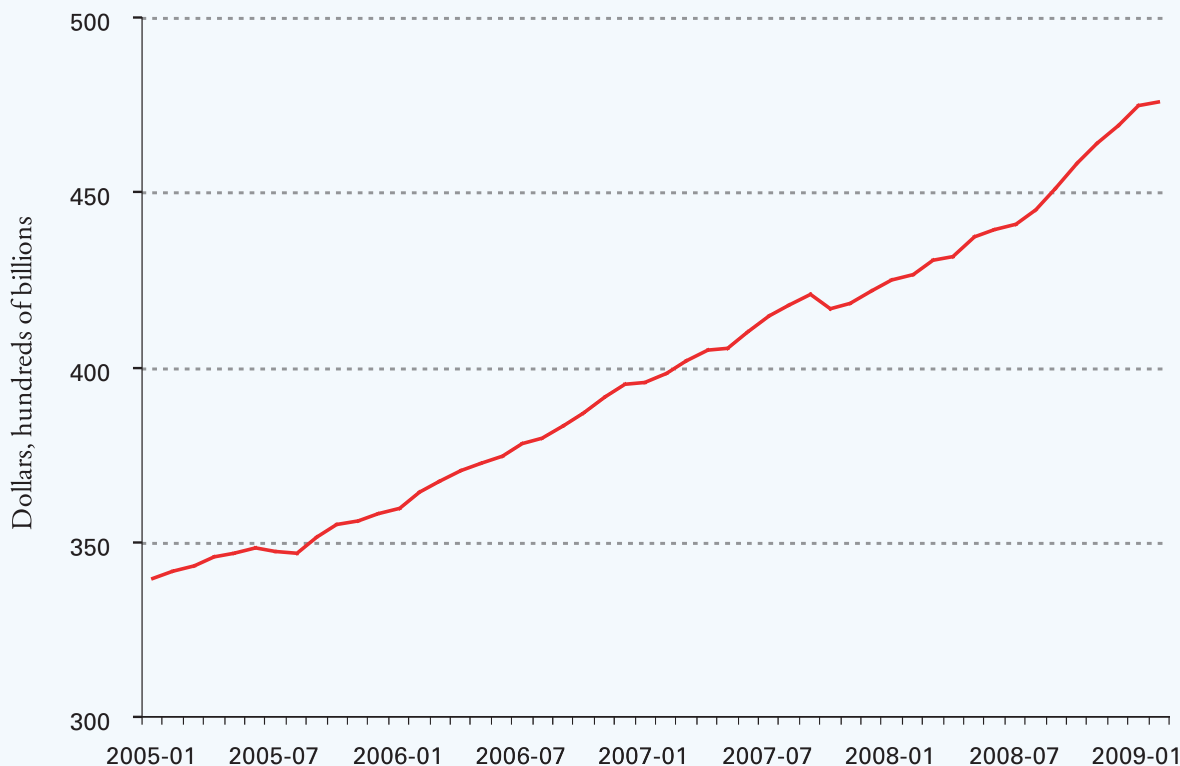
If spring rain is not yet falling, then Canada's economic garden surely requires a thorough monetary watering, and until very recently, it hasn't had it: hence the need for "quantitative easing," a new phrase for an old-fashioned policy measure: increasing the size of the Bank of Canada's deposit liabilities to the clearing system to encourage faster money growth – growth that overnight interest rate cuts would suffice to generate in normal times. Money supply growth slowed down unusually abruptly in late 2007 in the wake of the local collapse of the market for asset-backed commercial paper (Chart 1).[3] The slowdown did not last long, but it left the level of the money supply below its long run trend until late 2008, when the Bank's interest rate policy – importantly supplemented by measures designed to take risky assets off financial-sector balance sheets – began to overcome this setback, and by January 2009, the year-on-year growth rate had reached a more encouraging pace, above 12 percent per annum.

More encouraging certainly, but perhaps not enough, because although a growth rate for M1+ of around 7 percent per annum seems to be needed to sustain 2 percent inflation in normal times, current times are not normal.[4] It is a fair bet that there will be a positive impact on demand later this year if current money growth is sustained, but no one can be sure that this will be enough to offset all the other negative factors currently at work – not least the tendency for Canadians to hang on to more cash than usual as a precaution against an uncertain economic outlook.

3 Using M1+ (gross), the narrowest transactions-related monetary aggregates for which the Bank publishes readily available data.

4 The most recent empirical paper on such topics cited on the Bank of Canada's own website is a decade old – See Bank of Canada (1998). Previous C. D. Howe Institute work – see for example, Laidler and Robson (2004) – has stressed the fact that, when the supply of transactions-related money exceeds the amount that the public demands , increases in the pace of real economic activity usually follow about three quarters later. Recent work by Robin Banerjee carried out at this Institute suggests that such a relationship might still hold for M1+. This work also finds an elasticity of demand for M1+ with respect to real national income of around 1.6 – considerably higher than that which seemed to rule for the old and now abandoned net M1 aggregate – and it is this estimate which underlies the rough and ready estimate offered above of the rate of money growth needed to sustain inflation at 2 percent when the economy is growing at a usual real rate of approximately 3 percent per annum.

Figure 1: Level of M1 + (Gross)



Source: Bank of Canada.

Currently, actual and shorter-term expected inflation are both well below 2 percent, and the economy's real contraction will continue to exert downward pressure on both for a while yet, so were the Bank now to inadvertently over-stimulate the economy, the worst risk would be inflation returning to 2 percent earlier than its 2011 forecast date, leaving little time to tighten up in anticipation of this event. But it is hard to see that the consequences here would involve a really serious inflation-overshoot, and harder still to believe that such an outcome would be worse than the consequences of excessive monetary caution: namely continued economic sluggishness and a steady erosion of confidence in Canada's inflation targeting regime just as the 2011 deadline for its renewal and possible refinement is beginning to press.

With policy interest rates now about as low as they can go, the Bank of Canada should therefore ensure that money growth is sustained at, or above, its current rate in the coming months. Without such continued monetary irrigation, any green economic shoots that do appear will quickly wither, and if its application turns out to be over-enthusiastic and to nourish a few inflationary weeds, these ought to be recognizable early enough to be dealt with before they can take over the entire garden.

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David Laidler is a Fellow-in-Residence at the C.D. Howe Institute

For more information call David Laidler at 416-865-1904.

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