We Should Be Thankful Stephen Poloz Understands Monetary Policy's Limits

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The Globe and Mail, February 23, 2016

For the six years after 2008, many Canadians recognized the aggressive actions taken by the Bank of Canada to stimulate our slumping economy. With the dramatic decline in the world price of oil over the past 18 months, many seem to expect equally aggressive actions. But they shouldn't—instead, they need to recognize the genuine limitations of monetary policy.

Let's begin with what monetary policy can do very well. When the Bank of Canada expands or contracts its balance sheet, it exerts a powerful influence on market interest rates, ranging from the overnight interest rate to yields on longer-term bonds. Such movements in market interest rates, which affect all regions and sectors, lead to changes in aggregate demand that, in turn, drive movements in real GDP.

When Canadian households are pessimistic about the future and reluctant to spend, lower interest rates on lines of credit can lead them to increase their spending, and lower mortgage rates can induce them to purchase new homes. Similarly, when Canadian firms are reluctant to expand their operations because they lack confidence about the future, lower interest rates can induce them to make new investments.

These are exactly the conditions that we faced between 2008 and 2014. The global financial crisis led to a widespread and long-lasting collapse in confidence, and the Bank responded appropriately with significant and sustained interest-rate reductions.

This policy response worked very well after the onset of the crisis, but the last few years also reveal a fundamental weakness of monetary policy. With sustained pessimism about the future, fuelled by a global economy that shows declining overall growth and also some isolated signs of real trouble, even low interest rates may not be enough to spur on private spending.

The famous British economist, John Maynard Keynes, emphasized the role of "animal spirits" in determining private spending; he argued that there were times when even aggressive central-bank actions would be quite ineffective in sparking aggregate demand. The Bank of Canada's governor, Stephen Poloz, has recently echoed these sentiments when he stated that with interest rates already so low, further reductions might have little impact.

Now let's consider something monetary policy can't do well at all—deal with the massive decline in the world price of oil. As a major oil exporter, the price decline leads to a large reduction in Canadian income and spending power. But these negative impacts aren't evenly spread across the country; they're concentrated in the oil-producing sectors and regions. To make things even more uneven, the many sectors and regions that are net "users" of oil are actually helped along by the price decline.

A fall in the world price of oil therefore produces a very different economic environment than an economy-wide slowdown in consumption and investment. What can monetary policy do in response?

The lower oil price will eventually lead labour and capital to flow out of oil-producing sectors and regions toward other parts of the economy. Relative wages and prices will adjust, although not fast enough to prevent increases in unemployment, idle capacity, and bankruptcy. Canada's oil output will eventually fall, but our labour and capital will end up producing more of other things. As a nation, we are surely worse off as a result of the price decline, but our resources will eventually be better positioned to operate in a world with very different relative prices.

Monetary policy can do very little to help. The decline in a key relative price, driven by powerful global forces, is simply not the kind of shock monetary policy is designed to address. The best a central bank can do is hope that its expansionary stance will ease the necessary transition of labour and capital. But it certainly can't stop this transition, and it shouldn't try.

Few people like to talk about the limitations of monetary policy; far too many like to think that central banks can confront and solve any economic problem. But this simply isn't true.

The Bank of Canada controls a policy instrument that is very effective at dealing with some economic situations, and Mr. Poloz and his predecessor employed this instrument to great effect over the past several years. But this same instrument is far less effective at dealing with the negative impact of falling oil prices, and Mr. Poloz's hesitance to use it shows that he understands these limitations. We should be glad that he does.

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