Monetary Policy

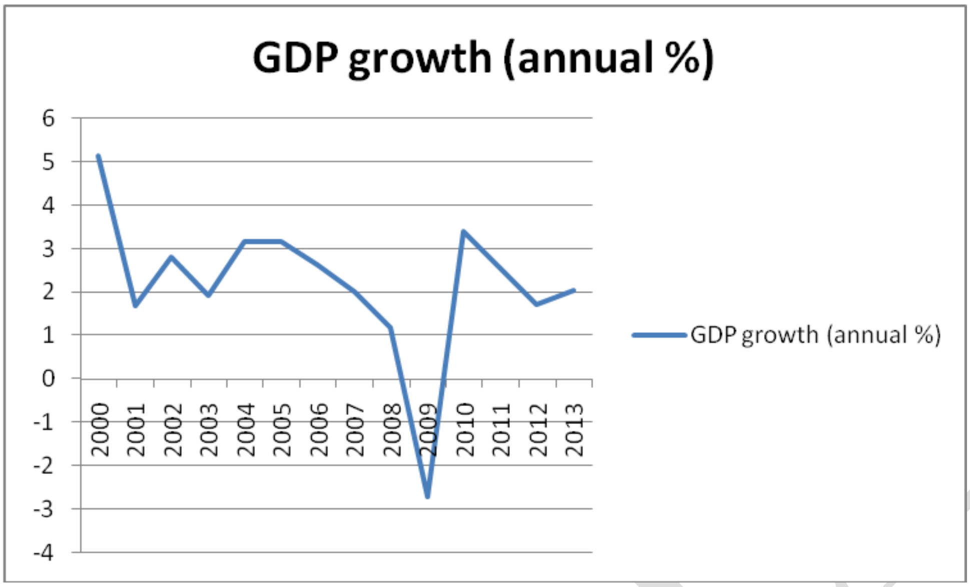
Introduction

Monetary policy is one of the most effective tools that have been used by policy makers around the world to stimulate economic growth of a country. Monetary policy has the power to influence the price level of an economy and this in turn has the influence the economic growth of a nation. Aggregate demand of an economy can be stimulated by devising a favourable monetary policy (Carbaugh, 2013). If the economy is in the state of recession then the Central Bank of the country tends to follow an expansionary monetary policy to boost the aggregate demand and stimulate economic growth. Similarly, a contractionary monetary policy is followed to prevent inflationary boom (Mankiw, 2014). The purpose of this paper is to explore the impact of global financial crisis on the economy of Canada and the way in which it had affected the economy. The policies taken by the Central Bank of Canada in order to solve the crisis has also been discussed. The idea is to explore the effectiveness of the monetary policy in Canada and the way in which the government of the country has devised ways to pull the economy out of the grim phase.

Background of country

The economy of Canada is a largely market driven one and the government aims to establish a close integration with the world economy. The economy has undergone successful transformation from an agricultural economy to an economy that is largely driven by burgeoning manufacturing and service sector (CIA, 2014). Agriculture is a minor activity in Canada accounting for less than 2% of the GDP, construction services provides job to many and accounts for 13% of GDP whereas the services sector employs majority of the people in the economy and its share is 18% (CIA, 2014). The government of Canada has successfully increased the extent of foreign trade in the country mainly by signing two agreements, the US-Canada Free Trade Agreement and North American Free Trade Agreement (CIA, 2014). Both of these agreements had successfully helped in the tight integration of the Canadian economy with the world economy. The U.S.A. is the largest trading partner of Canada and imports three-fourth of the merchandise that is exported from Canada (The World Bank, 2014).

Figure 1: GDP growth rate of Canada



(Source: Author's creation)

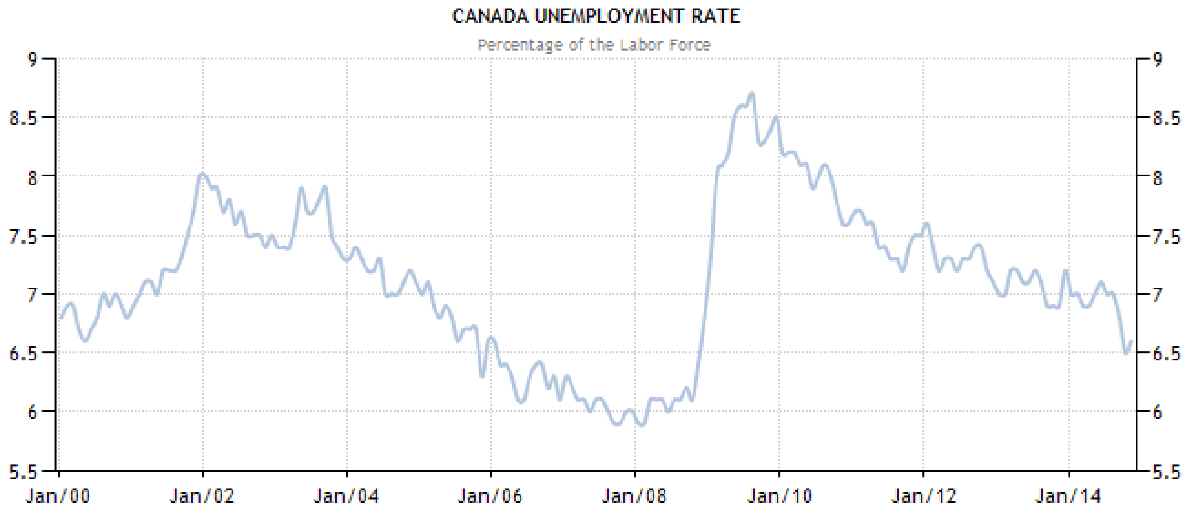
Prior to the global economic crisis the economic growth of Canada was largely fuelled by the impressive growth of the energy sector and rising oil prices. As of 2013 the GDP of Canada had reached a value of $1.518 trillion (CIA, 2014). This was supplemented by the productivity growth of the skilled labour force and modernization of the economy. However, the situation had begun to deteriorate after the crisis and in 2009 the economy had registered a negative growth rate (The World Bank, 2014). The government of the country had taken some prudent macroeconomic policies to combat the existing situation and the country had again achieved significant growth in 2010.

Impact of the global financial crisis

U.S. economy as it was the epicentre of the crisis so the impact on Canada was profound. Close trading relations with the U.S. and strong financial connection had caused the growth of the Canadian economy to plummet in the first year of the recession. Two major factors had caused the growth of Canada to slow down. First was the fall in the global demand and second was the spill over that occurred from the financial crisis. Specific industries like the automobile sector had suffered particularly due to fall in global demand. Most of the researchers and analysts agree that the impact of the financial crisis was not very strong on Canada (Bergevin, 2014). Canada was almost unaffected by the sovereign debt crisis of Europe but the ties with the U.S. had affected the country. The temporary losses resulted from three main areas: firstly the drying up of funds for financing economic activities as borrowing money became highly costly, secondly the fall in demand for the domestically produced goods and the third one is the fall in the profits of the commodities due to the decline in the prices of the commodities.

The impact on the unemployment front of Canada was also comparatively smaller and this could also be attributed to the wise macroeconomic policy reforms of the government. The unemployment rate of the country had reached the 8% mark which was highest compared to the value in the last eight years.

Figure 2: Unemployment rate in Canada



(Source: Trading Economics, 2014)

It can be clearly seen from the graph that the recession had particularly affected the labour market of Canada in a negative manner. Job losses were recorded in all the major sectors of the economy like construction, energy sector and manufacturing. More than 34000 jobs were lost in the manufacturing sector while the job losses in the energy sector were 11,000 people. Youth unemployment of the economy had also suffered negatively and in 2009 the estimated value of youth unemployment reached 14.9% (International Law Office, 2014). Those who could retain their jobs had also experienced a decline in their real wage rates. For instance, the real wages of the full-time workers fell from C$930.84 to C$926.34 (International Law Office, 2014).

The capital position of the bank and their ability to bear the external shocks had shielded them from the crisis. Activities like the sub-prime lending and securitization were almost negligent for the Canadian banks which had primarily shielded them from the crisis. 75% of mortgages were held by the financial institutions in a manner which did not pose much risk. In a recent research conducted by Duttagupta and Barrera (2009) it was revealed that the effect of the financial crisis was small in Canada. However, their research had also suggested that in order to ensure a proper sustained recovery, the revival of the U.S. economic growth was mandatory. Especially the real GDP growth of the U.S. and improvement in the lending standards were crucial for the Canadian economy.

Measures taken by the Central Bank

In retrospect, the Central bank had first reacted to the crisis by cutting down the interest rates. This monetary policy tool of Central Bank of Canada became one of the primary ways to control the negative impact of recession. Overnight interest rates were regulated strongly by the Central bank. The theory of monetary economics states that controlling the interest rates helps in influencing domestic asset prices, general interest rates of the market and finally the domestic demand of the country (Macklem, 2010). Economists have stated that the connection between the demand and the level of production capacity of the market (Mishkin, 2007). The Central Bank of Canada had also understood that the labour market of the economy also has an impact on the inflation rate and began to closely monitor the unemployment rates in the country (Zmitrowicz and Khan, 2014). This action of the Central Bank of Canada can be described as forward looking. Researchers like Gertler and Karadi (2011) had pointed out that it is best if the monetary policy is devised in a forward-looking manner. The chief rationale behind this law is that there is considerable lag from the point of time the monetary policy is implemented to the point where the actual effects on the output and the inflation materializes. This implies that if the monetary authorities try to control inflation once it appears then the process becomes very costly to control (Blanchard, et al., 2012). Bank of Canada had particularly used open market mechanisms in order to enhance its commitment towards maintaining the low overnight interest rates (Historica Canada, 2014). However, the open market mechanisms were not fully implemented by the Bank to ease the pressure of the overnight interest rates. Historically the bank had relied less on the open market operations and only considered it as a viable option if the cash management is unable to generate sufficient growth. Purchase of 3 months treasury bills were made to provide monetary stimulus (Historica Canada, 2014).

The interest rate was lowered and brought as low as 1% which was the lowest in the 75 year history of the country (Bank of Canada, 2009). The bank had also closely monitored the inflation target to ensure that the impact from the monetary policy can be maximized. The inflation target of the economy was kept at 2% and the monetary policy was designed in this manner to boost the confidence of investors in the economy. During the recessionary phase, the central bank of Canada had decided to follow the policy of forward guidance (Department of Finance, 2009). In this process the Central Bank announces that the interest rates are going to be maintained at a low level even if the full employment and output is achieved in the long-run (Bank of Canada, 2014). The economic rationale behind this policy is to control expectations of the investors in future and continue investing in the economy. The policy makers knew that by announcing the future interest rates they will help the key economic agents to predict the extent of excess demand or supply in the economy. This in turn helps to have an overall understanding about the future rate of inflation and the risks that are associated with it (Mishkin, 2007). Additionally the bank has also developed a flexible and symmetric inflation targeting framework which can help to monitor inflation in a better manner.

The Central Bank of Canada had also devised measures to reduce the cost of borrowing for business enterprises so that the domestic demand could be boosted. For instance, the overnight rate was reduced by $1/4^{th}$ of a percent and the bank rates were also reduced by 1/2 percent. The deposit rates were however not altered. The bank thought that maintaining the interest rates close to the lower bound would have helped the forward guidance policy framed by the government. From an economic point of view the monetary policies that were taken by the Bank of Canada can be largely considered as unconventional (Lane, 2014). This is because Central Banks largely control the monetary policy of a country by three main processes namely the open market mechanism, discount rate and changing the reserve requirements (Rochon and Olawoye, 2011). These policies were however not utilized during the financial crisis. A significant amount of research regarding the policies of the central banks of developed countries during the financial crisis reveals that the governments had realized that conventional monetary policies were unlikely to work during this period.

The Bank of Canada had realized that in order to boost the economy it should follow its commitment of maintaining the interest rates lower through the entire 2010. The Bank had also decided to influence interest rates which had longer period of maturities. The biggest concern for the bank was to target the inflation as well. The central bank had considered only to maintain the interest rates low if the inflation was low. This provided a sort of conditional arrangement and researchers had shown that it was this conditional arrangement that had particularly worked for Canada. Federal Reserve of the U.S.A. had no explicit assumption regarding the timeframe for which the interest rates would be maintained low in the future. In an insightful research that was conducted by He (2010), the impact of this conditional commitment was explored. His research had pointed out that the conditional commitment of Canada had actually proved to be beneficial for the nation and the interest rates had reached a lower value compared to their previous historical levels. When the Bank of Canada had announced in 2009 that the interest rates would be kept as low as 0.25 percent till second quarter of 2010 the expectations of the financial market regarding the interest rates in the short-run were reframed in a positive manner. As a result of these policies the Canadian economy rapidly started to come out of the recession and the growth rate of the economy had reached higher than the pre-crisis level in 2010 (He, 2010). Therefore, it can be commented that the forward guidance policy had particularly worked for Canada and the efforts of the central bank was commendable.

Critics have often suggested that maintaining a low rate of interest for a prolonged period is actually a high risk for the economy as it creates chances of raising the inflation rates and particularly hurting the profitability of the financial organization. This was particularly the reason for which the Bank of Canada had decided to withdraw the monetary stimulus from the end of 2011 mainly by increasing the interest rates. In 2012, the Bank of Canada had again decided to set its inflation target at 2% and evidences suggest that it has been able to maintain the desired rate (Lane, 2014). However, recently the strain on financial institutions of the country is rising up because of the commitment of keeping the interest rates low. It is expected that the financial institutions may indulge on risk taking activities on account of these policies.

Conclusion

During recession or economic boom the role of the central bank of any nation is of utmost importance as the central banks are in control of maintaining the money supply. In this regard the role of the Bank of Canada has been commendable as the organization has managed to deal with the crisis in an effective manner. The close tie of the Canadian economy with the U.S.A. economy had particularly depressed the demand for the domestic producers in the country. The Central Bank of the country had immediately sprung into action as the economic growth began to plummet and the unemployment scenario became grim. At this juncture the Central Bank had devised a number of unconventional monetary policies which was relatively new. The bank had resorted to forward guidance mainly in order to reinforce the trust of the investors. Additionally, the commitment of keeping the interest rates at a low level was largely conditional depending on the way in which the inflation of the economy had performed. These policies had worked very well for the Canadian economy and the country had rapidly picked up growth which had even crossed the pre-crisis level. The bank was successful in managing the crisis in an effective manner. However, the formidable challenge for the economy in the future is to maintain the robust health of the financial institutions.

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