What is to be done? Stick to 2% solution

Christopher Ragan
Montreal Gazette, November 13, 2008

The economic news is worsening with each passing week, and a Canadian recession appears all but unavoidable. Perhaps it has already begun. It is therefore no surprise that the newly re-elected Harper government is coming under considerable pressure to "do something" about the economy.

What can and should be done? Though politicians rarely say as much, Canadians need to recognize that the business cycle is a standard feature of all modern economies, and that no government has ever displayed the ability or power to prevent recessions. Nevertheless, by making two specific policy commitments, Prime Minister Harper could do much to help the Canadian economy weather the coming storm.

First, the Government of Canada and the Bank of Canada should publicly reaffirm their joint commitment to keeping the annual rate of inflation at or near its current target of two percent. With the prospects of a coming recession, some people are concerned that the economy will enter a phase of "deflation", a period of falling average prices. Though there is nothing necessarily worse about deflation than an equal amount of inflation, many people associate deflation with the extreme economic trauma of the 1930s because that was the last time it occurred. By reaffirming Canada's commitment to inflation targeting, the Government and Bank of Canada would be sending a clear signal that monetary policy will take whatever actions are necessary to avoid deflation; any decline in economic activity that tends to reduce inflation will be met with interest-rate reductions large enough to stimulate the economy and keep inflation on target.

Somewhat paradoxically, there are also fears of an impending *increase* in inflation. Recent government and central-bank actions in support of the banking system injected billions of dollars of liquidity in various ways, from government purchases of banks' equity and troubled assets, to central-bank loans and loan guarantees to financial institutions. The concern is that these massive liquidity injections will be inflationary, even as the economy enters a recession. But the same reaffirmation of Canada's commitment to its inflation target will help to dispel these worries;

inflation expectations will remain anchored at or near two percent, and the actual inflation rate will thus be kept on target more easily.

Economists have known for many years that one of the best contributions central banks can make to our economic well-being is to keep inflation low and stable. By reaffirming their commitment to the current inflation target, Prime Minister Harper and Bank of Canada Governor Mark Carney would be sending a signal that an important foundation of Canada's current relative financial and economic health will remain firmly in place. For many other countries that have displayed less of a commitment to low inflation, especially the United States, such a commitment would be well worth copying.

The second commitment Prime Minister Harper should make is that of maintaining a sensible fiscal policy focused on longer-run considerations, meaning that tax revenues and government outlays should be kept roughly in balance over the next several years. Despite the massive political pressure that will soon appear for temporary tax cuts or boosts in spending, both intended to stimulate the slowing economy, Harper should resist the temptation to fiddle in significant ways with the levers of fiscal policy. What economists call "automatic fiscal stabilization" policy is embedded in the design of the government's tax-and-transfer system and requires no policy decisions in order to take effect. This leaves "discretionary fiscal stabilization" policy, the intentional acts of government designed to increase spending plans or reduce tax rates in the hope of providing greater overall economic stability.

The problem is that experience in Canada and elsewhere, over a great many years and business cycles, shows that such discretionary fiscal changes tend to be slow to design, even slower to implement, and are often driven by political rather than economic considerations. The most effective kind of macroeconomic stabilization policy is done by central banks; their interest-rate decisions can be made more quickly, have a more immediate effect on the aggregate economy, and are far less political. Monetary policy is a blunt instrument, to be sure, but a very effective one.

None of this suggests that the government should commit itself to exactly balancing its books every year. Indeed, with a coming recession, such a commitment would force the government into either reducing spending or increasing tax rates, both of which would exacerbate an already bad situation. However, if the slowing economy does result in a budget deficit, the government needs to announce a clear and credible plan of action for how the deficit will evolve into a surplus by the time the economy is fully back on its feet. By doing so, the government will be signalling that it will keep the public debt-to-GDP ratio from rising back toward the dangerous levels from the mid 1990s. This is a promise we all should value.

*****

Christopher Ragan is an Associate Professor of Economics at McGill University and a member of the C.D. Howe Institute's Monetary Policy Council. Christopher.ragan@mcgill.ca.