

Intelligence MEMOS



From: Jeremy M. Kronick
To: Canada's Governments
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Re: **MAKE THE BANK OF CANADA'S JOB EASIER**

When every party understands its role, better public policy ensues.

For Canada's monetary and fiscal authorities, this means central bankers ensure a stable currency value and governments create conditions for strong economic growth.

Right now, however, inflation is as high as it has been in 40 years, and the economy is potentially heading toward recession. The Bank of Canada is working hard to bring down inflation. If governments were helping to boost the economy's potential, it would make the Bank's job a heck of a lot easier.

With mandates that target inflation – and ones that target maximum sustainable employment as well, such as that of the US Federal Reserve – central banks tend to react primarily to two things: the deviation of inflation from its mandated target rate – 2 percent in Canada's case – and something called the output gap.

This output gap is the deviation between an economy's current output of goods and services versus how much it could produce at full capacity. The output gap is a measure of whether the economy is running too hot or too cold.

If inflation is above its target and/or output is above its potential, central banks increase the policy interest rate to cool things. If the reverse is true, they decrease the policy rate to stimulate things.

Central banks focused on deviations from a baseline are aiming for stability. They stabilize inflation and the economy when it is above or below capacity. That's what the Bank of Canada's policy rate does, and, today, with inflation well above its target, we see rate hikes at a pace and size we haven't seen in a generation.

While it might be tempting to let the economy run hot, we have seen the damage inflation can do beyond just the devaluing of the money in our pockets: strikes, bad investment decisions from a misreading of prices, and tax distortions, to name a few.

We may or may not be nearing the end of this tightening cycle, but there are lessons either way for governments on where to focus their attention to take some of the pressure off the central bank – lessons currently unheeded.

Remember that the central bank is hiking its overnight rate because the economy is running too hot: economic growth exceeds the economy's potential – what can be produced at the maximum sustainable level of employment.

To bring growth and the economy's potential back in line there are two options: decrease economic growth (which is what the rate hikes are doing) or increase our economy's potential. The latter sounds much better than the former, and that's where governments come in.

We cannot directly measure an economy's potential. But what we can do is estimate it by looking at several factors, including trends in the labour market, e.g. how many hours people are working, and how much businesses are investing in machines and equipment to boost productivity.

Government focus should be on policies that increase productivity. When productivity increases, inputs become cheaper, which leads to less expensive output and lower prices. So, as potential output increases, the output gap closes on its own, inflation comes down and smaller interest rate hikes are needed.

What are some of these productivity-enhancing policies? There are many, but one that stands out is Canada's need to boost growth in small and medium-sized enterprises (SMEs).

While it is a nice soundbite that 90 percent of our private-sector labour force works in SMEs, the US number is 47 percent. That reflects Canada's inability to grow SMEs into the kinds of large enterprises that will close the productivity gap between us and our neighbours to the south.

Policies in other countries provide a template Canada can follow to improve our SME growth story. In 2010, the US enacted the *Small Business Jobs Act*, which exempted from taxation capital gains realized on the sale of certain shares in small businesses that were held for at least five consecutive years.

In Israel, SMEs that have achieved a successful liquidity event (e.g., an initial public offering) can reinvest those proceeds into innovation and pay no capital gains tax as long as they do it within two years.

Other examples exist, and other policy levers exist. Any movement in this direction will encourage greater innovation, productivity gains and increase the economy's potential.

While the Bank of Canada is a Crown corporation, it is important to differentiate between the role a central bank plays in the economy and the job of fiscal authorities.

The former creates the conditions for stability, the latter create the conditions for growth. When they work together you get a steady and sustainably growing economy. Sounds pretty good to me right about now.

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