OPINION

# Requiring the Bank of Canada to follow a financial stability mandate is a bad idea

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CONTRIBUTED TO THE GLOBE AND MAIL
PUBLISHED NOVEMBER 24, 2019



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In the coming months, the Bank of Canada's mandate to target inflation is coming up for review. Some have suggested that the mandate should be expanded to include responsibility for financial stability, defined as heading off the imbalances that could trigger a severe financial crisis, such as what the world experienced just more than a decade ago. In a recent C.D. Howe Institute report, we argue, marshalling historical and empirical evidence, that granting the Bank an explicit mandate to target financial stability is not a good idea, and that doing so would create a conflict with its tried and true mandate for price stability.

Calls for central banks to take on responsibility for maintaining financial stability are increasing the world over. But policy-makers need to be made aware that such views are sometimes based on erroneous assumptions. These assumptions include: 1) All financial crises are the same. They are not. 2) We know the size, timing and spillovers from financial crises.

There is no one-size-fits-all response to financial crises. 3) Financial stability policy is capable of being forward-looking. Unlike monetary policy, which has been forward-looking for more than two decades, there is little evidence yet that the same is true for financial stability.

How do we come to this conclusion? Primarily, through a study of past financial crises in Canada and nine other advanced countries from the late 19th century to the present. What one sees is considerable differences in the timing, form and international scope of financial crises; financial crises vary considerably across countries and over time. The cause that has been given prominence since the financial crisis of 2007-08 – credit-driven asset price booms – is only the case for the recent crisis and the Great Depression of 1929-33. The vast majority of crises in other times reflected other factors, including fiscal and current account imbalances, international shocks and idiosyncratic shocks to the banking system.

It is critical to understand that financial crises are created differently, since the upshot is that the Bank would arguably be overburdened by having primary responsibility to prevent them. In particular, the public needs to understand that some decisions in this realm are closer to fiscal policy. This is not to say the Bank should have no role; it should be shared with other institutions.

Moreover, comparing the timing of "financial" or "credit cycles" to the business cycle makes the case for an expanded mandate more questionable, since they don't tend to move in the same direction at the same time. We find a very low correlation between financial cycles over the past century and business cycles as identified by the C.D. Howe Institute's Business Cycle Council. The only exceptions have been during the two "perfect storms" of the 2007-08 financial crisis and the Great Depression.

In both of these cases, the crises were unexpected. Indeed, history often suggests that policy-makers are fighting the last war when it comes to managing financial stability. In contrast, the Bank of Canada, and most other inflation targeting central banks, have had more success at controlling inflation, at least over the past two decades or more. This is thanks in part to improvements in central banks' ability to forecast future economic activity. Yet, even in this sphere, many monetary authorities have also admitted that further improvements can be made.

Any renewal of the Bank of Canada's inflation target, while explicitly acknowledging the Bank's role as one of several agencies responsible for the maintenance of financial stability, should not confuse the public by adding the burden of meeting a goal that it cannot reasonably achieve on its own. Unlike inflation, which inflation-targeting central banks have managed to control within tolerance ranges for more than two decades, financial stability requires a much wider set of tools. If the central bank were to become responsible for these tools, this would bring the institution dangerously close to making political-style decisions.

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