

# Intelligence MEMOS



From: Pierre L. Siklos  
To: Minister of Finance  
Date: July 28, 2017  
Re: **SHOULD WE REVISIT THE MONETARY POLICY TO CONSIDER  
A FINANCIAL STABILITY LINK?**

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In his letter to the Minister of Finance regarding the most recent renewal of the inflation target, dated 21 September 2016, Governor Poloz wrote that: “We conclude that monetary policy should be adjusted to address financial vulnerabilities only in exceptional circumstances”. The same letter goes on to state that: “The existing macroprudential framework in Canada has functioned reasonably well.” In *Central Bank Into the Breach: From Triumph to Crisis and the Road Ahead* (Oxford: Oxford University Press, 2017) I revisit these questions from a global perspective and conclude that on the first point improvements can be made which have a distinctive Canadian flavour while, on the second point, the evidence to support that the existing framework in Canada has done “well” is not clear. Unless we want to wait and see how the next financial crisis will test the current framework, more needs to be done.

Some central banks are wary of being responsible for the maintenance of financial stability while others have had the role thrust upon them. The Bank of England is the archetypical case of the latter, while the Bank of Canada comes closer to the former model. The US is largely a hybrid of the two frameworks. It is far too early to tell how any of these models will fare in the next financial crisis. It is likely that no one model will suit every central bank, either for historical reasons or owing to the structure of the financial system.

As the last financial crisis has taught us, it is unthinkable that the Bank of Canada will be excluded from any financial crisis fallout. And, unless the “exceptional circumstances” Poloz refers to are somehow defined, we may end up with a problematic failure to cooperate, if not coordinate, between the responsible agencies.

Instead, borrowing from the internationally known ‘directive’ included in the *Bank of Canada Act* that assigns ultimate responsibility for defining the objectives of monetary policy to the government, an additional directive should be added so that markets and the public have a clearer understanding of when and how the Bank’s involvement will take place. In particular, this would ensure that the Bank normally sticks to monetary policy while responsibility for financial stability, is clearly assigned between the Bank and other agencies, The Bank need not be entirely responsible for both.

Turning to macroprudential frameworks, the book presents some recent evidence, based on work with a colleague, which suggests that the resilience of the Canadian framework lags behind that of other advanced economies, most notably in the timeliness of the response to any instability as well as the transparency and accountability of the existing framework. In both cases the US, the UK, and the Eurozone are ahead of us.

To be sure, the three economies highlighted were at the centre of recent crises and this makes a considerable difference. However, Canada should use the valuable lessons learned from other jurisdictions to ensure minimal instability during the inevitable next financial crisis.

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1 See D. Lombardi, and P. Siklos (2016), “Benchmarking Macroprudential Policies: An Initial Assessment”, *Journal of Financial Stability*, 27 (December): 35-49.