

Monetary Policy

Almost immediately following the worldwide financial meltdown, the Bank of Canada began lowering its key lending rate from 3% to 0.25% between September 2008 and April 2009. This near-zero rate is the lowest in Canadian history.

In an unprecedented move to jawbone down long-term interest rates, the Bank pledged — barring the return of inflation — to keep its main rate at that level until the middle of 2010. Even this date to begin raising interest rates is premature, since inflation is nowhere on the horizon. In fact, the greater threat at the moment is *deflation*. Moreover, in looking solely at factors that affect consumer prices (with its rigid 2% inflation target), the Bank is ignoring the inflation of asset prices and the severe effects of asset price bubbles on the real economy.

The Canadian dollar is now seriously overvalued, threatening economic recovery and causing a further slide in Canadian exports. The Bank of Canada should be giving top priority to measures designed to lower unemployment and mitigate speculative capital inflows that are driving up our dollar.

The AFB will instruct the Bank of Canada to maintain its key lending rate at 0.25%; increase its inflation target from 2% to 4% as recommended by the IMF; and broaden its policy goals to include asset bubbles, employment, and economic growth, along with inflation, as near-term objectives.

Financial sector regulation

Since October 2008, the Harper government has purchased \$65.9 billion worth of residential mortgages from Canadian banks, and auctions are continuing to a promised potential maximum of \$125 billion. The amount of funds marshalled to provide liquidity to the banks is staggering. By the New Year, the government had already purchased the equivalent of almost the entire value of the fiscal stimulus package for 2009, including provincial contributions.

The Bank of Canada also created several additional loan facilities to channel funds to financial firms, including Term Purchase and Resale Agreements, as well as a Term Loan Facility, which allowed firms to borrow from the Bank using a variety of financial assets as collateral.

The government's stated purpose in providing this massive financial assistance (and the easing of interest rates to near zero) was that it would make loans and mortgages more available and affordable to Canadian businesses and households. But, because it imposed no conditions or reporting requirements on the banks, it is difficult to know whether these measures did in fact have the desired result of increasing lending to businesses and households. On the contrary, there are signs that credit market conditions continued to be tight, despite these extraordinary measures. Short-term business credit has contracted severely since the financial rescue package was delivered. Consumer credit has continued to grow, although at a reduced rate.

This is unacceptable. If government, and ultimately the taxpayer, is going to provide this high level of support to financial institutions, it is incumbent on them to supply adequate credit for a real economic recovery. The AFB will ensure that such conditions and reporting requirements are applied to any future bailout.

Moreover, government action has enabled the Big Six banks to register very healthy profits throughout 2009 — a combined \$4 billion in the quarter ending October — and to hand out bonuses that will reach a record \$8.3-billion for fiscal 2009, an increase of 18% from 2008. Banks should pay their fair share of the cost of recovery, specifically the cost of the fiscal stimulus, in the form of additional taxes (*addressed in chapter on Taxation*).

To further protect the Canadian financial system from instability and systemic risk down the road, the AFB initiates the following financial reform measures:

- Work with the provinces to create a single national Canadian securities regulator with responsibility for regulating all financial institutions, markets, and instruments.
- Authorize the Office of the Superintendent of Financial Institutions (OSFI) to approve

all financial instruments that are available in Canada to Canadians, starting with all instruments handled by federally regulated financial institutions. When the Canadian securities regulator is set up, all financial instruments should be regulated, as well as finance companies, hedge funds, private capital funds, and trusts. They will be required to have appropriate capital reserves against all obligations.

- Ensure that the OSFI examines executive compensation schemes to make sure they do not encourage risk-taking that would put financial institutions, and indeed the whole system, in jeopardy.
- With all financial institutions under federal regulation, capital rules similar to the banks and federally regulated insurance companies will be applied across the board. A “countercyclical capital charge” will be a reasonable first step for Canada.
- The credit rating agencies operating in Canada will be put under close scrutiny. High ratings were given to ABC paper, which resulted in serious problems here. Credit rating agencies operate with clear conflicts of interest, as they are paid by the issuers of the securities being rated. The AFB will make credit ratings a public good provided by independent analysts who are free from conflicts of interest.
- Payment by credit card has become the principal method of consumer payment and a major part of retail operations. This business is now dominated by two independent and largely unregulated companies, Visa and Mastercard. For both prudential and consumer-interest reasons, the AFB will require these companies to have their Canadian operations operate as federally-regulated financial institutions.