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Abstract of Remarks by Stephen S. Poloz
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Investing in Monetary Policy Independence in a Small Open Economy

This paper explores the limitations that global financial cycles bring to monetary policy in small open economies, even under a flexible exchange rate. It then suggests ways to overcome those limitations to buttress monetary policy independence.

The argument that global financial integration has reduced the ability of central banks to pursue independent monetary policy is surely self-evident by now, at least episodically. This amounts to a shortage of policy instruments. This paper develops a menu of ways in which small open economies can invest in strengthening policy independence. Having a menu of policy instruments available permits customization of responses to the circumstances that arise. The paper focuses on three sets of instruments that may not fall under the purview of central banks.

The first set of instruments comes under the rubric of macroprudential policy. For example, adjusting countercyclical capital buffers in both directions can dampen the procyclicality of capital flows. Similarly, tightening or easing rules around mortgages—leverage or debt-service restrictions, in particular—can blunt foreign interest rate shocks passing through the domestic bond market. These tools have so far been used only for macroprudential purposes, but if authorities were willing to adjust them in both directions, they could serve as a powerful way to buttress the independence of interest rate policy.

The second set of instruments is based on direct public sector financial intermediation. Public sector financial intermediation—such as providing export credit, small business lending or mortgage underwriting—is generally designed to address credit gaps left by an oligopolistic banking sector. But it may also be used to counter procyclicality in credit creation, even if it is being driven globally. Tapping these tools was one key reason why Canada was able to weather the global financial crisis as well as it did, as public sector institutions were able to offset considerably the credit crunch that emerged. In turn, this allowed the central bank to maintain its focus on inflation.

The third set provides a promising avenue in the development of additional automatic fiscal stabilizers. It is widely recognized that fiscal policy becomes relatively more powerful when monetary policy is approaching its limits. Calibrating fiscal parameters to become more active at that time, and less so in normal times, can promote an appropriate mix of fiscal and monetary policies, reduce output volatility and help preserve monetary policy independence.

In all three areas, it is not possible to simply flip a switch in the heat of the moment. The paper argues that, to become effective policy tools, these instruments all require up-front investment and a demonstrated willingness to adjust them in both directions. The benefits of doing so are clear—the risk of losing the domestic monetary policy independence generally associated with a floating exchange rate can be significantly reduced.