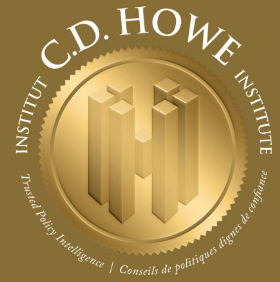
Intelligence MEMOS



From: Jeremy M. Kronick and Steve Ambler

To: Canadian Economic Observers

Date: October 2, 2024

Re: **WHY THE BANK NEEDS TO THINK BIGGER FOR ITS NEXT RATE CUT**

It is rare for the Bank of Canada to change its policy interest rate by more than 25 basis points, either up or down. Big changes have been reserved for crises, like the beginning of the pandemic, when the Bank made three 50-basis-point cuts in a single month, or when inflation runs out of control, as it did in late 2022 when the Bank raised its rate by 50 basis points. The latest news that inflation has returned to the Bank's 2-percent target does not signal a crisis, but in our view it does mean a larger-than-normal cut is called for. Without an aggressive cut, the economy could tip into a needless recession.

It's been a long road since inflation first rose above that 2 percent in March 2021. It peaked at 8.1 percent in June 2022, before interest rate hikes started to work their way through the economy, and it took 26 months to bring CPI finally back to its 2-percent target.

One of the key concepts in central banking is the "neutral interest rate," a term that describes a situation where the economy is operating at its potential and inflation is sustainably at its target. The bank estimates this neutral rate to be in a range from 2.25 to 3.25 percent. Today the policy interest rate, the overnight rate, is 4.25 percent – 100 to 200 basis points above the neutral rate. That means monetary policy is still tight. If the policy rate remains above neutral, inflation will likely continue to fall.

The questions of the hour are how much to cut and how quickly? There are good reasons not to lower the policy rate by the full 100 basis points at the next meeting this month. First, the range for the neutral rate is uncertain. Also, the Bank does not want to re-ignite the inflation it has worked so hard to defeat. Finally, there are still pockets of stubborn inflation about – shelter in particular and services more broadly. Despite all that, the usual 25-basis-point increment may not be enough, as the US Fed indicated with its recent 50-point cut.

Although the *nominal* policy rate – currently 4.25 percent – gets the headlines, it is the *real* policy rate that matters. That's the nominal rate adjusted for inflation. Just before this latest cut, when the policy rate was still 4.50 percent, headline inflation was 2.5 percent, which means the *real* policy rate was 2 percent. But now, with a policy rate of 4.25 percent and inflation of 2 percent, the *real* policy rate is 2.25 percent – actually a little higher, meaning, despite the Bank's most recent cut, monetary policy is tighter. With the economy slowing and inflation declining, tighter monetary policy isn't appropriate.

We will get one more CPI release next Thursday before the Bank's Oct. 23 policy announcement. If inflation remains at 2 percent, a 50-basis-point cut would at least move the real rate down to 1.75 percent.

One possible concern is that in adjusting the policy rate for inflation we are comparing the current policy rate with current inflation when monetary policy needs to be forward-looking. That's true, but if instead we use the Bank's own inflation expectations data, we get the same story. For example, in the third quarter of 2023, 52 percent of respondents to the Bank's regular survey expected inflation six months out to be greater than 3 percent: The latest numbers (from the second quarter of 2024) have that down to 24 percent. Using inflation expectations to calculate the real policy rate would continue to show tighter monetary policy.

Inflation falling below 2-percent may not sound so bad. But if it's happening because overall demand is falling short of the economy's capacity to produce goods and services, that's not a good thing. With unemployment rising and GDP per person falling in seven of the past eight quarters (including five straight), we believe that's exactly what's happening. Governor Tiff Macklem's public **remarks** after the last monetary policy announcement suggest the Bank does, too.

Forecasting where the economy will be six to eight quarters out and setting monetary policy accordingly is not easy. The Bank can take comfort that inflation is returning to target. A cut in interest rates is therefore coming. The increase in the real policy rate since the Bank's past cut suggests it should be big. To us, 50 basis points sounds right.

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A version of this Memo first ***appeared*** *in the* Financial Post.