Intelligence MEMOS

From: Steve Ambler and Jeremy Kronick

To: Canadian Interest Rate Watchers

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Re: **Bank of Canada Holding out Against Global Rate Cuts Trend**

The Bank of Canada last week held its overnight rate constant at 1.75 percent. This was expected by markets, but flies in the face of the general trend towards rate cuts by central banks around the world. It seems unlikely that the Bank of Canada can resist conforming to this trend for much longer, despite the overall strength of the Canadian economy.

Current conditions certainly seem to justify holding the line. Second-quarter economic growth was particularly strong, making up for weakness in the first quarter. Headline inflation in July was steady at 2 percent, and the average of the Bank's three measures of core inflation was also very close to 2 percent.

However, the Bank's goal in choosing the overnight rate target is to achieve its inflation target at a horizon of six to eight quarters. This goal reflects the fact that it takes time for the effect of monetary policy to make its way through the economy. For this reason, the Bank's monetary policy is forward-looking: it steers monetary policy with its eyes on the road ahead, not by looking only where we are now or in the rearview mirror.

Because short-term interest rates only affect demand for goods and services and inflation with a lag, the value of current data is in their use for forecasting the state of the economy two years down the road. It is in this sense that the Bank's monetary policy is data-dependent. But data dependence and risk/uncertainty go hand in hand.

The current climate of uncertainty in the global economy is an integral part of the calculations that go into the Bank of Canada's projections six to eight quarters out. This uncertainty is two-sided. There is an optimistic scenario in which the US and China rapidly come to an agreement on trade that doesn't further damage supply chains. Under the pessimistic scenario, the US and China will continue to impose tit for tat tariffs and other restrictions. Whoever "wins" the trade war under that scenario is of second-order importance – most economies in a world of complex supply chains will lose, including Canada's. The best forecast of where we will be in two years is somewhere in between these two scenarios.

The rate cuts that other central banks have already made or are predicted to make are largely based on this calculus of risk. They are cutting as insurance to guard against a future slow down, leading some to refer to this type of central banking as risk management, as opposed to data dependence.

But in fact there is no contradiction between the two. If central banks are cutting rates on the basis of a current slump in economic growth and inflation below target, they have missed the boat. Of course, this can happen, but all central bankers would prefer to act to head off impending slowdowns and below target inflation. As we said, monetary policy is forward-looking, and data dependence and risk/uncertainty are inextricably linked.

Nevertheless, and notwithstanding the influence of US domestic politics, the fact that markets are predicting at least three more rate cuts by the Fed means they view the risks to the downside. If the Fed cuts later this month, the Bank of Canada may find it hard not to cut in October. In fact, past work by Bank of Canada researchers shows that the US Federal Funds Rate is an important predictor of the Bank of Canada's overnight rate target. Why? Because US monetary policy is often a reflection of global economic conditions, if for no other reason than the sheer size of the US economy.

If the domestic economy remains strong and the Bank of Canada cuts the overnight rate in October, it will likely be because they place more emphasis on risk management than on data dependence. However, as we have argued here, risk and uncertainty are an integral part of the data that go into a central bank's forward-looking monetary policy. And, the outlook abroad is uncertain at best.

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