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The Dangers of an Extended Period of Low Interest Rates: Why the Bank of Canada Should Start Raising Them Now

After five years of extraordinarily low interest rates, the time has come to reduce monetary policy stimulus in Canada. The worrisome symptoms of "low for long" interest rates are already evident.

Paul R. Masson

About The Author

Paul R. Masson
is Principal, Weatherstone Consulting, and Fellow, C.D. Howe Institute. He has held senior positions at the International Monetary Fund, the Organisation for Economic Co-Operation and Development, and the Bank of Canada.

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The Study In Brief

Interest rates in Canada and in many other countries have not been so low since the Great Depression. When taking into account inflation, short-term interest rates are negative in most developed countries, including Canada where the overnight rate currently stands at 1 percent in nominal terms.

These historically low rates were initially a response to the global financial crisis that broke out in 2008. The financial crisis led to a sharp fall in economic activity, a dislocation of the financial system, and the need in many countries to recapitalize banks with public money. Output growth has resumed in the United States, but unemployment remains unsatisfactorily high. In the European Union, the recovery has been hampered by high public debt and fears of a breakdown of the euro area.

Canada however does not face the same problems as either the United States or the EU. Its financial system was exposed to a much lesser extent to complicated sub-prime, mortgage-backed securities, and its economic difficulties are nowhere near as pronounced. The current downturn of output compared with its potential, although significant, has been less severe in Canada, and gross domestic product (GDP) has returned to a value closer to the economy's capacity.

In this *Commentary*, I argue that short-term rates are therefore too low in Canada, a situation that is starting to build in pervasive problems for the economy. Below-equilibrium interest rates for an extended period distort investment decisions, leading to excessive risk taking and inefficient and ultimately unprofitable investments. They also encourage the formation of asset bubbles whose collapse could lead to a recurrence of the recent financial crisis.

Some of the symptoms of inefficient investment and asset price bubbles are already evident in Canada, in the housing sector for instance. The cumulative effect of artificially low interest rates also risks fuelling an underlying inflationary process. Therefore, I recommend that the Bank of Canada start now to reverse some of the monetary stimulus and begin raising interest rates.

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"[T]he question remains whether there will still be cases where, in order to best achieve long-run price stability, monetary policy should play a supporting role by taking pre-emptive actions against building financial imbalances."

— Bank of Canada governor, Mark Carney

"[L]ong-time former Federal Reserve Chairman Bill Martin used to observe that the key task of a central bank is to take away the punch bowl just as the party is starting to get interesting. But, as I liked to remind the IMF Executive Board, 'Party poopers are not popular.'"

— former International Monetary Fund Chief Economist, Michael Mussa

Canada, like most advanced economies, is experiencing record low levels of interest rates. These rates were initially a response to the global financial crisis that broke out in 2008, but they have prevailed now for five years, and they constitute a danger for future economic stability. Below-equilibrium interest rates for an extended period distort investment decisions, leading to excessive risk taking and inefficient and ultimately unprofitable investments. They also encourage the formation of asset bubbles whose collapse can lead to a recurrence of the recent financial crisis. Some of the symptoms of inefficient investment and asset price bubbles are already evident in Canada.

Low interest rates and exceptional monetary stimulus, such as quantitative easing in the United States, unless reversed in time, will lead to generalized inflation, which Canada can escape only by raising interest rates. Although notable inflationary pressures are not yet in evidence, the experience of the 1950s, 1960s, and 1970s suggests that inflation dangers should not be ignored, since, once built into expectations, they are difficult to dislodge. The challenge for Canada is to find the right balance between raising rates to avoid financial distortions and inflation, while protecting economic growth in a context of weak export demand by the United States and other trading partners. After five years of extraordinarily low interest rates, the time has come to reduce monetary stimulus to achieve a more neutral setting for interest rates.

Why Interest Rates Are So Low

Interest rates in many countries have not been so low since the Great Depression (see Figure 1). Indeed, in nominal terms, short-term interest rates are at zero in the United States and, in real terms – that is, after subtracting inflation – they are negative

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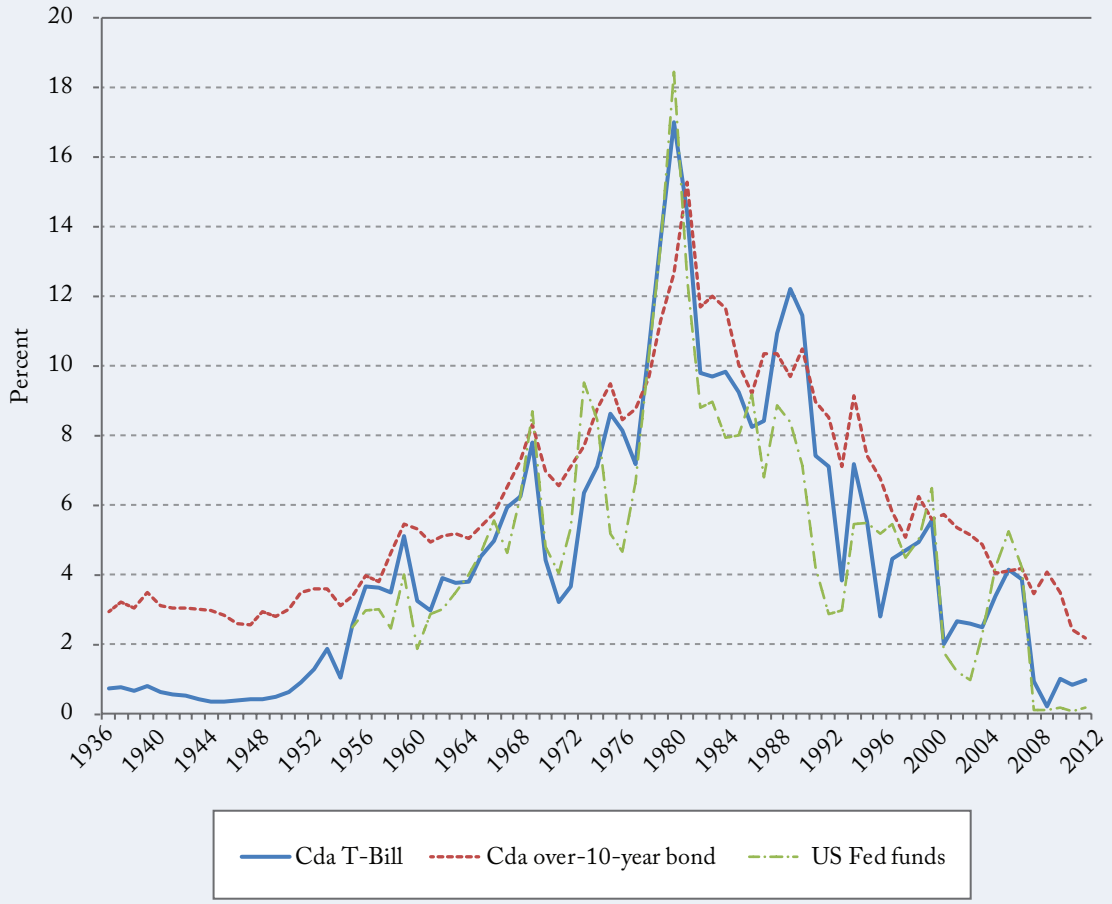
Figure 1: Canada and US Interest Rates



Source: Bank of Canada, historical series.

in most member countries of the Organisation for Economic Co-operation and Development (OECD). Long-term rates, too, are at record low levels because of extreme monetary easing on the part of many central banks. The recent financial crisis led to a sharp fall in economic activity, a dislocation of the financial system, and the need in many countries to recapitalize banks with public money. Output growth has resumed in the United States, but unemployment remains unsatisfactorily high – although it is nowhere near levels seen during the Depression.

Despite this and, to some extent, because other policies – in particular, fiscal policy – do not have further room to manoeuvre to provide stimulus, the US Federal Reserve has taken extraordinary steps to prop up the US economy. It has also promised to keep rates low for at least the next few years – in

fact, for as long as it takes to reduce unemployment significantly.[1] The European Union also faces severe financial dislocation and weak economic activity, amplified by concerns that the eurozone might not remain intact. Indeed, the widespread over-indebtedness of eurozone governments means that the European Central Bank is the only public body able to provide stimulus. In addition, the toxic interaction of weak banks and their holding bonds issued by governments whose solvency is in question makes low interest rates the only way for EU governments to service their debts and for such banks to stay solvent.

Low short-term interest rates allow banks to deleverage by earning higher profits, since their liabilities typically are shorter term than their assets. This is especially important in countries such as the United States, the United Kingdom, and those in the eurozone, where public money has been used to bail out banks on the brink of insolvency. Over time, higher profits should allow the banks to meet higher capital requirements and to reimburse government assistance. Lower rates similarly narrow the deficits of governments, by reducing their borrowing costs.

Canada does not face the same problems as either the United States or the EU. Its financial system was exposed to a much lesser extent to complicated sub-prime, mortgage-backed securities, and its economic difficulties are nowhere near as pronounced. The current downturn of output compared with its potential, although significant, has been less severe in Canada, and gross domestic product (GDP) has returned to a value closer to the economy's capacity (see Figure 2). Moreover, the environment of low rates has allowed the net interest margins of Canadian banks to widen relative to pre-crisis levels, with the big five reaping record profits, totalling $27 billion, in their fiscal years ending October 31, 2012.

Neutral Interest Rates

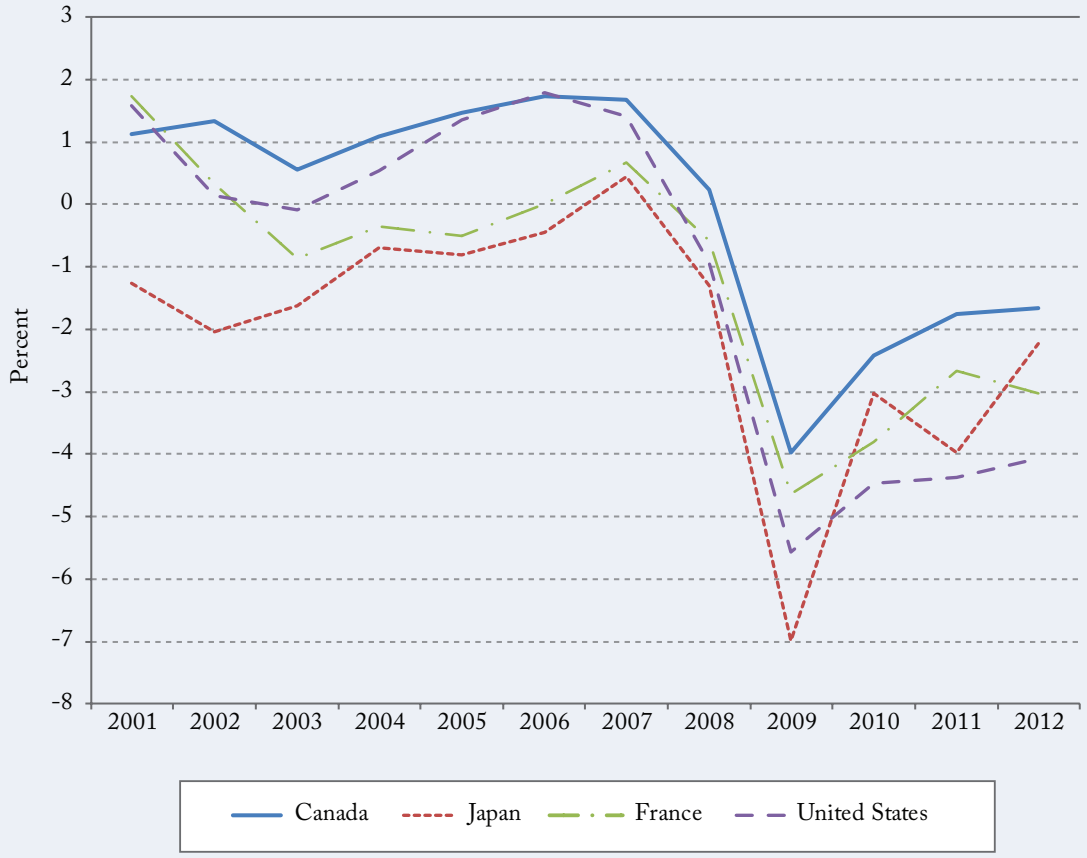
Canada's current output gap is somewhat narrower than in the previous two recessions – those of the early 1980s and early 1990s (see Figure 3). Why, then, have real interest rates been so low and for so long? To get a rough benchmark of the normal reaction to an economic downturn, one can use the so-called Taylor rule,[2] which relates interest rates to deviations of inflation from target and the output gap. According to the Taylor rule, when GDP is about 1 percent below potential and inflation, at 1 percent, is one percentage point below the Bank of Canada's 2 percent target, the interest rate should be roughly one percentage point below its equilibrium value (see Box 1 for more details on the calculations).[3] Instead, the real Treasury bill rate, at -0.5 percent, is about three percentage points below its long-run average. Figure 4 plots, for the period over which Canada has had an inflation target, the real interest rate implied by the Taylor rule compared to its actual value, both calculated relative to the long-run average value of 2.5 percent.

1 The Fed's Federal Open Market Committee has announced that monetary easing would continue until unemployment reached 6.5 percent, even if inflation temporary exceeded 2 percent, as long as inflation expectations remain contained; see United States (2012).

2 The Taylor rule is named after Stanford University economist and former US Treasury undersecretary John B. Taylor (see Taylor 1993, 1999).

3 This ignores lags in adjustment, which, in the Taylor rule, are captured by a lagged interest rate on the right-hand side of the equation. But since the crisis peaked more than four years ago, those lags should have worked themselves out by now.

Figure 2: Output Gaps, Selected G7 Countries



Source: International Monetary Fund, October 2012 *World Economic Outlook* database.

It is true, however, that the equilibrium real interest rate might not be a constant, and it could have declined as a result of the financial crisis. Indeed, in the United States and the EU, there are clear indications that the transmission mechanisms of monetary policy have altered, making a lower real rate appropriate. For Canada, however, this seems much less obvious, as the financial system suffered no great damage: the drying up of liquidity in financial markets was of brief duration, and the solvency of the system was not at risk. In contrast to the United States and the EU, Canada's housing market, far from experiencing a collapse, has remained strong, its banks are in good shape, and the federal government's indebtedness is among the lowest in the OECD countries. Moreover, non-financial companies remain very profitable, suggesting that there has been no fall in the marginal efficiency of capital in Canada.

But severe recession in Canada's trading partners has had its effects, and Canada has followed the United States and the EU down to record low nominal interest rate levels – although not quite as low as those in the United States, where short-term rates are virtually zero. Canada's loose monetary policy in the face of the worldwide financial

Box 1: The Taylor Rule

The Taylor rule implies that the nominal interest rate, i_t, needs to increase more than one-for-one with a rise of inflation, π_t, above its target, $\bar{\pi}$, while at the same time monetary policy should lean against movements in the output gap. In equation form,*

$$i_t - \pi_t = r^*_t + \alpha(\pi_t - \bar{\pi}) + \beta gap_t$$

The first term on the right is a measure of the equilibrium real interest rate, which is unobserved. Conceptually, it reflects the rate that balances saving and investment at a zero output gap, and is closely related to what Swedish economist Knut Wicksell has termed the natural, or neutral, rate.** If the neutral rate is a constant, it may be estimated by taking the average rate over a long period, since output gaps and deviations from target inflation should average out to zero. The real rate averaged 2.5 percent over the 1981–2012 period. With an output gap that is now almost closed, it seems reasonable for the real rate to rise toward its long-run value, rather than remain in negative territory.

The Taylor rule's calibration to Canadian historical data is by no means straightforward; for one thing, the Bank of Canada explicitly sets policy to take into account forecasts of inflation, rather than just react to current values – and rightly so. Nevertheless, it is instructive that the parameters Taylor suggests for the United States – namely, coefficients of one-half on both the deviation of inflation from target and the output gap (α and β) – would imply that an output gap of –3 percent (its peak value for Canada, reached in 2009) should have reduced the real rate below its equilibrium level by just 1.5 percentage points.

* The Taylor rule also usually includes the lagged interest rate, since central banks smooth movements in rates; however, these effects are short term.

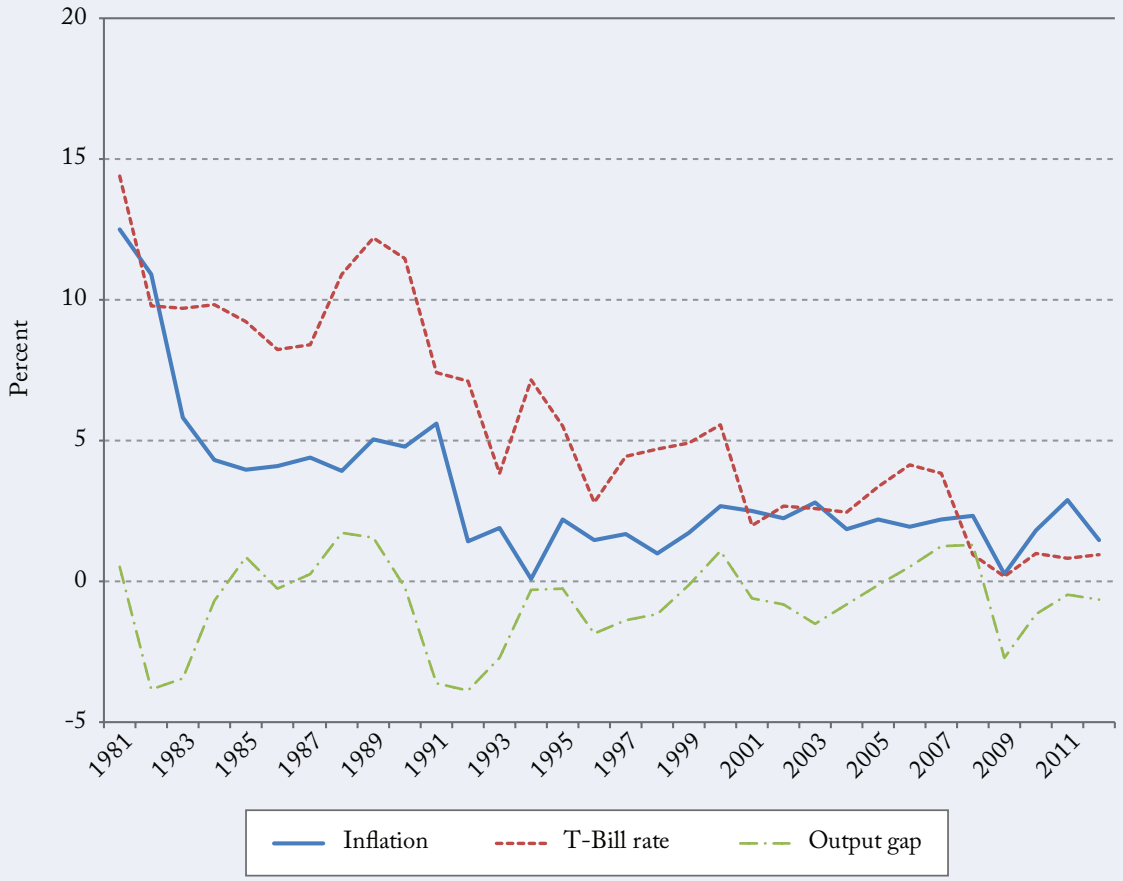
** Measuring the neutral rate is, however, subject to conceptual and practical problems; see Laidler (2011).

crisis has been appropriate, given this country's circumstances and as part of a coordinated response by the G7/G8 (and G20) countries (see Masson and Pattison 2009, 2010), and it has helped sustain demand for Canadian goods. Given the slowness of the recovery, the Bank of Canada should not be faulted for being cautious in raising rates. Canada has faced headwinds from abroad in returning to satisfactory growth, and inflation has remained low. After five years of low rates, however, problems are building for the Canadian economy that make it vulnerable to a future crisis.

Artificially Low Rates Lead to Excessive Risk Taking and Asset Bubbles

If capital is efficiently allocated, it should earn a (risk-adjusted) return that equals that of additions to machinery and equipment and other productive

Figure 3: Inflation, Interest Rate, and Output Gap, Canada



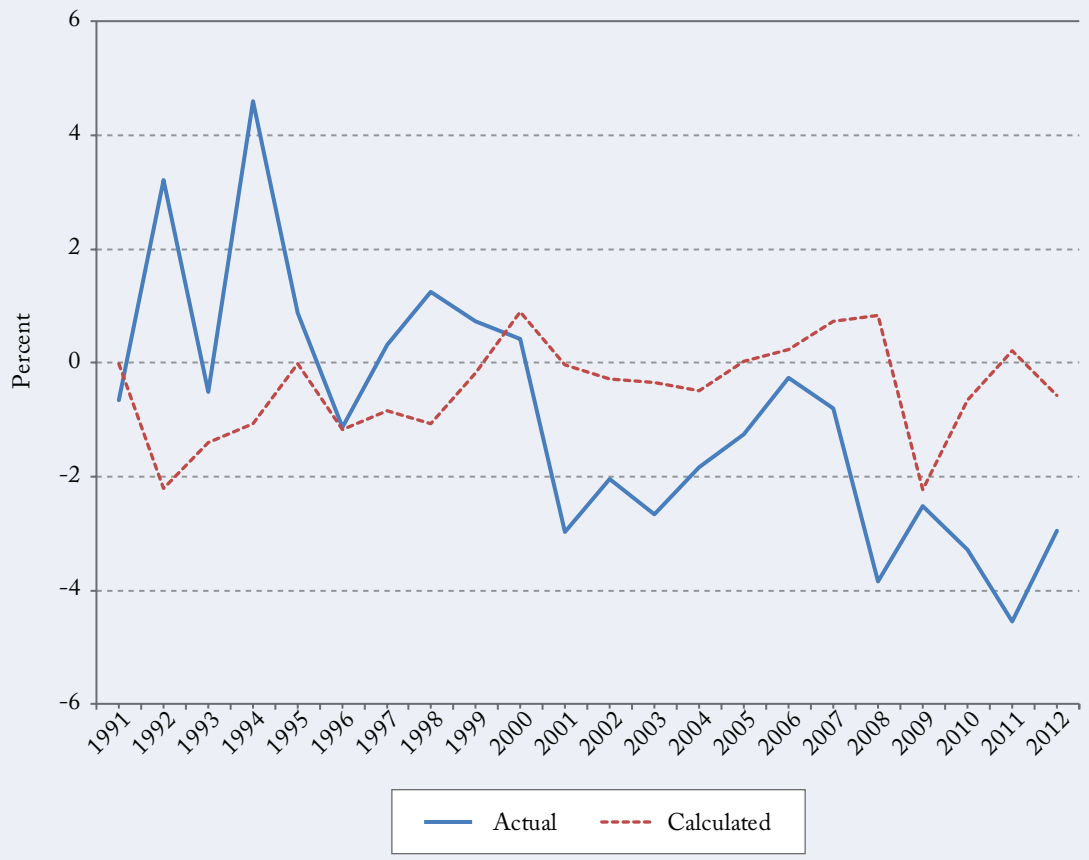
Source: Bank of Canada.

investment. Rates of interest on financial assets that are pushed below this level temporarily by a central bank risk distorting investment decisions and creating asset-price bubbles. Typically, because of constraints on financial intermediation, speculative excesses will show up mainly in a few asset classes – for instance, commodities and real estate, as well as some financial assets. Looking at individuals' investment decisions, two main categories of consumers and savers are especially exposed to variations in interest rates: younger households who typically dissave – that is, they borrow in order to spend more than their income – and older households with accumulated assets who live off the income their retirement nest egg generates.

Borrower Households

An important item of spending is the purchase of a house and associated consumer durables. Typically, access to borrowing involves a mortgage loan that is secured by the value of the house, but consumer credit is also important. Many younger households are limited in the amount they can borrow by their income or by the value of their collateral. In particular, lenders are concerned that debt service

Figure 4: Real T-Bill Rate Minus its Long-Term Average: Actual values and those predicted by Taylor rule

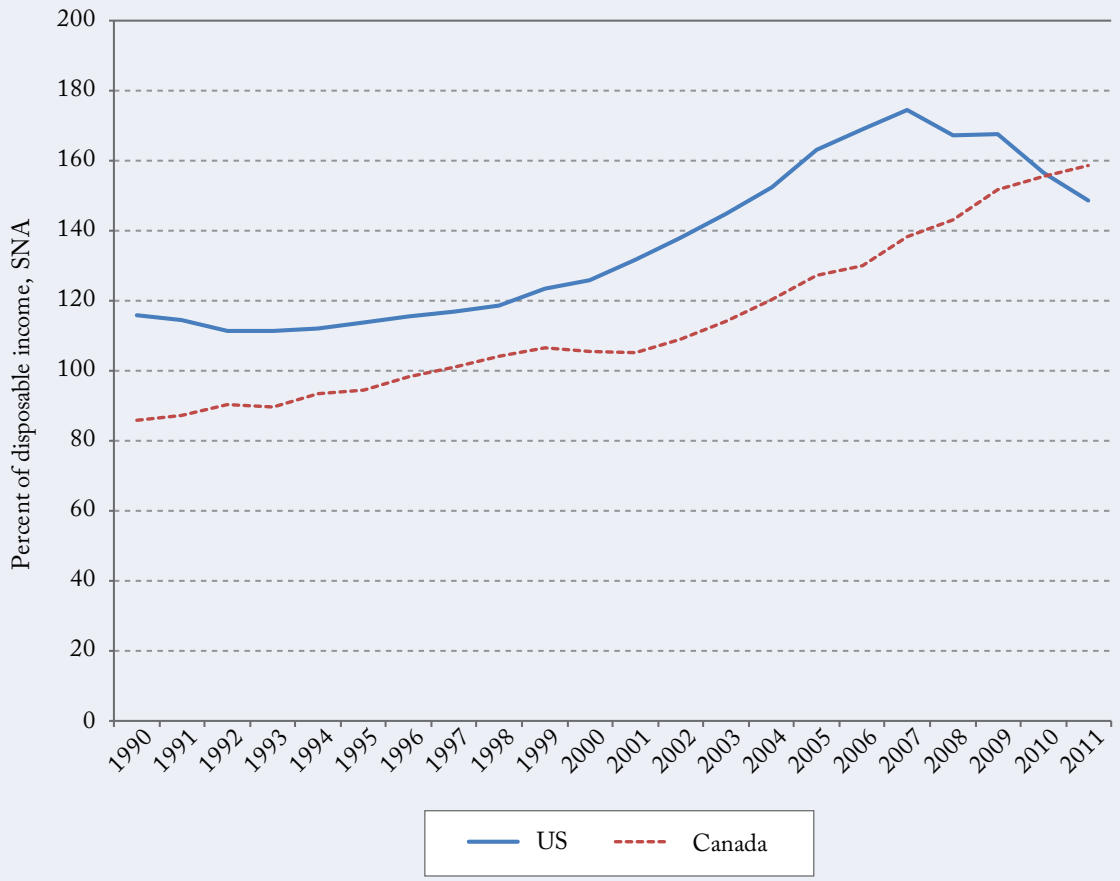


Source: Bank of Canada and author's calculations.

does not exceed some fraction of borrowers' income. Low interest rates, however, relax the constraint on borrowing by such households. Typically, a lender will insist that no more than 32 percent of a household's income be devoted to housing costs – that is, monthly mortgage payments for principal and interest, real estate taxes, and heating.[4] At an interest rate of 10 percent, and assuming that annual non-mortgage housing costs are equal to 5 percent of the mortgage amount, this means that a household with annual income of $100,000 can borrow, at most, $203,000. But with mortgage interest rates at their current level of about 3 percent (for a five-year mortgage amortized over 25 years), this allows such a household to take on $300,000 of debt. Thus, low interest rates have given

4 See Canada Mortgage and Housing Corporation, "Planning and Managing Your Mortgage"; available online at http://www.cmhc-schl.gc.ca/en/co/buho/plmayomo/index.cfm.

Figure 5: Household Debt Ratios



Note: The series usually quoted for the two countries are not strictly comparable; data in Figure 5 have been reconciled, and both use the System of National Accounts income concept; see Statistics Canada (2012).

Source: Statistics Canada http://www.statcan.gc.ca/pub/13-605-x/2012005/c-g/desc/desc03-eng.htm.

Canadian consumers an incentive to accumulate a record proportion of household debt compared with their income, despite increasingly restrictive regulations on mortgage credit and warnings by the Bank of Canada of the dangers of excessive debt (see, for example, Bank of Canada 2012b).

Although borrowing a multiple of a household's income might seem a rational decision for many, it also exposes borrowers to the risk of not being able to service their debt payment when, inevitably, interest rates go up. The average Canadian household's ratio of debt to income now exceeds that in the United States – where the financial crisis has forced the sharp downward adjustment that has occurred since 2008 (see Figure 5). Canadians could experience the same fate if interest rates rise sharply or an economic downturn makes housing less affordable.

The Bank of Canada, in fact, has looked at the effect of increasing interest rates and unemployment on the fraction of household loans in arrears, using a model that takes into account

the distribution of debt across households (Bank of Canada 2012a, 24–6, appendix). In a scenario in which the unemployment rate rises by three percentage points, the duration of unemployment lengthens, and the risk premium on household debt rises by 220 basis points – but policy rates are unchanged – the proportion of household debt in arrears roughly doubles. A more severe scenario is quite conceivable, in which policy rates also rise – for instance, if there is a repeat of the "stagflation" of the early 1970s and early 1980s, which led to severe recessions. Such a scenario likely would produce much higher arrears and lead to widespread default.

Households that Rely on Investment Income

For older households, either working or retired, that have accumulated financial assets, the effect of lower interest rates is quite different, since those households are more likely to rely on interest income to provide for their living expenses. Living expenses have not declined – inflation continues to be positive, though moderate – so such households are led to "reach for yield" to maintain a similar flow of interest income and standard of living. Consider a household with a nest egg of $800,000 and annual living expenses of $36,000 (after taking into account any other sources of income). Before the financial crisis, 10-year government of Canada bonds yielded 4.5 percent, a return that allowed the household to live off its investment income without having to dip into the principal. Currently, however, 10-year government bonds yield only 1.8 percent, so making up the shortfall inevitably involves finding riskier investments that the household previously would have avoided. Indeed, as discussed below, high-yield equities – in particular, those paying high dividends – and real estate investment trusts (REITs) have risen sharply as a result of increased investor demand. Again, although a move to riskier investments might not result in any immediate losses, the danger is that a correction in asset prices and/or defaults on the higher-yield securities could expose such households to later widespread losses.

Thus, even though the two categories of consumers differ markedly in their response to low interest rates – net borrowers gain from them, while net creditors lose – both are led to take on more risk.

Financial Institutions and Pension Plans with Long-dated Liabilities

Low interest rates also have pervasive effects on the profits and balance sheets of pension plans and financial institutions that provide retirement income and life insurance or that have other long-dated liabilities.[5] Typically, their liabilities are longer term than available investible assets. As a result, they are exposed to interest-rate risk: when rates decline, the current value of their liabilities increases more than the value of their assets, creating a funding gap. As a counterpart to this, the decline in interest rates means that pension plans and insurance companies have contractual commitments to pay benefits that exceed the income produced by their holdings of interest-bearing assets. Low interest rates, for instance, have apparently played a large part in the operating losses suffered by some of Canada's largest life insurance companies in recent years. Net income, as a percentage of equity, is down markedly for the industry as a whole since the onset of the financial crisis, and now stands at 8.8 per cent (2012), compared to 16.6 per cent in 2007.[6]

5 See Bank of Canada (2012b, 32–3). The Bank identifies two risks related to low rates: pressures on the balance sheets of institutional investors such as pension funds and life insurers, and the incentives for excessive risk taking in search of yield.

6 The industry totals are for federally regulated life insurance companies as reported in regulatory returns filed with the Office of the Superintendent of Financial Institutions (Source: osfi-bsif.gc.ca).

To bridge the funding gap, financial institutions with long-dated liabilities might turn to riskier assets or attempt to hedge against the risk, but at a cost, which would reduce their profitability. The funding gap is pervasive, as it applies not just to individual retirement and insurance accounts, but also to company pension plans. If a way is not found to reduce the gap, however, then many investors might need to postpone their retirement or make difficult adjustments to their spending. At year-end 2011, the average estimated solvency ratio for all federally supervised plans was 0.81, down from 0.93 at year-end 2010,[7] and approximately 93 percent of all defined-benefit plans were underfunded, up from 76 percent in 2010 – meaning that their estimated liabilities exceeded their assets.

The Bank of Canada has considered the possible threat to financial stability caused by the weakening financial position of insurance companies and pension funds as a result of low interest rates, and concludes that "long-term risks remain a significant challenge for the [life insurance] industry", and that "strategies used by pension funds to address interest rate risk can pose other risks" (2012b, 35–7). Operating losses due to low interest rates contributed to the closure of Union of Canada Life in 2012 – the first failure of a life insurance company since 1994 (Perkins 2012).[8]

Another threat to financial stability comes from the dramatic increase in the exposure of Canada Mortgage and Housing Corporation (CMHC), a Crown corporation, to mortgages whose underlying collateral, based on the price of houses, might not be adequate. Researchers at the C.D. Howe Institute have highlighted the risks that CMHC is assuming, and argue that its mandate should be more limited (see Bergevin and Poschmann 2013; Poschmann 2011). CMHC currently insures over 30 percent of Canadian mortgages, and dominates the mortgage insurance market. This exposure to the housing market and the over-indebtedness of Canadian households mean that the federal government – and ultimately Canadian taxpayers – are at risk should a housing price correction occur.

Asset Price Bubbles

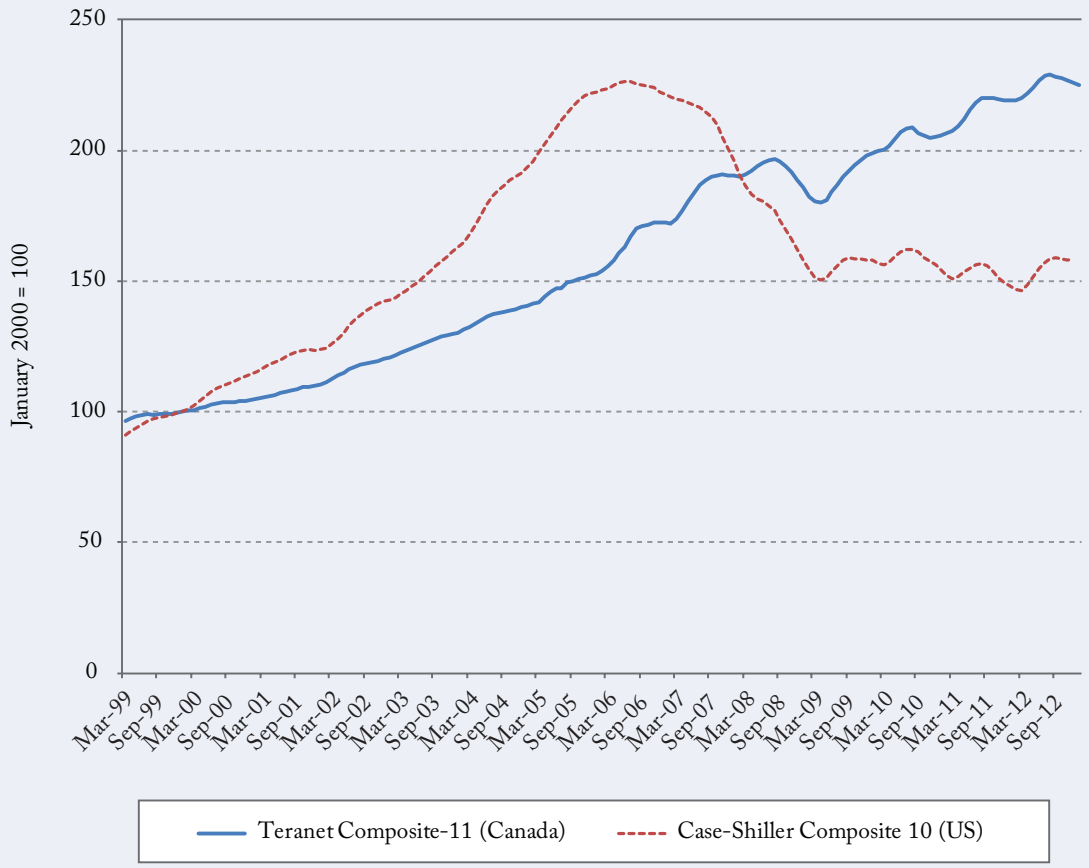
Canada has been undergoing a housing boom, with house prices having risen by 50 percent since the end of 2005, even as US house prices *fell* on average by 29 percent (see Figure 6). Among the factors that explain the difference is that Canada did not face the same lax regulation that fuelled an earlier US boom. As well, Canadian households have experienced lower unemployment and higher income growth since 2005 than their US counterparts. Although economists disagree about the extent of overvaluation of housing prices in Canada, it is generally a cause for concern, especially in Toronto and Vancouver. Indeed, both Bank of Canada governor Mark Carney and finance minister Jim Flaherty have warned about overvalued house prices, and have placed restrictions on the terms of mortgage credit to address the problem. But is this the right way to go about it? After all, if the housing bubble is being fuelled by low interest rates, then raising rates should be part of the solution.

Symptoms of the reach for yield are the large run-up in the price of real estate investment trusts (REITs) and of high-dividend-paying stocks. As of the end of February 2013, for example, the Capped Real Estate, Capped REIT, Income Trusts, and Dividend Aristocrats Indexes had risen by 9.6, 7.0,

7 This is the ratio of assets over liabilities on a plan-termination basis for federally regulated private pension plans (see Canada 2012).

8 For evidence of the search for yield as it applies to US insurance companies, see Becker and Ivashina (2013).

Figure 6: House Price Indices



Sources: Standard and Poors (Case-Shiller index of 10 US urban areas); and Teranet Composite, 11 Canadian urban areas, rebased to January, 2000, (© All rights reserved Teranet and National Bank of Canada).

6.8, and 5.9 percent, respectively, over a year earlier, while the overall S&P/TSX Composite Index had *fallen* by 0.3 percent.[9] High-yield equities provide attractive returns, but in normal times are considerably riskier than government bonds. Flows into these assets also mean that small and medium-sized enterprises, which typically pay no or low dividends because they can reinvest their earnings more profitably, are disadvantaged, even though they are the most dynamic companies, with the greatest potential to contribute to employment and output growth. Indicative of this disadvantage is that the S&P/TSX Small Cap Index *fell* by 16.0 percent between February 2012 and February 2013.

9 See "Globe investor: Indexes," *Globe and Mail*, February 26, 2013; available online at http://www.theglobeandmail.com/globe-investor/markets/indexes/.

As the Bank of Canada's Business Outlook Survey notes, "[t]he balance of opinion on credit conditions remains slightly negative…Although the majority of firms indicated no change in credit conditions over this period, those that did report an easing were mostly large firms" (Bank of Canada 2013a, 4).

Why should there be concern about a run-up in prices in housing and riskier financial investments? Does this not make us all better off? The trouble is that the longer the boom lasts, the more likely it will end in tears. The situation in the US housing market is a case in point. A long period of increasing house prices bred the conviction that they could not go down, which fuelled purchases for speculation and by households with a poor credit rating. When the inevitable bust came, falling house prices meant that some households had to abandon their homes because they could not refinance them or service their existing mortgage; mortgage defaults led to widespread personal and company bankruptcies; and the construction of new housing virtually stopped, contributing to income losses and unemployment. The bursting bubble endangered the soundness of financial institutions and had severe consequences for the real economy. In Canada, there are reasons to expect that a correction in asset prices would not lead to as severe an outcome as occurred in the United States, but a significant fall in house prices could lead to difficulties for financial institutions (including CMHC), a sharp contraction in construction, and trigger a recession.

Deleveraging versus Evergreening

The period of low interest rates in Canada has not deleveraged household balance sheets – rather, the reverse. Canadian banks also have not had to deleverage because they did not face the same difficulties as banks in other countries. But another consequence of easy monetary policy is the lack of financial discipline it allows to take hold. This effect is sometimes called "evergreening," because low interest rates permit insolvent or unprofitable borrowers to stay in business and to postpone hard decisions. If rolled over at very low interest rates, loans can be serviced by such borrowers almost indefinitely – after all, at a rate of zero, any level of debt is sustainable. In Japan in the early 1990s, after the bubble burst, easy money saw the emergence of "zombie companies" that should have been closed down but whose debt was continually rolled over (Peek and Rosengren 2003). Having no prospects of growth or ultimate survival, they contributed to the long period of stagnation that Japan endured. While this is an extreme case, it illustrates the inefficiencies low interest rates cause.

Another aspect of the problem is the lack of discipline imposed on governments (White 2012). In Canada, provincial government debt as a ratio of GDP exceeds that of the federal government, and shows no sign of stabilizing. Low borrowing costs have not forced the provinces – in particular, Ontario and Quebec – to make hard choices to limit their budget deficits, even though they face revenue slowdowns and projected strong growth of healthcare costs and civil service pensions in the future. Only Alberta, with its sharp fall in resource revenues, has plans to tighten its belt significantly. The environment of low rates thus has not been conducive to addressing fundamental fiscal imbalances.

Can We Assume Inflation Is Tamed?

Economic theory and historical experience teach us that monetary expansion in excess of real growth, or interest rates lower than the return that balances saving and investment, ultimately leads to inflation. This phenomenon might take time to manifest itself, however, and, in the first instance, it might show up in increases in asset prices. Thus, over the past decade or so, there has been a heated debate about whether central banks should tighten monetary policy pre-emptively to burst asset bubbles or at least to diminish their ultimate damage. Most central banks decided not to do so – notably the US Federal Reserve, whose

chairman, Alan Greenspan, was firm in rejecting the notion, arguing that the role of the central bank should be to clean up after the bursting of a bubble (Goodfriend 2003).

The extent to which raising interest rates in the first half of the previous decade would have limited the subsequent crisis in the United States is still open to debate, but in the light of the severity of the crisis, a consensus has emerged that monetary policy should address financial imbalances earlier, rather than waiting for financial crises to occur. This is part of an ongoing re-evaluation of the roles of central banks and financial regulators in the economy.[10] In the opinion of many, central banks should have financial stability as an additional objective, rather than a strict focus on inflation targeting. The case for pre-emptive policy actions to prevent financial crises is further strengthened by the recognition that using monetary policy to repair the economy afterwards – by a period of low interest rates – has major limitations. If the initial conditions involved too much debt, excessive risk taking and too low interest rates, then monetary stimulus might take the economy in the wrong direction (Borio 2012, 20).

Canada has been well served by the Bank of Canada's inflation-targeting framework, which has kept the rate of inflation in a narrow range around its target mid-point of 2 percent. Now, however, monetary stimulus is creating financial imbalances that are becoming more serious as time goes on. Moreover, the experience of earlier decades suggests that risks from building in an inflationary spiral should not be underestimated. Models are not really able to forecast accurately beyond the 18-to 24-month horizon of the Bank's monetary policy framework. Some economists have suggested, for instance, that, given the size of government deficits and public debt outstanding and with the prospect of large future deficits related to population aging, higher inflation is the only way out for governments that want to avoid outright default (see, for example, Ydstie 2011).

The threat of inflation is not imminent, but the postwar experience of Canada and other countries provides powerful evidence of the dangers of letting inflation rise and of inflation expectations becoming entrenched, given the persistence of inflation (Fuhrer 2010). Meltzer (2005), in evaluating the various reasons given for the "Great Inflation" of 1965–81 in the United States, attributes an important part to the resistance of successive US administrations to raising rates, in a context in which the Federal Reserve felt its dual mandate required it to coordinate monetary with fiscal policy. Mussa (2003) suggests that pressures on central banks are asymmetric – rises in rates are never popular – in which circumstances, there is a real danger that central banks will do too little, too late.

Monetary policy doves respond that central banks have the tools to reverse monetary stimulus if and when they judge it necessary to do so – the US Federal Reserve has made this argument in relation to concerns about the extent of its quantitative easing. Feldstein (2013) argues, however, that the Fed might find it very difficult to assess the right moment to shrink its balance sheet, and in the meantime an inflationary process might be under way.

The Bank of Canada does not face the same need as the Fed to shrink its balance sheet, but given the distance between the current level of interest rates and a neutral setting for them, the Bank would find itself in a difficult position when inflation

10 A number of recent C.D. Howe publications discuss the locus of responsibilities for macroprudential policies; see, for example, Crow (2012); Jenkins and Thiessen (2012); and Ragan (2012). See also Borio and White (2004); and Hahm et al. (2012).

picked up. It would have to bring about a series of interest rate increases over a number of action dates to eliminate monetary stimulus, while facing great pressure not to harm households and financial institutions that are exposed to interest rate risk by making large and rapid increases or by letting the exchange rate appreciate. In those circumstances, the Bank might not be able to remove the monetary stimulus in time to prevent inflationary expectations from taking hold.

What Is Canada to Do?

Not for the first time in recent memory has Canada been faced with a policy tradeoff made worse by international developments not of its own making. Increasingly, the Bank of Canada's interest rate announcements have emphasized headwinds from abroad – the "fiscal cliff" over which the United States could fall, worsening tensions in the eurozone, weakening demand in China – rather than forecasts of domestic developments (Bank of Canada 2013b). In fact, as the Bank itself notes, global tensions have receded in recent months. The United States has begun to address – albeit in an erratic and uncertain way – its fiscal challenges, while fears of a breakdown of the eurozone have started to ease and growth in China has continued at a pace faster than in virtually any other economy.

Despite these apparently diminishing headwinds, economic activity in Canada has slowed in recent months and inflation is below the mid-point of the Bank of Canada's target range – conditions that no doubt justify a continuation of a degree of monetary ease, or an interest rate below the "neutral rate." The extent of the stimulus seems disproportionately large, however, and financial imbalances and risky behaviour are becoming evident. The longer low interest rates persist, the more difficult – and costly – it will be to tighten monetary policy.

In these circumstances, a pre-emptive tightening to limit financial imbalances – which Governor Carney mentioned in a speech more than two years ago (Carney 2010) – would be appropriate now. In the meantime, the federal government has been right to ring alarm bells about asset bubbles (in particular, in housing) and the level of household indebtedness. It could implement other "macroprudential" policies that do not rely solely on monetary policy – indeed, it has acted on this front on several occasions to tighten up on the terms of mortgage lending. But the limits of these policies should be recognized. The cumulative effect of artificially low interest rates on the economy increasingly will show up in pervasive distortions of economic decisions, and risk fuelling an underlying inflationary process. Therefore, the Bank of Canada should start now to reverse some of the monetary stimulus and begin raising interest rates.

Objections

There are, however, two major objections to raising rates now. The first is that the Bank of Canada should continue to focus exclusively on output and inflation, as it has done, over a two-year horizon, and that macroprudential policies are best left to other agencies, using tools other than interest rates to achieve their objectives. In this view, although asset bubbles might be a problem, they are best dealt with by the Office of the Superintendent of Financial Institutions or the Department of Finance. Indeed, there are already signs of a slowdown in house sales and a decline in prices in major markets, so actions taken in that regard are already bearing fruit. The answer to this objection is that financial cycles are often pervasive and long lasting (Borio 2012). Although one might be able to fix some problems, unless the underlying excessively loose monetary policy is corrected, other distortions will emerge. Underfunded pensions, the reach for yield, and distortions in equity prices will not be fixed by ad hoc measures.

The second objection is that higher interest rates now will appreciate the exchange rate, make Canada's manufacturing sector uncompetitive and choke off the recovery, so the time is not right for monetary tightening. In response, one can point

to signs that the US economy is picking up steam, and to the fact that the Canadian dollar is below parity with its US counterpart at present. Although one would not want to push them up sharply, there is some room for raising rates. With the upswing in US construction, and a North American auto industry that is doing relatively well, Canada's manufacturing sector would be able to absorb a modest strengthening of the currency.

Conclusion

Raising interest rates is never popular, but keeping rates low for too long builds in pervasive problems for the economy. Interest rates in nominal terms are at record low levels and negative in real terms, even though Canada's GDP is only slightly below capacity. At the same time, there are symptoms of distortions created by low interest rates in financial markets: unfunded pensions, losses by insurance companies, excessive household debt, high house prices, and a bias toward high-yielding equities. Extremely low interest rates mean that the Bank of Canada has a long way to go before they approach a neutral setting. The time has come for the Bank to start raising interest rates gradually to lessen the continued build-up of financial imbalances.

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