

Intelligence MEMOS



From: Jeremy Kronick
To: The Bank of Canada
Date: September 22, 2016
Re: **NEGATIVE INTEREST RATES**

In a recent [study](#), the Bank of Canada discussed the true nature of the effective lower bound for nominal interest rates and showed that it is not in fact zero, as was the widely-held assumption. Furthermore, some countries are currently testing limits as low as -0.75%. With this in mind, the Bank of Canada is acknowledging that it has room beyond zero to lower the nominal interest rate in order to stimulate the economy should it be deemed necessary. This is good for the central bank as it means more room to use conventional monetary policy if and when the economy begins to struggle.

But here's the rub: lowering the overnight rate is only effective to the extent that other rates in the economy react as well. Economic theory suggests that as it becomes less attractive to lend in the overnight market, banks will look to lend in other bond markets, thus driving up the price of bonds in those markets, leading to a fall in those markets' interest rates. As rates in all markets fall, a corresponding increase in aggregate expenditure will occur. However, some recent [research](#) suggests that the unconventional monetary policy introduced as a result of hitting or approaching the zero lower bound has weakened the pass-through to rates in the rest of the economy. When this occurs, the resulting increase in spending never materializes.

The point here is that the benefits of negative rates are unknown. What are the costs then? How about pensions and other forms of retirement savings? As interest rates continue to decrease, households are forced to save more for retirement. When they do this, less money is available for consumption, a dampening effect on the economy. The [difficulty](#) for central banks is that the neutral rate of interest in the economy—the rate at which we believe inflation is stable and the economy is growing at its potential—is low exactly because people are getting older and saving more. So while lowering rates further may not be a good option, neither is increasing them without slowing the real economy and real returns on investment.

The Bank of Canada would like to increase interest rates. But as an inflation targeter, when inflation is consistently [near](#) your 2% target, it is hard to justify changing tack, especially with economic growth as low as it is. Therefore, the ideal scenario is to generate strong economic growth well above potential giving cover for an interest rate increase in a stable inflation environment. The starting point should be Canada's weak productivity growth. Governor Poloz [recently](#) suggested that through infrastructure spending and international trade economic growth could increase by 3 to 5 percent nominal per year for the next decade. If he is right, the economic environment would be appropriate for increasing interest rates and, if we are lucky, prevent the uncertainty negative interest rates present.

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