Intelligence MEMOS

From: William B.P. Robson

To: Borrowers and Investors

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Re: **INTEREST RATE HIKES ARE COMING**

Bank of Canada governor Tiff Macklem, like U.S. Fed chairman Jerome Powell, is clearly starting to view continuing high inflation with concern. A change is coming in monetary policy. With demand outrunning supply, our central banks' policy interest rates need to rise – and may rise a lot.

Before COVID-19 triggered a monetary explosion, inflation in Canada and the United States had been so low for so long that most people could ignore it, and ignore monetary policy as well. Inflation was reliably close to 2 percent year after year. The Bank of Canada's overnight rate, its benchmark policy rate, and the U.S. equivalent, the federal funds rate, moved much less than they had when inflation was high and variable. How central bank policy rates affect spending and inflation became a question for technicians.

Now that it is a wider concern, it is time to refresh an old insight. Whether an interest rate is low or high depends on what potential borrowers and lenders expect. Suppose the going rate for a mortgage or a business line of credit is 2 percent. If a slump knocks your house's value down or pummels your business's sales, 2 percent can look scarily expensive. If a boom pushes your house's value up or boosts sales, the same 2 percent can look laughably cheap.

The first situation was a concern after the 2008 financial crisis and again early in the pandemic. Expectations got so bleak that some people thought even a central bank policy rate of zero was too high. The second situation is a concern today. A recovering economy and high inflation are raising expectations about future values and sales. The 0.25 percent target for the overnight rate the Bank of Canada has been maintaining might once have looked high. Now it looks low.

Identifying a central bank rate that would be "just right" – consistent with steady growth and low inflation over time – is tough. A good start, though, is to think about the "real" interest rate – the return borrowers and lenders would pay or receive after allowing for inflation. We can subtract inflation from the bank's policy rate to get a real overnight rate, and look at past values for perspective on our current situation.

From the 1960s until the advent of the 2 percent target at the end of 1995, the average real policy rate – the difference between a nominal policy rate close to 7.9 percent and inflation above 5.2 percent – was 2.6 percent. From the end of 1995 until 2020, the average real policy rate – the difference between a nominal rate around 2.4 percent and inflation around 1.8 percent – was 0.6 percent. Now, the difference between the 0.25 percent policy rate and inflation yields a real rate that is way negative: more than 4 percent below zero.

If potential borrowers and lenders thought the economy was shrinking, a real overnight rate that low might stabilize things. But incomes and spending in Canada in the third quarter of 2020 were up 12 percent from a year earlier. A real overnight rate that low adds fuel to that fire.

Former New York Fed president Bill Dudley is warning that U.S. inflation is so hot that cooling it may require a federal funds rate far higher than the market expects. The Bank of Canada has been less loose, and Canadian inflation is lower. But the bank's latest forecast showed it above target until late 2024, and subsequent numbers on inflation and job growth are adding to the upside risks. The Omicron variant and the policy response to it will depress demand for a few months, but they will pinch supply as well. Inflation picked up through the Delta variant's period, and there is no reason to expect anything different this time.

Suppose that, as we emerge from this episode, inflation is running at 3 percent, and containing it only requires a real policy rate typical of the post-1995 period. That still means raising the overnight rate to around 3.6 percent. Suppose inflation is running at 4 percent, and containing it requires a real rate more typical of the higher-inflation 1960s, 1970s and 1980s. That means an overnight rate above 6 percent. Suppose reluctance to tighten in time yields inflation running at 5 percent. When Canadians demand an end to the erosion of their money – as they eventually will – the overnight rate that is needed would be higher yet.

Even the mildest of these scenarios exceeds forecasters' predictions and market expectations. Hardly anyone expects an overnight rate above 2 percent before the end of 2023. But loose monetary policy has contributed to high inflation, and it will take tighter policy to contain it. Investors, homeowners, businesses, and our big-borrowing governments need to get ready. Higher interest rates are coming.

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