Intelligence MEMOS

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To: Canadian Economic Observers

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Re: **THE IMPORTANCE OF A SHIFTING MONETARY POLICY STANCE**

The Bank of Canada, which has been lowering the overnight rate of interest following a nearly three-and-a-half-year battle with inflation, cut rates again last week. So: How tight does monetary policy remain in this easing cycle? How much further loosening needs to happen? And where will interest rates end up when all is said and done?

Answering these questions involves juggling two things at once. First, defining the current monetary policy stance. Second, comparing it to a neutral stance – where the economy is producing at its potential and inflation is at its target – in order to determine whether it is loose or tight. Both are hard.

Start with the first element. For the first two decades of inflation-targeting, central banks used just one tool: The "policy rate," the key lever of conventional monetary policy. For the Bank of Canada, it was the overnight rate. By moving this policy rate up or down, the Bank was able to influence other interest rates, including those on government and corporate bonds, which in turn influenced real economic activity.

After the financial crisis of 2008-9, however, policy rates across the developed world hit their "effective lower bound" – basically, zero – and central banks had to find new tools, what came to be known as "unconventional" monetary policy. These included "forward guidance," e.g., speeches suggesting where the central bank saw the economy and therefore the direction of interest rates going, and "quantitative easing," in which it bought up government bonds (typically) further out the yield curve to lower those longer-term rates directly.

Because interest rates remained unusually low even after the crisis and resulting recession passed, these unconventional policies continued to be used as central banks struggled to get inflation back up to target. And they kicked into high gear when COVID hit. By now this communication from central banks on how they see the economy and interest rates unfolding has itself become conventional.

Until the crash, people evaluated the Bank of Canada's policy stance just by looking at the overnight rate. But now, with the Bank's continued use of formerly unconventional tools to influence longer rates directly, we need to look at the whole yield curve in order to assess what the policy stance is.

And to determine how tight or loose policy is, we can't simply compare the overnight rate to a single neutral rate. We need to compare the current yield curve of interest rates to a neutral yield curve. In **recent work**, we have attempted to generate the first-of-its-kind-in-Canada neutral-rate yield curve to compare to the actual yield curve in order to comment more meaningfully on monetary policy. (As far as we know, only the Bank of Japan has gone so far as to create a neutral-rate yield curve.)

What we find is that at the short end of the curve, consistent with most existing narratives, monetary policy is still tight. Tight doesn't necessarily mean too tight, but with inflation on a downward trend and potentially falling below the Bank's 2-percent target, interest rates are still above neutral. Before last week's announcement we estimated there was about 100 basis points of room to cut before the overnight rate hits neutral – so that's down to 50 basis points now.

Monetary policy is also tight further out the yield curve, though – at least before last week – not as tight. On balance, that tightness suggests the Bank may want to communicate that longer rates are still above what it regards as neutral.

Monetary policy, which was already hard, is getting more complex as modern economies continue to evolve. To hope to do it well requires a more complete picture of the Bank of Canada's current monetary policy stance, one that takes the whole yield curve into consideration. When we do that, we conclude that monetary policy remains tight at both the short and long ends of the curve. It follows that more cuts are to come.

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