Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Canadians Worried About Inflation

Date: June 9, 2022

Re: **MONETARY POLICY IS LOOSER NOW THAN IT WAS IN FEBRUARY**

The Bank of Canada continued its tightening cycle last week with a 50-basis-point increase that brings its target for the overnight interest rate to 1.50 percent. That met market expectations and means the total increase since February has been 1.25 percentage points. Expect more to come.

By the end of last year, the Bank of Canada had recognized that inflation had overshot projections and was going to be more persistent than previously forecast. The Bank passed on an opportunity to raise rates in January, but has done so three times since, including the two highly unusual 50-basis-point moves – unseen for more than 20 years.

Does this mean monetary policy has tightened since the end of last year?

No.

Given the acceleration of inflation during the first months of 2022, monetary policy is actually *looser* than it was in February.

Let's see how.

A common measure of the stance of monetary policy is the real policy interest rate: the policy rate minus a measure of inflation expectations. In the absence of good measures of expectations, we can use a cruder measure, namely, actual inflation.

So while the Bank's four months of tightening has boosted the overnight rate target by 1.25 percentage points, headline inflation has increased from 5.1 percent to 6.8 percent, an increase of 1.70 percentage points. The short-term real rate was -4.85 percent (i.e., 0.25 percent minus 5.1 per cent) and is now -5.30 percent. It has become *more* negative.

In real terms, monetary policy has become looser. And that's what matters.

To slow the economy and reduce inflationary pressures, you want to make it *more* costly for people to borrow. But negative interest rates encourage people to borrow more. Yes, if interest rates go up, borrowers have to pay that cost. But accelerating inflation makes their repayment dollars worth less in real terms. The real value of their loan shrinks as inflation proceeds. The more inflation there is, the better this deal is for borrowers.

The story isn't quite so dramatic if we use different measures of inflation, as the Bank of Canada does. These different measures exclude items whose prices are known to be especially volatile and they have all been increasing more slowly than the "headline" rate of inflation of 6.8 percent. The 125-basis point tightening of the overnight rate has led to an 80-basis point real tightening if we look at "CPI-common," a 50-basis point real tightening looking at "CPI-trim," and a 40-basis point real tightening looking at "CPI-median." On the other hand, without exception, the real rates of interest using these core measures of inflation continue to be substantially negative, even if they are rising.

Another way to measure the current stance of monetary policy is to compare the overnight rate to the so-called neutral rate, the rate at which we have both full employment and inflation equal to target in a sustainable way. The Bank now estimates that the nominal neutral rate lies in a range of 2 to 3 percent – compared to the current policy rate of 1.5 percent.

With the Canadian economy operating above full employment, plus inflation almost five percentage points higher than target and almost four percentage points above the top end of its target range, the Bank's policy rate should *already* be at or above neutral – which could even mean 1 .5 percentage points above its current rate.

This means the Bank still has some catching up to do. The big question is: how much?

We will need updated numbers on inflation to determine the rate hike impact. But, as the Bank said in its announcement last week, price growth "will likely move even higher in the near term before beginning to ease" – higher, that is, than the most recent 6.8 percent year-on-year increase. We may therefore find that, rather than being exceptional, hikes of 50 basis points will become the norm for the next few announcements.

In order to rein in inflation, the *real* policy rate will have to become much less negative, if not actually positive. If inflation is nearing its peak and starting to decelerate – and some moderation in housing markets suggests that may be true – then a rising policy rate may meet an inflation rate that is on its way down. That could provide the soft landing that will allow the Bank to tame inflation without inducing a major recession. But at the moment that's more hope than certainty.

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