Breaking the cycle

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The only major central bank that has any ability to influence economic activity is the People's Bank of China. Lower rates in the Middle Kingdom are translated immediately to increased lending, mainly due to the fact that banks are "told" to lend. M1 money supply in China is rising by north of 20%, and a lot of that new money is going to real estate. Many would agree that the last thing China needs is another empty shopping mall. Nevertheless, cheap credit has helped to stabilize economic activity—at least for now.

Outside China, all other major central banks are impotent. Interest rates are now about as low as they can go, and the marginal effectiveness of taking them lower is diminishing.

Yet, the cycle that has been dominating markets since 2008 continues. That cycle started during the financial crisis; markets got nervous (for good reason), confidence and outlook worsened, and the Fed came to the rescue by cutting rates and introducing QE1. As you may recall, it actually worked and markets rebounded, leading to improved confidence and outlook. At one point during that stage, the Fed started to hint about the possibility of ending QE1. That was met with a very nervous reaction by the market. Once again, confidence and the outlook worsened, the Fed backtracked and the cycle continued.

That merry–go-round is still turning. Yes, the Fed raised rates in December 2015, but earlier this year the communication from the Fed was that rates would rise faster than investors were comfortable with, judging by their negative reaction. So the Fed has changed its tone, and downgraded expectations. This *de facto* easing was an important factor behind the improvement in US equity markets. And currently, June and probably July are off the table, and any tweeting about the possibility that September is also a question mark would probably lead to a positive market reaction.

In Canada, the central bank continues to warn about the risk of debt accumulation and overvalued real estate markets, but at the same time, at this stage of the game, it is more comfortable cutting rates than raising them. That focus on the dogma of the day is potentially risky. We might have reached a point in which the cost of low rates exceeds their benefit. Ultra-low interest rates mask a lot of bad things that will not be fully visible until rates rise. The longer rates stay abnormally low, the greater the risk we develop an economy addicted to low rates, in which a modest but swift increase in rates can be recessionary.

To avoid getting caught in this trap, the BOC should take a longer-term view. Luckily there is still time. The earlier the Bank starts hiking, the slower it can go. The ultimate risk to Canada's housing market is not higher rates, but fast rising rates. Starting early and moving very slowly over the coming 2-3 years will buy insurance against the risk of being forced to raise rates quickly (eg. Greenspan in 2004)—a scenario that would bring Canadian housing to its knees.