Unlike the Fed, the BoC's hands are tied by a paradox of household debt

By Louis-Philippe Rochon
September 21, 2016 – *The Globe and Mail*

The Federal Reserve didn't hike interest rates on Wednesday, but in a way, it was immaterial. The U.S. talk now is all about when and how high, not if.

This strongly contrasts with the state of monetary policy in Canada, where rates are not expected to go up until well into 2018, especially in light of Bank of Canada Governor Stephen Poloz's acknowledgement this week that our economy is failing to get traction.

Eventually, though, rates will increase here, too. This is nothing but bad news, and Canadians' fondness for debt is compounding the problem.

Unlike U.S. household debt levels, which have been declining in recent years, Canadian household debt has been increasing, which poses unique challenges for the conduct of monetary policy. Raise rates too high or too quickly, and risk plunging the economy into a severe downspin – or worse.

At the moment, household debt relative to disposable income stands at a record 167.6 per cent. At record low interest rates, and with the lack of any meaningful regulations on household personal borrowing, this trend will most likely continue.

However, such high debt levels pose risks for the Canadian economy and for economic policy. For instance, while high household debt may stimulate consumption in the short run, debt must eventually be reimbursed. As Canadians deleverage, there will be inevitable depressing effects on economic activity.

To prevent a serious downturn, Canadians would have to severely plunder their savings, or governments would have to increase deficits – two scenarios that are unlikely. This means that sometime in the near future, the economy will find itself facing considerable obstacles.

But it's with respect to monetary policy that the stakes are particularly high. This debt paradox raises important challenges for the Bank of Canada regarding how exactly it will manage monetary tightening in the years ahead.

Our central bank keeps a careful eye on inflation (I disagree with this policy, but that's a topic for another day), while trying to avoid deflating the economy too much. While inflation has been tame for quite a while, the bank believes it will begin to rise as the economy eventually starts growing. Mr. Poloz will keep his finger on the trigger, ready to raise interest rates.

The problem is central bankers often tend to overdo rate increases, and examples of engineered recessions are numerous. Our limited understanding of how rate changes actually affect economies make monetary policy unreliable as a fine-tuning instrument.

Nevertheless, it will be a delicate balancing act: Raise rates too high or too quickly to kill inflation, and risk seeing the current debt problem explode in our faces.

As argued recently in a report by credit monitor TransUnion, up to a million Canadians would suffer financial stress if rates increased by a single percentage point.

Some may argue that a million Canadians is not a huge number in a field of 26 million borrowers, and that if rates increase by just a percentage point or so – say, to 1.5 per cent – this will have a limited effect on the Canadian economy.

Perhaps. But rates aren't poised to increase by just one point – they could go up by as many as three. According to the Bank of Canada's own research, the "neutral" (or natural) rate of interest is in the range of 3 per cent to 4 per cent. In other words, this is the rate where the bank believes the economy is in equilibrium, with output at its potential and inflation on target at 2 per cent. Rates in that range are far from uncharted territory – at the end of 2007, they were at 4.25 per cent and 4.5 per cent. They could easily return there.

An increase of 3.5 points would translate into considerable economic damage for far more than a million Canadians, and serious problems for several million more. In other words, there is nothing "neutral" in the Bank of Canada's monetary policy philosophy.

Mortgage rates would increase in the neighbourhood of 6 per cent, which would be potentially devastating for real-estate markets in the larger Canadian cities – Toronto and Vancouver in particular. If these markets aren't under control by then, they will come crashing down.

These very real scenarios are placing Canadian monetary policy in a straitjacket. Until the debt issue is resolved, there are serious limits to what monetary policy can do.

If the bank raises interest rates to between 3 per cent and 4 per cent, as its own research suggests it should, it risks destabilizing the Canadian economy. But if it recognizes the threat posed by household debt, it will refrain from that kind of hike, undermining its own economic model. Mr. Poloz will have to decide which is more important.

Louis-Philippe Rochon is a professor at Laurentian University and co-editor of the Review of Keynesian Economics.