Low rates, slow growth: Why loose policy isn't working

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When the global financial system had a meltdown in 2008, central banks cut interest rates to rock-bottom levels. The moves likely saved the world from a depression. But after eight years of crisis-level rates, the economy is barely staying afloat. Now, as many consumers rack up big debts while others squirrel away savings, it's time to rethink policies that are proving ineffective at reviving growth.

It was early October, 2008. The global financial system was teetering on the edge of collapse. A collection of many of the most powerful central banks in the world – including the Bank of Canada – simultaneously slashed interest rates in an effort to stop the hemorrhaging in financial markets and stabilize a sinking global economy. The move marked the beginning of a wave of monetary policy easing in Canada and elsewhere over the next six months, reducing interest rates to unprecedented lows.

The banks had released the economic-policy equivalent of a nuclear option – an act of extreme aggression aimed at crippling an imminent threat, namely a deflationary spiral and another Great Depression. And, to that extent, it worked. The financial system pulled back from the brink. Much of the world suffered a severe recession, but a depression was averted. In Canada, whose banking system and government finances were healthier than most, the recession was over by the middle of 2009.

Eight years later, those same central banks are keeping interest rates nearly as low as they did after the deep cuts of late 2008 and early 2009. In some countries, such as Canada, rates were inched higher in the early stages of the post-crisis recovery, only to be cut again when growth stalled and cracks re-emerged in the patched-up economy. In others, rates are now lower than they were at the height of the crisis; some have cut their official central bank rates below zero.

The Bank of Canada cut its key rate twice last year, to 0.5 per cent, in the face of a severe slump in the resource sector – and some experts feel deeper cuts may still be necessary. While there's no suggestion that the Canadian central bank is considering taking its own rate into negative territory, it said late last year it considers negative rates to be a viable tool if necessary.

But after eight years of frustration, a growing chorus of voices – including those at the Bank of Canada, the International Monetary Fund and the U.S. Federal Reserve Board – has publicly questioned whether ultralow interest rates have outstayed their welcome.

Low rates have failed to ignite the economy. They were supposed to accelerate growth and inflation, but have delivered little of either. And now, with rates having remained near their absolute bottom for much longer than anyone could have predicted, the unforeseen negative consequences and looming risks – to savings, investment and the stability of the financial system – threaten to overshadow the waning benefits.

"The low-interest-rate environment has lost its sense," said Steve Ambler, economics professor at the University of Quebec at Montreal and the David Dodge Chair in Monetary Policy at the C.D. Howe Institute, an economic think tank. "It's been systematically off for quite a while."

"It seemed to work, until it didn't," said Carleton University economics professor Nick Rowe.

Growth and inflation have looked particularly unresponsive to the raft of additional rate cuts made by most of the world's major central banks since late 2014. The Organization for Economic Co-operation and Development recently estimated that the global economy would grow by less than 3 per cent this year, the weakest since the recession. The International Monetary Fund has predicted that inflation in the world's advanced economies will be just 0.7 per cent this year. In Canada, both the IMF and the OECD now expect the economy to grow by a meagre 1.2 per cent this year; the country's inflation rate last month was just 1.1 per cent year over year (about half of the Bank of Canada's target of 2 per cent), the lowest in 10 months.

"Monetary policy is overburdened," the OECD warned in its quarterly economic update last month. It argued that more years of ultralow rates "will not suffice to break out of the low-growth trap, while leading to growing financial distortions and risks."

The Bank of Canada raised its own alert level last month, in a pair of speeches from the bank's Governor, Stephen Poloz, and senior deputy governor, Carolyn Wilkins, that focused on the complications, uncertainties and risks emerging from the lower-for-longer climate for interest rates and growth.

"This odyssey has certainly proven long and perilous," Ms. Wilkins said. "Eight years into this journey, there is an urgent need for all of us to consult the map to see where we are headed over the longer run, and to take strategic decisions to help us avoid unnecessary trouble ahead."

The effects of ultralow rates

One of the key things low interest rates are supposed to do is create an incentive to borrow and spend, by lowering the cost of debt while also reducing returns on savings. In Canada, at least for a while, low rates most certainly did their job in terms of promoting borrowing. Consumer and business debts have risen to record highs. Nationwide household debt is up 47 per cent since the end of 2008; corporate loans (excluding the financial sector) are up 60 per cent.

On the consumer side, the bulk of that increased debt has gone into mortgages, as low rates have sustained a strong housing sector throughout the post-crisis period. The Canadian Real Estate Association forecast that the number of homes sold in Canada will reach a record high this year.

But the economic impact since the latest round of Bank of Canada rate cuts, in 2015, has looked less impressive. Growth in mortgage debt this year has slowed to two-year lows. We've seen some of the slowest growth in consumer credit (excluding mortgages) since the early 1990s. Retail sales, which increased more than 4 per cent annually in the years immediately following the financial crisis, grew just 1.7 per cent last year. Growth in business credit has been generally slowing since early 2015 and is below precrisis levels.

And while businesses have shown a willingness to borrow, that hasn't translated into spending. Business investment in machinery, equipment and facilities is on track for its second decline in as many years. Meanwhile, Canadian businesses were sitting on a record $533-billion in cash at the end of the second quarter – a formidable stockpile, built with the help of record-low interest rates, that remains unused.

Lower rates are also supposed to encourage banks to lend, by making it cheaper for them to finance their loan portfolios. But the Bank of Canada's quarterly Senior Loan Officer Survey, which polls the country's financial institutions, shows that business lending conditions have been tightening ever since the central bank began cutting rates again in early 2015.

"Our experience is that it's been getting tougher, not easier," says David Ross, chief executive officer of Ross Video Ltd., an Iroquois, Ont.-based manufacturer and global exporter of video-production equipment, who estimates that his company's lines of credit have shrunk by 25 per cent, given his bankers' stricter lending covenants. "The banks became far more conservative than they were before. While the interest rate is going down, the banks' willingness to give access to that money also went down."

The trouble with low rates

So why has the impact of low interest rates drifted so far off their expected course? A big part of Canada's story has been the oil slump. The fallout of the decline in crude has been heavy on the country's business investment (which had become tilted heavily toward the resource sector), it has prompted banks to tighten their lending in energy-related industries and it has rippled through consumer demand and the housing market. Lower rates alone have not been nearly sufficient to offset the damage, particularly in resource-producing regions.

The borrowing binge spurred by cheap interest rates has left many Canadians dangerously overextended. Canada's ratio of household debt to disposable income – the key gauge of debt burden – hit a record 168 per cent in the second quarter, up from 148 per cent when the financial crisis began. The Bank of Canada has repeatedly expressed concern about the potential risk this poses to Canada's financial and economic stability; it estimated late last year that 8 per cent of all indebted households have debt-to-income levels exceeding 350 per cent, leaving a significant portion of the country at high risk in the event of an economic downturn.

Paradoxically, Canadians are pouring more money into savings – quite the opposite of what standard economic theory predicts when interest rates have been cut to the bone. Canada's household savings rate was 4.2 per cent in the second quarter, and has averaged 4.6 per cent since the end of the Great Recession – more than double the average rate for the five years preceding the crisis, despite five-year Government of Canada bond yields that have been nearly two-and-a-half percentage points lower than during those precrisis years. And the savings rate has held steady over the past two years, despite the Bank of Canada's rate cuts and the downward drift of five-year bond yields to below 1 per cent. Canadians are saving more, even as the returns on their savings have dwindled.

Or maybe they're saving more because those returns have dwindled. While lower rates might encourage less saving and more spending for a while, economists believe that many Canadians are now compensating for years of slow growth in their savings (and the prospect of more to come) by putting even more money away.

"I have saved my whole life diligently, always maxing out RRSPs. And yet I have little faith my savings will give me freedom," said Paul Ronan, a 45-year-old sales representative in Oakville, Ont., who has stepped up his savings in light of the distressingly slow growth of his retirement portfolio. "Here I am, in my highest earning period, really not moving forward on any front."

This trend is exacerbated by the aging of the baby boomers, who have become more acutely focused on bolstering and protecting their retirement nest eggs. Since the Great Recession ended in mid-2009, the number of Canadians over the age of 65 has increased nearly 30 per cent, while the number aged 18-64 has risen just 6 per cent. For those masses of aging boomers, low-for-long rates create a need to save more, not less – discouraging consumption, rather than fuelling it.

The slow growth of invested savings creates another potential danger – investors opting for riskier assets in their quest for better returns to

meet their longer-term savings goals. That could expose even more consumers to financial calamity in the event of another shock from the markets. The same goes for pension funds, which are increasingly looking at alternative asset classes in order to generate sufficient returns to meet their obligations to current and future pensioners.

"History is rife with examples of when excessive and prolonged search for yield ended badly," the Bank of Canada's Ms. Wilkins warned in a speech last month in London.

A double-edged sword

On the corporate side, the lure of cheap credit continues to be superseded by the reality of overcapacity. The Bank of Canada has estimated the Canadian economy has somewhere between 1 and 2 per cent more capacity (the amount of goods and services it is capable of producing) than it is using, evidence that demand hasn't caught up with supply. Its quarterly Business Outlook Survey indicates that companies have more slack in their capacity than historically normal.

Yet even at companies that are bumping against their capacity ceilings, the pressures have been remarkably slow to translate into spending. Statistics Canada's annual survey of capital spending intentions showed that companies outside of the mining and oil-and-gas extraction sectors only planned to increase their spending by 1.7 per cent this year – barely keeping up with inflation.

With continued slow growth on the horizon, implying historically low returns on business investments, businesses are taking a pass on capital projects, opting instead to use the low-cost funds available to them to bolster their stock prices. Data from Standard & Poor's show that companies on the Toronto Stock Exchange's S&P/TSX composite index spent nearly $30-billion buying back their own shares last year – up 13 per cent over 2014 – and are on track for about the same this year.

In a speech last month, Bank of Canada Governor Stephen Poloz argued that the problem may be that businesses are looking for historical rates of return that are out of sync with the prevailing low-growth, low-return conditions. That's causing them to reject projects as failing to meet their investment thresholds and divert their money elsewhere.

Bank of Canada surveys have also indicated that even where businesses have taken advantage of low borrowing costs to invest, they have often focused more on replacing old equipment than on adding new capacity – limiting its more lasting contribution to economic growth.

"Our customers are under intense cost pressures," said Ray Simmons, president of Toronto-based Darcor Ltd. The global exporter of specialized casters and wheels has focused its spending in the past year or so on modernizing its manufacturing equipment to improve efficiency. "We're investing in finding ways to make our product in a more cost-competitive way."

Meanwhile, one of the big benefits for manufacturing exporters of the Bank of Canada's rate cuts – the downward pressure on the Canadian dollar – has proven to be a double-edged sword. While the lower loonie has made Canadian goods more price-competitive in foreign markets, it has also made it much more expensive for manufacturers to buy foreign-made machinery and equipment.

"Your cost of goods on borrowing money [to buy new equipment] might be a few per cent less, but the cost of the goods themselves are now 20 or 30 per cent more expensive," Mr. Ross of Ross Video said.

What's the solution?

Given the many side effects of eight years of ultralow rates, economists and policy makers are re-examining the medicine itself. Why

have heavy doses of cheap rates not been more effective?

Some economists, and most central bankers, argue that low interest rates have worked – they just aren't enough. What's more, they've been relied on to pull the global economic cart for far too long; their capacity to stimulate has been exhausted.

One thing to consider is that interest rates aren't actually as low as they look – not when measured against an economy whose growth potential is a shadow of what it used to be.

Famed U.S. monetary economist Milton Friedman made the point that low interest rates are only stimulative to the degree that they are lower than the "neutral interest rate" – the rate at which spending and saving are equally attractive, and thus neither stimulates nor constrains economic activity. It's the gap between a central bank's policy rate and the neutral rate that matters, not the level of the policy rate itself. When the economy's growth potential is reduced the neutral interest rate is lower than it used to be.

The Bank of Canada estimates that Canada's neutral interest rate is now between 2.75 per cent and 3.75 per cent – nearly two percentage points lower than it was in the years leading up to the financial crisis. The decline reflects the economy's reduced potential to grow, which is largely owing to much slower growth in the labour force as the baby boomer generation moves into retirement.

"The decline in the real neutral rate means that any given setting of our policy rate will be less stimulative today than it was a decade or two ago," Mr. Poloz said.

Economists are increasingly urging policy makers to wean themselves off their dependence on monetary policy and invoke other key sources of economic stimulation, most notably increased government investment and free trade. Many governments have actually responded to the economic struggles of the past several years by tightening spending and adopting more protectionist trade stances – policies that actually leaned against the effects of low interest rates.

Others believe the failure of extended low rates demands a major reassessment of the usefulness of interest rates as the central banks' go-to policy instrument. While relying on rate adjustments to meet inflation targets served the Bank of Canada well in the decade and a half leading up to the financial crisis, the inadequacy of that strategy in the postcrisis environment suggests central bankers need to take a hard look at its shortcomings and consider their options.

"We need to think more radically about this," Carleton University's Prof. Rowe says. "There's got to be a better way."

Some suggest the Bank of Canada should raise its inflation target from its long-standing 2 per cent. That would effectively lift the nominal level of the neutral interest rate, giving policy makers more breathing room while raising yields on investments. The central bank has looked into the idea, but bank officials have fairly consistently indicated that they don't favour such a move.

Some believe inflation targets themselves have become the problem. Some favour linking rate policy to absolute price levels rather than the pace of inflation or to nominal gross domestic product (GDP without adjusting for inflation) – both of which might more effectively reinflate economies in the wake of crises, while possibly keeping rates from sinking toward zero for prolonged periods.

Others argue that interest rates may not be the best tool for the job. In an upcoming paper for the C.D. Howe Institute, Prof. Ambler will advocate the use of "quantitative easing" (QE) by the Bank of Canada – not just as a temporary last-gasp measure, as some other central banks have done with mixed results, but as a longer-term tool to stimulate

consumption by permanently increasing the money supply. With QE, the central bank buys large quantities of assets (usually bonds) in the open market and thereby increases the supply of money – the theory being that the excess money gets spent and economic activity accelerates. Money-supply targeting largely fell out of vogue among central bankers more than a quarter-century ago, but Prof. Ambler believes that in times of near-zero interest rates, it may be more effective than further rate cuts in firing up the economy.

"If it works in the desired way, you could envisage a situation where you don't have to keep interest rates as low for as long."