Holding steady – for now: Poloz makes case for a rate cut

By David Parkinson
October 19, 2016 – *The Globe and Mail*

The Bank of Canada just came much closer to cutting interest rates than anyone would have dreamed before Wednesday's rate announcement. Now, there's nothing blocking the path to a rate cut early next year – including the housing-market dilemma that until recently formed an imposing obstacle.

The bank's rate announcement and accompanying quarterly Monetary Policy Report made for bleak reading: Slashed economic growth forecasts, lowered inflation expectations, structural damage in the export sector that may have permanently impeded its progress, an anticipated hit to growth from Ottawa's recent tightening of mortgage rules.

Adding it all up, the bank concluded that the economy's output gap – the difference between what it is producing and what it has the capacity to produce, effectively the bank's bottom line for setting interest-rate policy – will remain open until the middle of 2018, roughly six months later than it estimated in its July report.

A gap nearly two years wide represents a gaping wound, pushing the limits of the central bank's tolerance. The bank opted against stitching it up with a rate cut – but it came awfully close.

In a press conference following the rate decision and MPR release, Bank of Canada Governor Stephen Poloz revealed that the bank's decision-making Governing Council "actively discussed the possibility of adding more monetary stimulus at this time."

This is more candour than we typically see from the bank about the backroom deliberations of Mr. Poloz and his senior brain trust, so the fact that he mentioned it at all is a strong signal. That he characterized it as being under "active" consideration implies that a cut was on the centre of the table, where they stared at it long and hard while debating the pros and cons.

Officially, the bank held off making a cut because it feels that many of the key factors it sees weighing on growth – the new mortgage rules, the surprising lack of traction in non-resource exports, the U.S. political uncertainty that may be contributing to slow business investment south of the border – are both hard to measure and still evolving.

It wants to let them play out a little longer to see if some of these problems go away, or at least turn out to be smaller than the bank has calculated.

Unofficially, the biggest argument against a cut was that it would have floored the financial markets, which were utterly unprepared for any such prospect.

The day before the rate decision, the bond market was pricing in a negligible 2.5-per-cent chance of a rate cut. Central banks sometimes like the shock value of an unexpected rate move, but that big a shock likely would have done more harm than good.

So instead, the bank presented a strong case for a rate cut, while saying it wasn't making one. A "yet" at the end of that sentence was pretty strongly implied.

Perhaps most importantly, Mr. Poloz went out of his way to make clear that the federal government's recent tightening of mortgage-qualification rules, designed to keep the highest-risk borrowers out of the housing market, have essentially removed an important impediment to a rate cut.

For a long time, the central bank's nagging misgivings about the financial-system risks from record-high consumer debt loads (largely driven by big increases in mortgage debt) have

been perceived as a key reason why the bank was very hesitant to lower rates further, lest it further stoke mortgage borrowing. (Indeed, the bank was criticized when it cut rates twice in 2015 for pouring gasoline on the real estate market while continuing to publicly fret about it.)

But the bank said in the rate announcement that the new mortgage rules "should mitigate risks to the financial system over time," while Mr. Poloz volunteered that the new rules "were not seen as an impediment to easier monetary policy." But he didn't stop there. In answering a reporter's question, he further suggested that the rule changes could actually "work together" with low rates – with one encouraging more borrowing while the other improves the "quality" of those new debts. "Those two things working together gives us a better outcome," he said.

It wasn't quite a pledge to cut rates. But it might be as close as Mr. Poloz is ever going to get to saying that a cut has been loaded into the chamber and he's prepared to give the "fire" order.

One key factor that could lean against a rate cut is this: Now that the bank is talking out loud about it, the prospect will likely weigh down the Canadian dollar, especially given that the U.S. Federal Reserve may well raise its key rate at its December policy meeting. A lower dollar would lend a hand to the Bank of Canada's biggest concern – the struggling export sector. A lower currency would prop up price competitiveness and at least help offset the impact of some of the sector's structural shortcomings in the relatively near term – and, crucially, could lift the bank's outlook for growth and the output gap.

But a rate cut is now squarely in play, and we'd need to see a meaningful improvement in the economic trajectory over the next three months to change that. By late Wednesday the bond market was pricing in a 20-per-cent chance of a rate cut in January – the next time the bank issues a Monetary Policy Report, and thus the most likely next opportunity for such a move.

You could probably double those odds and still be undershooting. The bank's tone suggests that as things stand now, a January cut is at least a 50-50 proposition.