Spoiler alert: Stephen Poloz's potential rate hike at odds with inflation

By Ian McGugan
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Never go to a movie with Stephen Poloz. The Governor of the Bank of Canada would insist on blurting out the ending just as you were enjoying your first bite of popcorn.

In financial circles, this habit of telegraphing the plot line is considered a great virtue. Policy makers, at least of the contemporary variety, believe a central bank should rarely, if ever, shock markets. Instead, the bank is expected to prepare investors and lenders for what is about to come.

Mr. Poloz is working hard to do just that. Last month he told CBC that "the interest rate cuts we put in place in 2015 have largely done their work." Then, last week, he mused to a German business paper that it was time to "ease up on the accelerator."

Message received: Mr. Poloz appears to be doing everything he can to signal his intention to raise interest rates on Wednesday, when the bank releases its latest monetary-policy report.

That only leaves one mystery to clear up: What in the world is he thinking?

Inflation is running at a mere 1.3 per cent, nudging the bottom end of the bank's 1- to 3-per-cent target range.

Raising rates now runs the risk of slowing the economy in order to forestall a jump in inflation that remains only a theoretical prospect.

At least so far, Mr. Poloz's announcements fall short of a satisfactory explanation.

In his interview with the German newspaper Handelsblatt, he insisted that the bank was merely looking down the road at what is to come.

"If we only watched inflation and reacted to inflation, we would never reach our inflation target, we'd always be two years behind in the reaction," he said.

"So we have to look at the rest of our indicators in the models that predict inflation."

Mr. Poloz likes to put things in everyday terms, so he compared the central bank to a driver who begins slowing down well ahead of a red light, instead of slamming on the brakes at the last moment.

It's a nice metaphor, but it omits one important fact: The Bank of Canada's windshield has been anything but clear in recent years when it comes to inflation.

Go back two years, to the July, 2015, monetary policy report, and you'll read a confident assertion that "inflation is expected to return sustainably to 2-per-cent growth in the first half of 2017."

As you may have noticed, that inflationary surge has failed to materialize.

Given the way that reality has fallen short of the bank's inflation projections in recent years, you might think Mr. Poloz would be wary of touting his model's ability to forecast future moves. But apparently not.

The most cautious way to read his thinking is to assume he merely intends to reel back in the half-percentage point of rate cuts he made in 2015, when plunging oil prices were threatening the Canadian economy. If that's all that's driving his agenda, Mr. Poloz will hike the policy rate, probably in a couple of steps, raising it from the current 0.5 per cent to 1 per cent. He will then wait there to see how the economy reacts.

However, others believe a rate hike on Wednesday may be the first in a prolonged series of increases. Derek Holt of the Bank of Nova Scotia wrote in a note last week that his bank's model indicates a full percentage point of tightening may be needed by the end of 2018 to offset inflationary pressures.

Perhaps so. Still, it's difficult to see why there's so much urgency on the issue. The bank insists that its 2-per-cent inflation target is symmetric – in other words, that it views a low figure just as seriously as it regards a high figure. But it's lived with inflation considerably below 2 per cent for a long while.

Given that, why act so quickly to snuff out any possible move above 2 per cent? Maybe it's because inflation is only part of what now concerns central bankers.

Mr. Poloz's newly hawkish tone echoes similar recent pronouncements by other central bankers, including the leaders of the U.S. Federal Reserve, the European Central Bank and the Bank of England.

Their new willingness to contemplate tighter monetary conditions suggests a fresh consensus. After years of keeping rates low to nurse sick economies back to health, financial overseers appear to be turning their attention to other concerns, notably soaring asset prices and possible bubbles in areas such as U.S. stocks.

Fed chair Janet Yellen recently mused that many asset prices look "somewhat rich." In the minutes of the most recent Federal Reserve meeting in June, other policy makers also expressed concern about lofty stock prices. "In the assessment of a few participants, equity prices were high when judged against standard valuation measures," the minutes noted. That "could lead to a buildup of risks to financial stability."

Could Mr. Poloz be thinking in similar fashion, especially about the need to use higher rates to put a lid on increases in Canadian home prices and tamp down runaway consumer debt? His news conference on Wednesday may offer some valuable clues about the plot twists still to come.