Editorial: The Bank of Canada vs. the interest rate iceberg

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This week, a part of the Larsen C shelf broke off of Antarctica and became one of the largest icebergs ever reported, at more than 10 times the size of the island of Montreal. For scientists and the environment, it's a very big deal – though it's not at all clear what it means, or what comes next.

It could be one more of sign of global warming. Then again, scientists say it's possible the ice field it calved from will regrow over time. By itself, the berg is not expected to raise sea levels immediately, as the giant mass of ice was already displacing water. And this creation of a new mega-iceberg was no surprise: The event was anticipated, though its precise timing was always uncertain.

Which is kind of like the Bank of Canada's decision to raise interest rates for the first time in seven years. For anyone with a stake in the economy – borrowers, lenders, homeowners, investors, employers and employees – this is a Really Big Deal. But it's not a surprise: It was well understood that Governor Stephen Poloz would have to do this eventually, and widely anticipated that eventually would finally arrive this week.

It's also not at all clear what happens next. Short-term borrowing costs just moved a quarter point higher, but that doesn't mean long-term borrowing costs – things like fixed mortgages and longer bonds – will consistently march in lockstep. Long-term borrowing costs are influenced by the BoC, but not determined by it. They may over time move up much more than the short-term benchmark interest rate, or much less, or not at all, depending on the economy and expectations.

Nor is it clear what the Canadian dollar will do. It's been racing ahead versus the U.S. greenback, but depending on things like the price of oil, the interest rate spread between Canada and the U.S., the performance of the Canadian economy and expectations about its future performance, the loonie could reverse course.

There's also no certainty about what the Bank of Canada will do next. This first increase in seven years may be a precedent. Or depending on domestic and global economic conditions, it may be nothing of the sort. Even the BoC doesn't know what comes next; it says it is, as always, data dependent.

In much of the world, the recovery from the Great Recession and the financial crisis of 2008-09 has been painfully slow. When the downturn hit, central banks across the globe moved swiftly to shift short-term rates to rock bottom; basically moving the cost of borrowing money to near zero.

It was assumed that these measures would be temporary. Temporary lasted a very long time.

That's because it had to. In fact, though money has for years been historically cheap, pumping up assets like Canadian housing, there's lots of evidence that money, in some places and at some times over the last decade has not been cheap enough. Central bankers have sometimes been too eager to snatch away the crutches before the patient was ready to walk.

Steps to the "normalization" of interest rates turned out to be false starts. Repeatedly.

The European Central Bank, for example, started raising interest rates in 2011. The ECB claimed to be seeing signs of European economic warming. It was mistaken. At the time, much of the Eurozone was still deep in recession or even depression. By 2012, the ECB was reversing course.

The ECB's interest rates hikes of 2011 were not a prelude to more of the same. Instead, they quickly gave way to their opposite: rate cuts.

And when those didn't move the European economy out of the intensive care unit, the introduction of unconventional monetary stimulus.

Canada, in contrast, had one of the developed world's most shallow recessions and best recoveries. As a result, in 2010, the Bank of Canada raised its benchmark interest rates three times – from the sub-basement, all the way up to the basement, at one per cent.

But while Canada's economy was doing relatively well, the rest of the world was not. Canadian interest rates went from ultra-low to extremely low in 2010 – and then didn't budge for nearly half a decade.

The journey to normalization started, and then stopped.

And when Canada's benchmark interest rate moved again, in 2015, it went lower, not higher. As the bottom fell out of oil prices, the BoC cut rates in half, and promised more, if necessary.

Two years later, the Canadian economy is strong enough stand the removal of just a little bit of that monetary stimulus. However, there are few signs of inflation, here or in the U.S., and inflation is the thing central banks are supposed to use interest rate policy to guard against.

The era of massive monetary stimulus is finally ending – maybe. But a new era of "normal" interest rates, such as the BoC's 4 per cent benchmark of a decade ago? It's nowhere in sight. Not yet.