Monetary Policy: Turning point

By Barrie McKenna and David Parkinson
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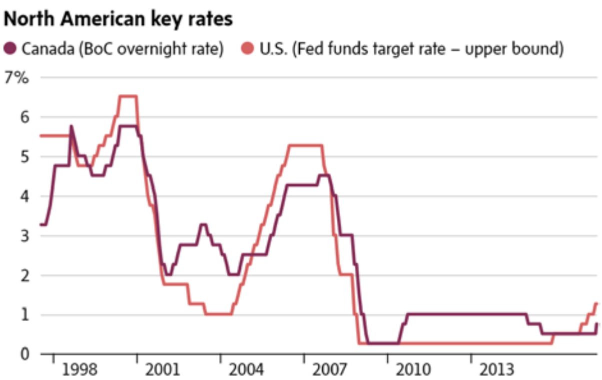
It's not often the world's financial markets pay rapt attention to the deliberations of Canada's central bank.

This week marked one of those rare moments as the Bank of Canada announced a modest quarter-percentage-point rise in its key interest rate – its first rate hike in seven years.

It's not that traders in London and Hong Kong care what the future holds for Canadians on fixed incomes or those stuck with big variable-rate mortgages and crushing debt loads. Nonetheless, they were watching events in Ottawa this week with unusual interest, seized by a sense that the world has reached a tipping point, where the costs of low rates are starting to outweigh the benefits.

In the rear-view mirror lies an unprecedented era of easy money. Ahead, looms a future of steadily rising interest rates, not just in Canada, but globally.



THE GLOBE AND MAIL, SOURCE: BLOOMBERG

And so it was big news that a G-7 central bank would suddenly flip the switch from loose monetary policy to tightening, without a whiff of inflation in the summer air. Tired of waiting for a spike in consumer prices, inflation-fighting central banks everywhere are suddenly looking at how to get out of the rut they've been in for nearly a decade – flooding the global economy with liquidity through ultralow interest rates and relentless bond buying.

"This is a really important turning point, not just for the Canada story, but for the global rate story," explains Frances Donald, senior economist at Manulife Asset Management in Toronto. "Central banks seem to be saying, collectively, that they don't expect inflation to get back to target. But they realize they can't keep rates at emergency levels forever. It's a tacit admission that low rates can't solve all of the world's problems. In fact, they may be exacerbating them."

From Ottawa and Washington to London and Frankfurt, central bankers are starting the complex process of unwinding a series of emergency measures they put in place to deal with the aftermath of the 2008 financial crisis and the Great Recession. They realize these policies have hung around, increasingly uncomfortably, for much longer than anyone had anticipated.

The way forward creates a delicate balancing act for the world's central banks. Higher interest rates will inevitably cause stress, particularly in pockets of the global economy where cheap money has created bubbles. Canada is just one of several countries that have witnessed sharp run-ups in real estate prices. There are also concerns that too much borrowed cash has flooded into bonds, emerging markets and even some infrastructure projects – investments that could now crumble in a rising rate environment.

One of the legacies of low-for-long interest rates is the potential for a dangerous debt hangover. Global debt as a share of GDP reached a record high of $217-trillion (U.S.) in early 2017, reaching 327 per cent of the world's GDP, according to the Institute for

International Finance. That's higher than it was before the financial crisis, driven by a combination of consumers, businesses and governments feasting on low rates. The shift in policy could take years to fully play out, and will have a profound impact on lenders, savers, borrowers and investors.

The past decade has been a remarkable learning experience for central bankers. They exposed us all to the exotic world of negative interest rates, quantitative easing and financial engineering. The consensus of experts is that these extraordinary measures were necessary, saving the global economy from financial ruin. But all that easy money, including low-for-long interest rates, was not without cost. And the unwinding process will not be without pain.

Canadians who live in Toronto, Vancouver and other hot housing markets know all too well what low interest rates have done to the cost of homes, and to urban skylines. Million-dollar fixer-uppers, mushrooming condo towers and home buying bidding wars are all part of the legacy of easy money.

On the flip side of the low interest-rate problem, savers are also feeling the unpleasant side effects of near-zero interest rates. There are people on fixed incomes struggling to get by, and pension-fund managers scrambling to generate adequate returns to meet generous promises made to retirees.

Investors have poured cash into stocks, corporate bonds, real estate and emerging markets – all in the pursuit of higher yields in a low-rate world.

Perhaps most troubling for Bank of Canada Governor Stephen Poloz and other central bankers is that easy money has not magically produced the robust economic recovery everyone hoped for. Instead, Canada and other countries have experienced a frustrating series of false economic starts since the last recession. Key economic drivers, such as business investment and exports, remain weak and inflation continues to fall in many countries.

"There has been a general belief that central banks can save the day, and the past few years are a great example that there are limitations to monetary policy," explains McGill University economist Christopher Ragan, a former special advisor at the Bank of Canada.

One of the lessons learned in Canada is that interest rates are a blunt instrument to deal with events such as the commodities shock in 2014 and 2015, when the price of crude plunged 50 per cent. The Bank of Canada responded with two quarter-point "insurance" rate cuts in a bid to ease the hit to the broader economy.

The rate cuts accelerated the decline of the already falling Canadian dollar. While that was good for exporters, it has inflated the cost of imported goods for consumers and businesses. Low rates also encouraged consumers to load up on debt – to buy cars, furniture, electronics and the largest personal expenditure of all, homes.

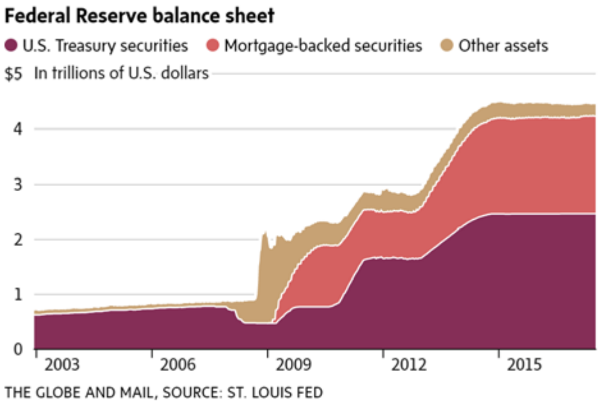
"The aftermath [of low rates] was to take an already hot housing market and throw kerosene on it," Bank of Nova Scotia economist Derek Holt complains. "One of the reasons we've had supercharged growth for several quarters now is because we have applied excess stimulus – both monetary and fiscal."

The Bank of Canada would have been wiser to let the dollar drift lower on its own, easing the pain of lower revenues from oil exports, according to Mr. Holt.

Mr. Poloz would dearly love to get back to a normal world, McGill's Mr. Ragan says. In that world, inflation would be on target at two per cent, growth would be steady and workers would be seeing their wages rising. And most importantly, interest rates would be firmly neutral, neither stoking excessive borrowing nor deflationary pressures.

"He wants to get back to normal," Mr. Ragan says.

There is now a growing consensus among central bankers – Mr. Poloz among them – that the time has come to start scaling what was clearly intended as emergency stimulus. The U.S. Federal Reserve has led the way with a few modest rate hikes and a promise this week from Fed chair Janet Yellen to shrink the central bank's $4-trillion (U.S.) balance sheet in a "slow, gradual, predictable way," likely starting later this year.



In Britain, Bank of England Governor Mark Carney has hinted at a possible rate hike. Even European Central Bank head Mario Draghi, the most enthusiastic user of unconventional monetary policy, endorsed the shifting mood when he mused recently that "deflationary forces have been replaced by reflationary ones." Even China is in tightening mode.

"The unwinding of monetary stimulus is significant, especially if central banks are jumping the gun," economist David Andolfatto, vice-president of research at the Federal Reserve Bank of St. Louis, said in an interview this week. "If central banks guide their decisions through the lens of conventional theory, then raising interest rates is contractionary and disinflationary. Given the present [weak] measures of real economic activity and inflation, it's not entirely clear why central banks are suddenly so keen to embark on a tightening cycle."

Former Bank of Canada Governor David Dodge sees it differently. He says the world put too much faith in monetary policy to carry the global economy in recent years, without the help of government spending. Rates have stayed too low for too long, creating dangerous distortions in asset prices.

"It's not a question of should we be going up [with rates], but how late are we in doing that," Mr. Dodge argues.

The unwinding won't be easy. Interest rates remain ultralow – negative even – after you factor in the rate of inflation.

Global central banks have swollen their balance sheets, scooping up mortgage bonds and other assets in an effort to create liquidity in financial markets artificially. Those assets have swelled to $19-trillion – roughly the size of the U.S. economy – from $3-trillion in 2000. And every month, the ECB and the Bank of Japan add tens of billions of dollars more in assets to their balance sheets.

A sudden move to sell those assets by Ms. Yellen or Mr. Draghi would send long-term interest higher and shock waves through financial markets. No one wants a repeat of the 2013 "Taper Tantrum," when the Fed first mused about scaling back its bond purchases.

"You have to watch the pace in which you unwind [central bank balance sheets]," says Steven Ambler, professor of economics at the Université du Québec à Montréal. "If you dump all this stuff on the market at once, it will be hard for the private sector to absorb."

As this unwinding progresses, central bankers in Canada and elsewhere will have to figure what to do about inflation – or rather, its mysterious absence. Inflation has become the most persistent and frustrating riddle of the low-for-long rate era. Over the past quarter-century, the use of a clearly identified inflation objective as a critical guide for setting interest rates has become a widely accepted practice among the world's leading central banks. (A 2-

per-cent target, which the Bank of Canada has relied on for more than 20 years, is pretty much the accepted standard today.)

OECD Consumer Price Index (excluding food and energy)

THE GLOBE AND MAIL, SOURCE: BLOOMBERG

But in many economies now talking about unwinding their substantial monetary stimulus, the inflation target remains stubbornly elusive – despite years of low rates that were pretty much designed to reinflate the economy. Indeed, that's the whole point of inflation targeting – to apply interest rates to steer the inflation rate toward the target. By extension, a near-target inflation rate is supposed to imply an economy generating relatively healthy and stable growth. (This relationship between inflation and the broader economy is known in economics circles as "the divine coincidence"; it is the very backbone of inflation-targeting monetary policy.)

Economists generally agree that extreme low rates successfully staved off a deflationary spiral during the depths of the 2008-09 financial crisis – and in doing so, averted a full-blown depression. But after the better part of a decade on the job, they have failed to revive inflation. Indeed, when central banks cut their rates to the bone, and even introduced quantitative easing in the wake of the crisis, many critics feared that, in their zeal, they would unleash an inflation storm; we've seen nothing of the sort.

Even as economies accelerate, inflation has continued its persistent lag. And most disturbingly, there are virtually no wage pressures, even in areas where there are skills shortages. Canada's inflation rate is a tepid 1.3 per cent, as is the euro zone's. In the United States, where the Fed has raised its key interest rate three times in the past eight months, the core inflation rate was a modest 1.6 per cent in June. Japan's inflation rate is a puny 0.4 per cent.

The reasons for why inflation is so weak are myriad and complex. The most obvious recent factor is the collapse in the price of oil and other commodities, whose effects filter throughout the global economy. Global trade, the emergence of new markets and technological change have also made it easier and cheaper to make things. Finally, populations in the developing world are greying, slowing the growth of the labour market. All this creates what economists call "slack," or an excess of labour and factory capacity.

"I don't think [ultralow rates] did what they were supposed to do. If they were supposed to get inflation back up to more or less target rates around the world, it has not been successful," UQAM's Prof. Ambler says.

"Part of the job of monetary policy was to prevent booms and recessions in the real economy, and inflation targeting was supposed to be a means in part to achieving that end. It didn't work," adds Nicholas Rowe, economics professor at Carleton University in Ottawa.

In the short run, central bankers face the kind of decision the Bank of Canada did this week: Whether to forge ahead with monetary tightening, despite the lack of an imminent inflation signal.

Mr. Dodge thinks central banks should set aside inflation targeting temporarily and commit to gradually lifting interest rates from their current extreme lows to something approaching "normal" levels.

"There's an argument to say, 'We're going to move those rates up to, say, 2 per cent, and we're going to move them up in a slow and deliberate fashion, and we're going to tell you ahead of time.' So that there need be no panic and no uncertainty as to what is going to happen. Without having some understanding of how fast and how far you're going to move, there's a danger that markets become unsettled," Mr. Dodge said.

In the longer term, central bankers will have to confront a much bigger question: Whether they've put too much faith in inflation as an anchor for monetary policy.

"I think the inflation target itself has taken a hit," Prof. Rowe says. "The 2-per-cent inflation target needs to be looked at. It didn't turn out to be as good a thing to target as some of us thought it would be."

There is no shortage of ideas out there to replace the 2-per-cent target. Some economists believe central banks need a higher target, say 3 per cent, to reset inflation expectations and create more breathing room from the bottom for both inflation and, by extension, interest rates. Others think central banks would be better off targeting a price level rather than an inflation rate, so slowdowns in inflation would be offset by policy aimed at temporarily higher inflation to return prices to their original growth path. Still others think that targeting growth in nominal gross domestic product – an indicator that essentially combines real economic growth and inflation in one package – is the solution.

"There are more questions being raised as to whether targeting domestic inflation is as appropriate as it was 20 years ago," Mr. Dodge says. "I don't think any central bank really has a definitive answer to that. We're all a little bit puzzled, quite frankly."

And Mr. Dodge feels for Mr. Poloz, Ms. Yellen, Mr. Draghi and the others. "This is a challenging time for central banks everywhere," he says.