Faster BoC rate hikes now will help prevent more later

By David Parkinson
October 24, 2018 – *The Globe and Mail*

The Bank of Canada has opened the door to raising interest rates at a faster pace than it has been doing over the past year and a half. If the central bank chooses to walk through that door, we may thank them in a couple of years. Quicker rate hikes now might save us from more rate hikes later.

While raising its key rate for the fifth time since July, 2017, the central bank conspicuously dropped its pledge to take "a gradual approach" to further rate increases. In its place, the bank said that "the policy interest rate will need to rise to a neutral stance to achieve the inflation target."

The removal of the "gradual" reference tells us the bank wants to give itself the freedom to raise rates more quickly. The reference to the "neutral stance" tells us where it sees its destination. The neutral rate of interest is, essentially, the rate that allows the economy to run at full capacity, while keeping inflation at the central bank's target.

If a central bank does its job perfectly, neutral should be as far as it ever needs to go. It should keep the economy humming and inflation stable. It's basically central-banker Nirvana. The BoC estimates the neutral level is somewhere between 2.5 per cent and 3.5 per cent. For the purposes of forecasting, it uses the midpoint of 3 per cent.

But here's the thing: Canada's economy is already at full capacity. The inflation rate has been above 2 per cent for eight months. The economy is at the point where a neutral rate of interest would be entirely appropriate. But we aren't there yet. Even with Wednesday's hike, the central bank's key rate is still a far-below-neutral 1.75 per cent.

As Bank of Canada Governor Stephen Poloz put it in the news conference following Wednesday's rate announcement, "We're still being quite stimulative, at a time when the economy really does not seem to need it."

The implication (although the BoC would never put it this way) is that the central bank may be behind the curve on bringing rates to neutral. The bank has, to some extent, been intentionally dragging its feet, with a wary eye on some serious risks facing the economic outlook. But a couple of recent developments suggested a change in thinking was in order.

The big one was, of course, the United States-Mexico-Canada Agreement (USMCA), which removed a massive monkey off the back of the Canadian economy. But even before the proposed trade deal was reached on Sept. 30, the BoC's quarterly Business Outlook Survey – conducted from late August to mid-September – showed that trade uncertainty was taking a back seat to widespread capacity constraints and near-record skilled-labour shortages.

Crucially, businesses indicated they planned to increase investment on new machinery and equipment despite the trade uncertainty. Many have no choice, with no production capacity left to meet rising demand.

With the trade-pact uncertainty removed, it's hard not to see an already squeezed economy edging into "too hot" territory – and still-low interest-rate levels are contributing to that heat. If the BoC acts too slowly to rein in its rates, it runs the risk of the economy moving into an undercapacity situation that would fuel inflation beyond the bank's comfort levels. The bank would then have little choice than to raise rates above neutral, to actually slow the economy.

Given the still extremely high levels of Canadian household debt, the BoC would almost certainly prefer a key rate of 3 per cent

to, say, 4 per cent or more. The higher rates go, the more pressure they will pile onto heavily indebted households, elevating what remains the most serious and persistent risk to the Canadian economy.

Perhaps the best way for the Bank of Canada to mitigate that risk is to remove the rate stimulus as quickly as is practical – starting with another quarter-point hike in its next rate decision in early December. Better to tap the brakes now than to have to stomp on them a year or two down the road.