Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Canadians Worried About Inflation

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Re: **DECISIONS DEFERRED MEAN TROUBLE TO COME**

The Bank of Canada surprised financial markets late last month by holding its overnight rate target constant at 25 basis points. Holding constant might seem to imply that the Bank's monetary policy is unchanged, but this is not the case. Because the markets had priced in a hike in the overnight rate, the rate announcement was, in fact, expansionary.

All indicators leading into the announcement pointed to a hike.

Headline inflation was up to 4.8 percent in December, all the Bank's core inflation measures increased (with two of the three above 3 percent), and the Bank's December Business Outlook Survey showed two thirds of firms expect inflation to remain above 3 percent for the next two years.

Meanwhile, markets had almost completely priced in the rate increase by the time of the announcement. Therefore, by leaving the overnight rate at 25 basis points, monetary policy is providing further stimulus to the economy, about 25 basis points worth – at least until the next announcement.

This amounts to a genuine monetary policy shock of the kind statisticians and econometricians rarely have the opportunity to observe.

What effects will this have?

And what are the implications for monetary policy?

First, we note that those same three-month Treasury bill rates dropped nine basis points on the day of announcement. Indeed, all Treasury bill rates up to and including one year fell on that day. So, despite markets still predicting the Bank will increase the overnight rate at the next announcement, and continue to do so in the weeks and months ahead, it didn't stop their rates from falling.

As other interest rates also fall, households and businesses will borrow more. This increase in borrowing and spending will send inflation higher than it otherwise would have been.

So, by waiting at least an extra six weeks before starting its tightening cycle, the Bank of Canada will have made its job more difficult.

In this respect, the Bank missed an early opportunity to fight inflation.

It is fair to wonder whether this delay was an issue of defending its credibility. The Bank had previously committed to keeping its rate at the effective lower bound (25 basis points) as long as Canada's economy was below its productive capacity, and it was of the opinion as of its December announcement that this was still the case.

Its stated December view was that slack would only be absorbed by the middle quarters of 2022.

But conditions clearly changed.

Not only did inflation increase in December, but labour market conditions have also tightened. The Bank's January Monetary Policy Report presents a series of indicators from labour and product markets that make the case that the economy is now at full capacity. The Bank weighed the difficult tradeoff between credibility of what they had previously said and what the new data was telling them, and chose the former.

If the Bank has fallen behind the curve, what are its options? It is not likely to increase the overnight rate target by more than 25 basis points at its next announcement: this could even lead markets to believe that the Bank is unsettled about inflation and have a perverse effect on inflation expectations.

One option would be to provide guidance (which in the past has been used only when the Bank's policy rate was at its effective lower bound) and commit to hiking by 25 basis points every six-week cycle until headline inflation settles back below 3 percent. This might alleviate any concerns over de-anchored inflation expectations.

Sometimes when the Bank keeps rates unchanged, there is no impact on the economy. Sometimes, there is.

We believe the latter to be the case this time, not least because a bump in borrowing and spending is set to send prices even higher.

Rate hikes were always coming, but they may have to go higher than we thought.

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