

Intelligence MEMOS



From: William B.P. Robson

To: Borrowers and Investors

Date: February 28, 2022

Re: **INFLATION MAY BE A SURPRISE – HIGHER INTEREST RATES SHOULD NOT BE**

Statistics Canada's latest inflation report showed the consumer price index up 5.1 percent year-over-year in January – more than forecasters and markets expected and more than the Bank of Canada's latest projections implied. That's not new: the CPI has risen more than expected most of the past year.

Expectations about how the Bank of Canada will raise its target for the overnight rate in response have also moved up – somewhat. Few forecasters and investors seem to expect an overnight rate above 2 percent, at least not until well into 2023. But Canadians would be wise to prepare for an overnight rate of 3 percent or more before long.

The prospect of interest rates being higher than expected follows directly from inflation being higher than expected. Whether monetary policy is tight or loose depends on how interest rates compare to people's expectations – especially their expectation of inflation.

Interest rates higher than expected inflation are positive in real terms. A positive real interest rate means a potential borrower will need positive real income growth to service the loan, and a potential lender will think the same way.

The precise interest-rate level that will slow the growth of credit and money, restrain spending, and thus rein in inflation, depends on much else. But in a growing economy, keeping inflation stable normally requires real rates above zero.

On the other hand, interest rates lower than expected inflation are negative in real terms. The real-growth bar that potential borrowers and lenders have to clear is negligible. That stimulates growth of credit, money and spending, and fosters higher inflation.

How did these numbers look in Canada before COVID knocked everything sideways? In the 12 months to February 2020, the CPI rose 2.2 percent, very close to the Bank of Canada's 2-percent target.

Over the same period, the average increase in the three core measures the Bank prefers as indicators of trend inflation was just under 1.9 percent, also very close to the Bank's target. (The three, "CPI-trim," "CPI-median" and "CPI-common," [described](#) on the bank's website, reduce the weight of outliers.)

As for interest rates, in the 12 months to February 2020, the overnight rate averaged a bit more than 1.7 percent. Subtracting 1.9-percent – the average of the Bank's core measures – to adjust for inflation expectations yields a real overnight rate so close to zero (-0.1 after rounding) that it barely shows in the nearby chart.

A positive rate would have been more normal with the economy operating around capacity, as it then was, but inflation had run slightly below target for most of the previous decade and the bank was leaning loose to get it back up to two per cent.

What about lately? In the 12 months to January 2022, the CPI surprised with its 5.1-percent jump. The Bank's core measures also rose more than expected: 3.2 percent on average. As for interest rates, the overnight target has been 0.25 percent since 2020, but thanks in part to the Bank's huge bond purchases, the actual overnight rate over the 12 months to January averaged below that: 0.2 percent. Subtract the core measures for inflation expectations, and the real overnight rate was way negative – minus 3.0 percent. Very loose.

Getting inflation back down, as the Bank has committed, and as Canadians upset by rising prices will demand, means getting the real overnight rate back up, at least to zero, and ultimately above it. If the Bank's core measures are good indicators of inflation expectations, a zero real rate currently requires an overnight rate of 3 percent – more than most observers are expecting. If the CPI beats forecasts again in February, March and beyond, the eventual overnight rate could be higher still.

Higher inflation has been a surprise. Higher interest rates from the Bank of Canada in response should not be.

Inflation and Interest Rates			
12-month changes and averages to month shown, percent			
	February 2020	January 2022	Change
Consumer Price Index	2.16	5.14	3.0
Bank of Canada Core Inflation	1.87	3.20	1.3
Overnight Rate	1.75	0.18	-1.6
Real Overnight Rate	-0.12	-3.02	-2.9

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An earlier version of this Memo first [appeared](#) in the Financial Post.

Notes: Inspired by Andrew Levin, Presentation to the Shadow Open Market Committee, 2022-02-11. CPI readings are year-over-year over relevant span. Core Inflation is average of Bank of Canada's three preferred measures. Real Overnight Rate is calculated with reference to Core Inflation.

Source: Author's calculations from Bank of Canada data.