Intelligence MEMOS

From: Paul Jenkins

To: Borrowers, Savers, and Policymakers

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Re: **INTEREST RATES…BACK TO THE FUTURE**

Interest rates, particularly rising interest rates, are on everyone's mind these days. The focus is primarily alarm about rising inflation and the actions – actual or anticipated – by major central banks to bring inflation under control.

Lost in this focus is the important role interest rates play in connecting the present to the future, and in underpinning the kind of productive, sustained economic growth we need.

After nearly 15 years of unprecedented monetary stimulus – policy interest rates at the Effective Lower Bound (i.e., close to, even below, zero) and the exceptional expansion of central banks' balance sheets through Quantitative Easing (QE) – central banks are now on a path to 'normalize' interest rates.

The pace of increase and to what level rates will rise are open to debate, but what is clear is that interest rates need to go up to re-equilibrate economies. (A useful discussion of the so-called neutral rate of interest can be found as an appendix in the Bank of Canada's April Monetary Policy Report.) History shows that to counter inflationary pressure, interest rates need to rise above the neutral rate.

The Bank of England has been first off the mark with three increases in its policy rate to 0.75 percent. At its last two policy meetings the Bank of Canada has raised its policy rate by a total of 75 basis points to 1 percent, with a clear signal that more is to come. And the US Federal Reserve is poised to start its upward march.

Two underlying factors are behind the need to raise rates:

i. To prevent excess demand pressures from fueling inflation.

ii. To prevent inflation expectations from becoming unhinged.

With rising commodity prices reflecting, among other things, supply disruptions, these two factors are also critical in preventing relative price movements from feeding into generalized inflation – a mistake made in the 1970s.

But there is another perspective on why interest rates need to rise: interest rates are what connects the present to the future.

Bringing the analysis back to the unprecedented degree of monetary stimulus, the objective was to encourage spending today over saving for future consumption.

By lowering interest rates to the Effective Lower Bound, central banks encourage consumers and businesses to shift their preferences to borrow and spend now. With interest rates on the rise, this channel will begin to work in reverse by dampening spending and signaling the central bank's resolve to bring inflation back down.

By purchasing financial assets (QE), central banks alter the mix and quantity of financial assets as well as the risk in the financial system. Combined with interest rates effectively at zero, investors are encouraged to shift into riskier, higher yielding assets, leading to an upward shift in the value of those assets.

This repricing has been most visible in the exceptional rise in equity markets and housing, resulting in significant wealth effects.

These wealth gains have been another key source of support for the economy. But with interest rates on the rise, these gains are at risk either because of higher debt obligations due to higher rates, or moderation, even declines, in asset prices due to slowing demand. Moreover, complementing higher policy rates, central banks have also begun to take steps to reduce the size of their balance sheets – a reversal of QE, or what has become known as Quantitative Tightening.

The general conversation about all this centres on the near-term implications for the economy, however these central bank actions are also a means of connecting us to future economic growth by encouraging a shift back towards more long-term, productivity enhancing investments.

Specifically, higher rates and portfolio re-balancing will lead to less consumption, more savings, and more available resources for these types of investment.

It isn't hard to find examples of lagging investment in Canada. The C.D. Howe Institute's Jeremy Kronick and Bill Robson recently made the important observation that residential investment as a percentage of GDP has risen for the first time above that for non-residential investment. While a roof over one's head is critical, economic growth models clearly show the importance of business investment in structures, machinery, and, increasingly non-tangible IP capital, for sustaining growth with rising productivity and full resource utilization.

There has been a growing awareness among analysts and government of the importance of having a pro-growth economic strategy in Canada. Indeed, a fundamental principle is the imperative of economic growth to provide equal opportunity for all Canadians, and to pay for the type of nation we wish to have.

While higher interest rates are going to cause some short-term dislocations, they are an important part of re-equilibrating the Canadian economy and putting it on a sustainable growth path.

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