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From: Steve Ambler and Jeremy Kronick

To: Canadian Inflation Watchers

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Re: **Silver Linings for Canada in the SVB Implosion**

The Bank of Canada held its overnight rate, its benchmark policy rate, at 4.5 percent two weeks ago. No surprises there. The data were consistent with the Bank's view that inflation would come back down to 3 percent by the middle of this year and that more tightening wasn't necessary.

In fact, if anything, the major economic development over the last two months, the failures of Silicon Valley Bank (SVB) and Signature Bank, as well as the emergency takeover of Credit Suisse by UBS Group AG, made caution even more prudent. Furthermore, it might actually make the Bank of Canada's fight against inflation easier.

The US crisis resulted from poor banking risk management, in particular poor interest rate management, and a failure of supervision. SVB was the banker to the tech sector and the venture capitalists that supported them. In the years leading up to the crisis, the institution received a massive influx of deposits, many of which, because of their sheer size, were uninsured, and thus, a flight risk.

This made it hard for SVB to find a home for all the deposits, and so they invested heavily in long-term bonds when interest rates were very low. The Federal Reserve's rate hikes caused a paper loss on SVB's holdings of long-term bonds. When interest rates go up, bond values fall. When depositors realized this and attempted to withdraw their funds, SVB was forced to sell assets to honour the withdrawals, and the paper losses became real. A liquidity problem turned into insolvency. Signature Bank failed shortly after, and systemically important Credit Suisse was taken over by its former competitor, UBS.

The root cause of this banking crisis is the fact that the world's central banks have been raising interest rates to cool off inflation. But, therein lies the rub: what to do if you must continue fighting entrenched inflation but at the risk of increased financial instability?

The Fed's March interest rate announcement (two weeks after the banking crisis began) insisted that there were no issues with the "sound and resilient" US banking system. And, despite pleas in some corners to pause the rate hikes in light of SVB's collapse, the Fed plowed ahead with a 25-basis-point hike on March 21. Even so, pundits and markets have revised downwards their expectations of how high the Fed's policy rate will ultimately go.

What does this all mean for the Bank of Canada?

First, that it deserves credit for being the first central bank to begin the monetary policy tightening process, which has allowed it to get inflation down faster than other countries and means it has minimized the potential trade-off with financial stability should there be spillovers in Canada from the banking crisis abroad.

Second, the fight against inflation may have become easier as a result of this crisis. Less tightening by the Fed means less of a differential between US and Canadian rates. A larger differential would have put downward pressure on the Canadian dollar, increasing import prices and putting upward pressure on inflation. The Bank's inflation fighting strategy involves tempering increases in demand, and a lower Canadian dollar would work against this by boosting demand for Canada's exports.

Moreover, as credit conditions tighten globally because of the bank collapses, borrowing becomes more difficult, including in Canada, which will reduce domestic aggregate demand.

There are other encouraging signs for global inflation. Headline inflation is decreasing in most major economies, helped partly by lower energy prices. It is still generally higher than Canada's headline inflation, although in the US, March headline inflation (announced just before the Bank of Canada's announcement) dropped to 5 percent, a full percentage point lower than the previous month. The International Monetary Fund has also revised down its estimates for world economic growth, which will help to calm inflation globally.

We're not out of the woods, but we are beginning to see more light through the trees. If Canadian inflation continues to abate with an overnight rate target of 4.5 percent, the Bank may succeed in slaying inflation while not throwing the economy into recession. Strange to say, but SVB's collapse might have made that outcome more likely.

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