Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Inflation Watchers

Date: October 31, 2023

Re: **No More Rate Hikes. So What's Next?**

The Bank of Canada once again held its policy rate at 5 percent last week.

After two months of disappointment, with the annual change in the consumer price index (CPI) ticking up in July and August, inflation resumed its descent in September, falling from 4 percent to 3.8 percent. That, plus weak economic numbers, made it practically certain – confirmed by market expectations – that the Bank would hold. The real questions concern the Bank's end point for monetary policy in the medium term and what that means for Canadians.

The Bank is probably at the end of its tightening cycle. But this doesn't mean interest rates are coming back to pre-Covid times.

The interest rate hikes the Bank began in early 2022 are bringing inflation back to target. Core measures of inflation also fell in September, consumption growth is flagging, and the unemployment rate is rising. As inflation subsides, the Bank's policy rate rises in real terms, making monetary policy more restrictive even if the Bank leaves its policy rate untouched. With the policy rate at 5 percent and inflation at 3.8 percent, the real policy rate, at 1.2 percent, is already on the restrictive side. We say that because this rate is above the Bank's estimate of its real "neutral" level – the rate when the economy is producing at its potential and inflation is sustainably at 2 percent – which the Bank thinks is between zero and 1 percent.

So the Bank's next move will likely be a cut. This raises a series of questions. How soon will the Bank move? How far will it move? What does the new normal look like? Are we headed back to where we were in the decade before the pandemic? Or will we land somewhere new, and what are the ramifications?

The 30-35 years that preceded the pandemic were marked by falling real interest rates alongside a decline in the neutral rate. Globalization was an important part of this story as China flooded world markets with cheap manufactured goods, keeping both inflation and interest rates low. As the Chinese labour force expanded with a massive migration from the countryside to coastal cities, young Chinese workers saved for retirement. World savings were high, keeping real interest rates low.

These demographic trends have largely reversed. China's urban migration has run its course, and its extremely low birth rate means that the labour force is actually decreasing. Older Chinese are running down their savings, lowering the world saving rate, which will increase the neutral rate.

A similar demographic shift is happening in Canada, as the increased savings we saw as people moved closer to retirement reverses and these same folks leave the work force and spend their savings.

A higher neutral rate has many negative effects including increased borrowing costs for highly leveraged households, businesses and government.

This is where productivity comes in. We have now had many years of poor productivity growth in Canada, driving investment and interest rates down. Reasons abound: Policies that encourage a disproportionate amount of lending to mortgages, which does very little to increase productivity; competition for our talent from the United States; and needless interprovincial trade barriers, to name but a few.

We badly need to reverse at least some of these trends and generate more investment opportunities.

That will further increase the neutral rate, to be sure. But this reversal and increased productivity will also offset the negative effects of a higher neutral rate.

We should all be preparing for a world with higher interest rates. Best to start now.

Jeremy M. Kronick is Associate Vice President, and Director of the Centre on Financial and Monetary Policy at the C.D. Howe Institute, where Steve Ambler, a professor of economics, Université du Québec à Montréal, is the David Dodge Chair in Monetary Policy.

To send a comment or leave feedback, email us at blog@cdhowe.org.

A version of this Memo first appeared in The Globe and Mail.