Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Canadian Interest Rate Watchers

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Re: **THE ROAD NOT TAKEN**

Last month, the Bank of Canada decided not to change its target for the "overnight rate" of interest at which lending takes place among large financial institutions.

It was a non-move that had extra significance given the speculation about a "micro-cut" of less than 25 basis points that arose from public statements from members of the Bank's Governing Council. They suggested the possibility of such a cut in the target overnight rate if weak economic conditions warranted such a move. With the Bank now predicting negative economic growth this quarter, such a cut might have seemed justified.

But it didn't happen. To us, this time, that was the right call. Here's why.

First, monetary policy is forward-looking. And the Bank's Monetary Policy Report (MPR) took a rosier outlook past the first quarter of 2021, with vaccines coming in faster than the Bank's last MPR predicted in October. If 25 basis points was the appropriate target back in October, 25 basis points or even higher is appropriate now.

Second, the overnight rate itself has, of late, often undershot the Bank's target, and dipped as low as 9.85 basis points on Jan. 4. How can trades be taking place at such a low rate when financial institutions can earn 25 basis points on their deposits with the Bank of Canada (which is where the so-called deposit rate is now)? The answer is that there are smaller players in the overnight market who don't have deposits with the Bank and are willing to lend overnight at this low rate.

Lowering the target rate to something in the range of 10 to 15 basis points would merely have recognized the reality that the Bank's target rate at 25 basis points is getting harder to achieve. With the overnight rate creeping up since its 9.85 basis-point bottom, the Bank apparently believes it can get it back to 25 basis points.

Third, micro-cuts may convey a false sense of precision in the Bank's ability to fine-tune the economy. A further cut of 10 basis points would likely provide little or no additional stimulus to the economy via increased lending. Financial institutions must weigh the interest they receive on deposit at the Bank versus the risk-adjusted rate of return they get from lending this money out. A rate cut would help here, but even if institutions were willing to lend, weak business investment in Canada – which the Bank sees continuing into 2022 – means muted demand for loans from businesses that are just too uncertain about the future.

Finally, the Bank's usual rationale that lowering the target overnight rate will lower longer-term yields likely does not apply. The Bank might be forecasting a return of inflation to target some time in 2023, but at the time of the Bank's decision, the average yield on one- to three-year marketable Government of Canada bonds was lower than the overnight rate target and about the same as the actual overnight rate. This is not all that surprising as the Bank's Quantitative Easing strategy was intended to lower these longer-term yields to bring forward borrowing and investment. However, there would then be little to gain from a micro-cut that sent the overnight rate target to 10-15 basis points.

While we agree with the Bank's decision this time not to implement a micro-cut, the takeaway from the hints provided by the Bank's senior staff is that 25 basis points is not the effective lower bound for the target overnight rate. And, there may come a time when a further cut, micro or even more, is warranted. This is consistent with the Bank's own research, which has put the effective lower bound – the rock bottom interest rate – at minus 50 basis points. If the Bank believes 25 basis points is not the lower bound, it should make that clear.

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