

Intelligence MEMOS



From: Thorsten Koeppel
To: Stephen S. Poloz
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Re: **WHEN DOVES BECOME ... KIWIS**

This week, the Bank of Canada left interest rates unchanged. Business as usual one might think. But far from it. In your remarks to the Standing Senate Committee on Banking, Trade and Commerce, you all but made the argument for a possible future cut in interest rates. Your reasoning, however, seems to reflect a brave new world in central banking where interest rates have to do all the heavy lifting and may even never rise again; in other words, a world in which doves become kiwis, a cute flightless bird.

The main reasoning for a cut in interest rates would be the dire state of Canadian exports – especially from the manufacturing and resource sector. Growth has remained anemic due to what the Bank admits is a competitiveness challenge. Uncertainty regarding future growth in the US and emerging economies have caused businesses to not make up for lost export capacity and to engage in productivity enhancing investment.

What has prevented a cut so far are financial stability concerns. But with the new mortgage rules in place, the Bank feels that an impediment to lower rates has been removed. After all, the measures change the likely composition in future household indebtedness away from “bad” borrowers to “good” borrowers.

This reasoning is puzzling. First, monetary policy is designed to address cyclical fluctuations. Structural changes cannot and should not be addressed with monetary policy. At most it can assist in transitions, but other measures such as fiscal policy and a national infrastructure initiative are better suited to rebuild lost export capacity.

Second, referring to the relative depreciation in the Mexican Peso vs. the Canadian dollar evokes memories of beggar-thy-neighbour policies where competitive exchange rate depreciations ruled the day. Meanwhile, inflation (and its outlook) has remained fairly stable, a bit below target, but solidly within the Bank’s operating band. The job of monetary policy is to manage inflation expectations and pressures. Lost capacity points to lower potential output so that a considerable fall in inflation that would argue against a cut seems not to be in store.

Third, the Department of Finance has finally addressed the frothy Canadian housing market. This should not give the Bank of Canada the freedom to pour new fuel onto this market. Indeed, optimal policy coordination implies that the new mortgage rules aim at reducing the pressure on the Bank to use higher rates to cool off the housing market. A 25 basis point cut would do little to change investment intentions, while removing some of the impact the new mortgage rules have.

Next month, I will be visiting the Reserve Bank of New Zealand, the first central bank to make inflation targeting a success story. The Reserve Bank has tried to lift off low interest rates twice since the global financial crisis, only to stay grounded after all and applying tighter mortgage rules to cool off a foreign investment driven housing bubble. Maybe, I will learn there how doves become kiwis.

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