

THE CASE AGAINST RISING RATES

Alia McMullen



Saturday, August 01, 2009

As the economy begins to creep out of its economic rut, the market has begun to speculate on when interest rates will rise. The Bank of Canada pledged in April to hold interest rates at 0.25% until the end of June, 2010. The move was designed to ease credit pressures on financial institutions and consumers as the recession intensified. However, the pledge -- an unconventional monetary policy tool used to keep short-term interest rates and mortgage rates low -- came with an exit clause. If price inflation begins to threaten the economy, the central bank could raise interest rates earlier. But will they? Two economists face off.

THE CASE AGAINST RISING RATES

CRAIG WRIGHT

Chief economist, RBC Capital Markets

The Canadian economy may be on the mend, but Mr. Wright said it will be some time before it can handle an increase in the benchmark interest rate and therefore the Bank of Canada will likely stick to its conditional pledge to keep the rate on hold until mid-2010.

"Eventually, they will have to raise rates, but we think given the deep recession we've had, the slow recovery we expect and contained inflation expectations, the Bank has time on their side," Mr. Wright said. He said the central bank will begin to slowly lift rates in the second half of next year.

"We don't think they will have to rush aggressively to move rates higher," he said. "I think it gets a lot more exciting in 2011 in terms of how much they have to raise rates, but that's a long time off."

For now, slow economic growth coupled with a large amount of excess capacity would prevent significant upwards pressure on inflation and hence interest rates.

"In an environment of excess capacity, the ability to pass on price increases is pretty modest and the ability to demand wage increases is pretty modest and workers tend to look more for job security than wage gains, so that keeps inflation low and that's alongside fairly low, well-anchored inflation expectations," he said.

Mr. Wright predicted the economy will grow 0.8% in the third quarter of this year after three quarters of recession. But the recovery process will be moderate with growth of 2.5% expected for 2010, a level much lower than historical post-recession periods where growth has been closer to the 4% level.

"If we look at where it was just a short while ago, everybody was worried about how deep and dark the recession was going to be and now we've kind of quickly swung around to how quick the recovery is going to take hold," he said. "I think we have to give some credence to the fact that there's still excess capacity in the economy and that allows growth to run for some period of time before we have to worry about inflation."

Further limiting economic growth is the appreciation of the Canadian dollar, which is up 21% to almost US93¢ since bottoming at US76.85¢ in March.

"If you look at the Canadian dollar's move to a stronger footing, that's doing some of the restraint for the bank," Mr. Wright said.

THE CASE FOR RISING RATES

STEPHANE MARION

Chief economist, National Bank Financial

The Bank of Canada will be forced to use its "conditional exit" card and begin to raise interest rates early next year to prevent a rise in inflation expectations as well as long-term interest rates, Mr. Marion said.

"The time for tightening is not yet at hand, but June 2010 seems too late," Mr. Marion said.

"The day when the condition for the Bank's low-rate commitment is no longer met will probably come before then. We see the first rate hike at its first meeting in 2010."

With the economy expected to return to growth this quarter amid a stabilization in credit conditions, Mr. Marion said the central bank would need to begin to reverse the unusually accommodative monetary policy put in place to address the worst credit crisis since the 1930s.

The "real" interest rate, which is the nominal interest rate minus inflation, is nearing a negative 2% based on a benchmark policy rate of 0.25% minus a core inflation rate at 1.9%. Mr. Marion said real interest rates under normal economic conditions are usually around 2%.

The Bank of Canada's predicts core inflation, which excludes some items with volatile price swings, to return to its target of 2% by mid-2011, with potential economic output also normalizing by then.

Mr. Marion said this means the central bank would need to push its benchmark interest rate up to 4% to achieve a real interest rate of 2% by mid-2011.

"They're going to have to go in large increments to bring the actual policy rate to roughly 4% in nominal terms," he said. "If you start in mid-2010 and you have to be there by mid-2011 with only eight meetings, then you're going to have to go with 50 basis point increments."

He said smaller interest rates increases made sooner would be less of a shock to the economy.

The other thing to consider is the 12-18 month lag between when interest rate adjustments are made and the time when the full effect of the adjustment is seen in the economy.

"Look at it this way: if they start raising rates in mid-2010 after four quarters of positive growth, monetary policy works with a lag so the first year of your rate increases will only bite later in 2011 if you believe the Bank of Canada's forecast," Mr. Marion said.