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"Low rates begets lower rates"

The most recent move in July by the Bank of Canada to cut their policy rate to 0.50% was met with praise by some, and frustration by others. I must allow that I was in the latter camp. At a time when Canada's record household debt levels remain at an elevated risk to the country's financial stability, we reduced borrowing rates further. With interest rates already at extreme lows, how will another 0.25% rate cut help the economy? My sceptical mind needed answers.

Those in praise of the rate cut cited the need to offset the deflationary pressures from the oil price decline and ensuing contraction in economic growth. From the Bank of Canada's (BoC) perspective, this is the major risk facing the Canadian economy that must be addressed. A severe decline in economic activity and employment could potentially trigger a financial crisis brought on by our high debt levels. The BoC feels that another rate cut helps to address these financial stability risks.

For those of us who remain doubtful after their plausible explanation, time will tell whether our scepticism was warranted. The problem facing the Canadian economy, along with other industrialized economies is how to generate sustainable economic growth, which will translate to higher incomes and improving productivity.

A continuing challenge after seven years of exceptionally low interest rates is the anemic pace to business fixed investment, a precursor for this much needed growth. The Bank of Canada's own surveys suggest that firms continue to wait for signs of a sustained pickup in demand before increasing investments. From the US Federal Reserve Bank's perspective, weak productivity growth stemming from a lack of fixed re-investment has held back improvements in the US labour markets.

The recent annual report from the Bank of International Settlements (BIS) contemplates another theory. They argue that the current economic "malaise" may reflect a failure to understand how financial boom and busts interact with the real economy. Rather than just reflecting the current economic weakness, low rates can fuel costly financial booms and busts. The result is too much debt, too little growth and excessively low interest rates. Or, in other words, "low rates beget even lower rates". Canada now comes to mind.

From their perspective, monetary policy has relied too much on measures that have entrenched dependence on the very debt-fuelled growth model that lay at the root of the recent financial crisis. This has resulted in the failure of global debt burdens to adjust, the continued decline in productivity growth and, above all, the loss of policy room for manoeuvre if another crisis occurs. The economic impact of the financial crisis affected asset prices, not goods and services and therefore they feel that inflation targets should not be overemphasized in policy. They feel government policies focused on supporting investment and innovation are needed to boost productivity; the low oil price now presents an opportunity not to be missed.

The BIS report further highlights the risks to the financial system from the persistence of ultra-low interest rates. These include undermining the profitability and solvency of insurance companies and pension funds, and the pervasive mispricing in the financial markets which elevate risks for investors. They feel that more weight should be attached to the financial risks caused by the persistence of ultra-low interest rates, and of normalizing too late and too gradually.

Over a longer horizon, low or negative interest rates are "hardly conducive to rational investment decisions and hence sustained growth". Perhaps that is the concept that is lost on policymakers. How do you ignite sustainable growth not fuelled by debt? The US Federal Reserve Bank has indicated that they will begin raising their overnight interest rate sometime in 2015. It is a small step towards policy normalization. Their own internal analysis may support the view of the Bank of International Settlements; a change in mindset and policy is needed to heed change in the "real" economy.

We share the view that persistently low rates have created pockets of overvaluation in the bond and equity markets. As noted in our weekly letter of August 7th, we have made another step towards reducing risk in the balance portfolios through a reduction in equities to 50%. We anticipate further volatility in the markets in contemplation of policy normalization.

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