



CANADA

Negative key rates are possible, according to the Bank of Canada

In a speech yesterday, Bank of Canada (BoC) Governor Stephen Poloz opened the door to using negative key interest rates. The lower bound of the target for the overnight rate would no longer be 0.25%, where the BoC had set it in 2009 during the financial crisis. Instead, it would be around -0.50%. The Governor nonetheless added that he did not believe he would have to use rates this low in the coming years, as the Canadian economic situation should improve and inflation should return to and stay at its target on a lasting basis around mid-2017.

In an *Economic Viewpoint*¹ published last July, we looked at the possibility of seeing negative interest rates in Canada, as is now the case in several countries in Europe. Among other things, we concluded that Canada's economic situation did not demand such a measure yet. That being said, numerous risks still weigh on the economy and we can think of scenarios in which resorting to unconventional monetary policy tools such as negative interest rates could become necessary. The fact that the BoC's main key rate is at just 0.50% increases the chances, as well.

Governor Poloz was careful to mention that there was no preset sequence for using unconventional monetary policy tools. The choice of tool would depend on the situation. In July's *Economic Viewpoint*, we determined that negative interest rates could be an effective tool for bringing the Canadian dollar down, but not for stimulating credit, given the heavy debt loads Canadian households are carrying. In Europe, negative rates weakened currencies but also stimulated credit, as household debt rates were generally lower.

Given that the Canadian dollar is already very low, the BoC could opt to use other tools before turning to negative

interest rates. Still, if the U.S. economic situation were to deteriorate and the U.S. dollar depreciated, the negative interest rate option would gain credibility. This could also be the case if oil came up enough to make the Canadian dollar rise, but not enough to make the economy pick up. Note, however, that other tools, such as forward guidance and massive asset purchases, could have an impact on the exchange rate, with the advantage of lessening the risk of impacting the normal workings of the financial system.

Implications of negative interest rates: If the target for the overnight rate were to be lowered to -0.50%, a number of money market rates and bond yields would likely to go into negative territory, too. Financial institutions, institutional investors and insurance companies would be among the most affected. This could cause investors to reach for yield and favour other asset classes, such as shares. The retail rates offered to consumers seem much less likely to go into negative territory. In Switzerland, where the principal key interest rate was set at -0.75%, only a few deposit rates were taken below zero. Taking out a loan with a negative rate would be even less likely.

On another note, having the BoC lower the bottom bound for key rates increases the chances that it will keep its inflation target at 2%. The possibility of a higher target had been raised to increase inflation expectations and the neutral interest rate. It also made it possible to reduce the likelihood of key rates being lowered to close to 0%. This threshold now seems less of a problem in the BoC's eyes.

Hendrix Vachon
Senior Economist

¹ Desjardins, Economic Studies, *Economic Viewpoint*, "Negative interest rates: Will Canada be spared?", July 9, 2015, www.desjardins.com/ressources/pdf/pv150709-e.pdf?resVer=1436448617000.

François Dupuis
Vice-President and Chief Economist

Mathieu D'Anjou
Senior Economist

Benoît P. Durocher
Senior Economist

Francis Généreux
Senior Economist

Jimmy Jean
Senior Economist

Hendrix Vachon
Senior Economist

514-281-2336 or 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com