High Debt Loads Call for a Gradual Rise in Canadian Interest Rates

The Bank of Canada (BoC) ordered two consecutive key rate increases last summer, then opted for the status quo at its October 25 meeting. Although the decision was expected, the BoC’s fairly cautious tone seemed to be somewhat of a surprise for the markets. The press release’s most important sentence read: “While less monetary policy stimulus will likely be required over time, Governing Council will be cautious in making future adjustments to the policy rate.”

The Monetary Policy Report and remarks by Governor Poloz suggest that the caution the BoC is signalling does not stem from concern over Canada’s economic outlook, but rather from uncertainty over the impacts of the key rate increases given high household debt loads. The BoC thus revised its principal economic model to better capture the impacts of household debt on the economy. Unsurprisingly, the BoC notes that rate increases could do more harm to the economy compared with a smaller debt load situation.

The BoC’s finding should surprise no one. Clearly, heavy debt makes households more vulnerable to a sudden increase in interest rates. This reality should, however, be construed as a normal, predictable consequence of the highly aggressive monetary policy of recent years rather than as a reason to maintain such policies.

Nearly 10 years after the financial crisis, interest rates remain extremely low worldwide, helping drive debt ever higher in many countries, including Canada. Maintaining highly aggressive monetary policies for some time to come would only make the problem worse by pushing debt even higher, making economies more vulnerable still to an eventual rise in interest rates.

IMPLICATIONS

There is no easy answer to the issue of high debt loads in Canada and many other countries. The central banks have clearly encouraged the phenomenon with their ultra-accommodating policies of recent years. This may have been necessary in the tough post-financial crisis years, but central banks should now take advantage of the improvement in the global economy to normalize their monetary policies at last. Far from arguing for a long status quo, high household debt loads are an important argument in favour of gradually, but not too gradually, and predictably raising Canada’s key rates, as the Federal Reserve is doing.

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**GRAPH**

Maintaining very low interest rates would help keep debt trending up

*Ratio of credit market debt to disposable income

Sources: Statistics Canada, Datastream and Desjardins, Economic Studies

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