

## Economics

# IN FOCUS

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## Three fallacies on interest rates and the economy

by Avery Shenfeld [avery.shenfeld@cibc.com](mailto:avery.shenfeld@cibc.com)

Interest rates are on the move, and that has shined a spotlight on their role in steering or predicting economic activity. While pretty much everyone gets the basics — higher interest rates act as a braking force on growth and inflation — there are a few common misconceptions when it comes to the details. Herein we address three fallacies that even sophisticated market participants sometimes espouse.

### #1: Rates have to be above neutral to slow growth

Economists are sometimes among those guilty of the first of these fallacies, in which it's claimed that in order to slow the economy, the overnight rate of interest has to be above the so-called neutral rate. Indeed, just this month, Fed Regional President Bullard, a voting member on the FOMC, appeared to do just that, arguing that even a substantial initial tightening would be just removing accommodation and would not be restrictive yet for growth. The error comes in conflating a rule that applies in an idealized "steady state" with what happens when interest rates are on the move in the real world.

The neutral rate can be thought of as the policy rate that keeps an economy that is already sitting at its non-inflationary limits (i.e. a zero output gap, or full employment) growing at a pace that matches its non-inflationary potential. It's usually measured under the assumption that there are no material headwinds or tailwinds (e.g. fiscal policy isn't stimulative or contractionary, for example).

Starting at that neutral level, a cut in rates would cause the economy to accelerate and overheat, while raising rates would engender slowing growth and widening economic slack. Model-based estimates from the last cycle suggested that the nominal neutral rate was roughly 2½%, and the Bank of Canada sees the Canadian neutral rate in similar territory.

So if we're now nearing potential GDP and trying to avoid an overheating, do we have to have rates at 2½% today or in very short order? Not necessarily. Remember that the growth

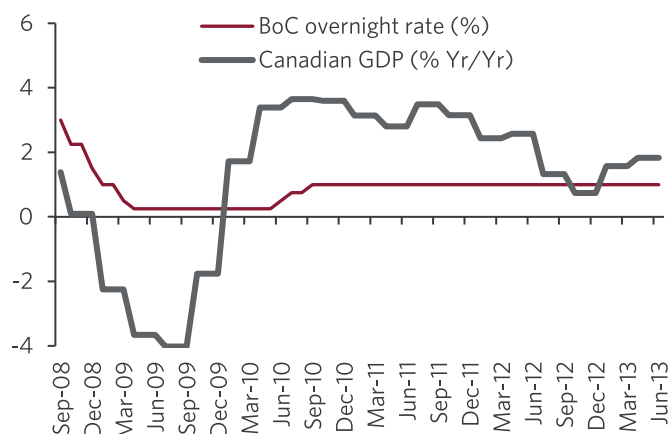
rate we observe in the US and Canada today includes the stimulative impact of near-zero interest rates.

A rate of 1% would entail less stimulus than what we see now, and all else equal, cause growth to decelerate, by prompting a deceleration in demand growth for housing, durable goods and business capital spending. Since rate hikes act with a lag in inducing these impacts in full, central banks will typically opt to pause during their tightening cycle to observe how much of a deceleration they have already engineered.

Some would argue that while growth would slow, if rates remain below neutral, the deceleration would still leave the economy growing faster than its non-inflationary potential. That might be true in a single variable idealized model. But in the real world, there will be many forces pushing and pulling on growth, in addition to interest rate changes, so even if the "neutral rate" is the eventual destination, the path there is rarely abrupt, and often entails pauses and even temporary reversals.

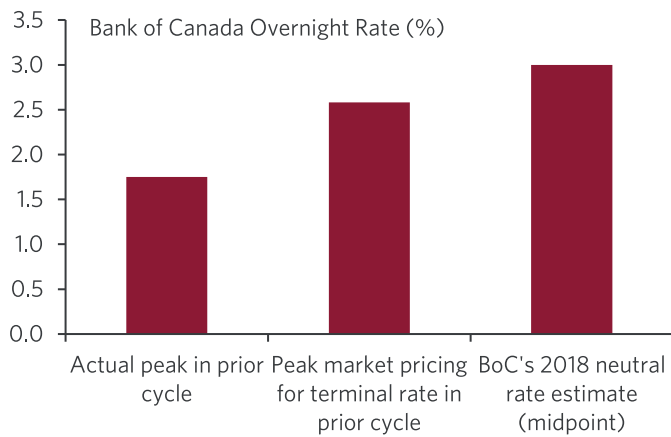
As a case in point, the Bank of Canada hiked rates by 75 bps to 1% in 2010, but the overnight rate didn't exceed that level for many years to come (Chart 1). Note that there was indeed a

Chart 1: Canada slowed after 75 bp 2010 hike



Source: Statistics Canada, Haver, CIBC

**Chart 2: 2018 peak overnight rate was well below market expectations and neutral rate**



Source: Bloomberg, Bank of Canada, CIBC FICC Strategy

deceleration in growth after that first dose of hikes, albeit amplified for a few months when the country was hit by the SARS virus, but also captured the drag from a much stronger exchange rate.

More recently, the Bank of Canada wisely ceased raising rates in the last cycle after October 2018, when the overnight rate was 1.75%, still well below what the Bank of Canada estimated the neutral rate at that time, and below what the market was pricing in for a further climb (Chart 2). But the economy decelerated to below-potential growth in 2019, in part a consequence of a global trade war that cut into exports, but also due to an evident slowing in interest sensitive aspects of domestic demand. Indeed, Governor Poloz subsequently stated that a modest easing in rates might have been in the cards for 2020 even without the Covid-19 shock.

Are there potential headwinds in our future? Clearly, geopolitics are a top-of-mind risk right now. While we want to forget about Covid-19, the virus hasn't forgotten about us just yet, and future waves could still be disruptive for services demand. Fiscal policy won't be as stimulative as it has been, and could turn contractionary as government winnow deficits back down.

None of this says that the central banks won't at some point get the overnight rate to current neutral estimates, which for the US and Canada sit in the mid-2% range. But that's not a decision that can be taken on autopilot, nor a rate that has to be reached in a hurry to take some of the steam out of growth and inflation ahead.

## #2: An inverted yield curve causes recessions

In this second fallacy, the central bank wants to avoid causing an inverted yield curve because when short rates exceed long rates that somehow causes recessions. A 1998 note on the St. Louis Fed's "On the Economy" blog made that claim, for example.

As in the neutral rate fallacy, there's a kernel of wisdom in this one. It is true that in many cases, an inverted yield curve comes ahead of a recession. But unless it comes with quite elevated short term rates, that isn't really causal, but rather, predictive, for reasons we discuss below. It's the degree to which rates are elevated, more than the shape of the curve, that has the causation.

In terms of causing recessions, some argue that inversions are negative for banks, seeing them as institutions that borrow short term, and lend longer term, and that an inverted curve squeezes margins and thereby stanches the flow of debt capital.

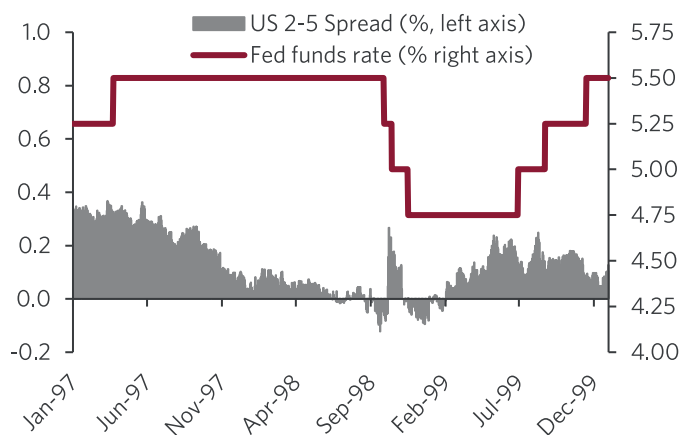
The reality is more complex. For one, banks hedge out most or all of their interest rate risk, rather than leave themselves exposed to rising short rates and a mismatch in the terms of their assets and liabilities. While the St Louis Fed noted the fact that yield curve inversions tend to coincide with survey data showing that banks are tightening lending standards, that correlation largely reflects the fact that both the yield curve, and bank lenders, are responding to signposts of an economic slowdown, with attendant credit quality risks.

The more important link between interest rates and bank lending profitability relates to the absolute level of interest rates. When overnight rates are near zero, yields on deposits that are bounded at zero can't fall far enough to maintain lending margins. So upcoming rate hikes in the US and Canada, which might flatten the yield curve, will still be a plus for the banking sector. When rates get too high across the yield curve, however, the banking system faces greater risks of credit defaults as the economy is squeezed, and that's when yield curve inversions can coincide with banks tightening credit standards.

## #3: An inverted curve signals a recession is coming

This one is sometimes true, but can be fallacious, particularly in present circumstances. It isn't that the yield curve is a soothsayer on its own. It's that investors, seeing signs of at least a slowing in growth, or short term rates that look intolerably high, sense that it won't be too long until central bankers start cutting short term rates. The result is that longer term yields, which imbed those lower short term rates in years ahead, fall below current short term yields.

Chart 3: 1998 US curve inversion foretold rate cuts, but not a recession



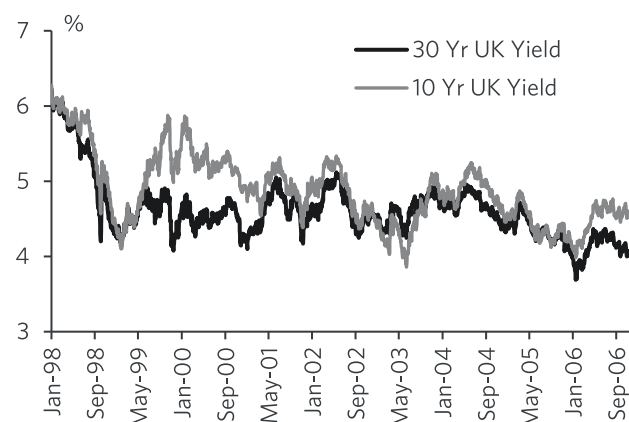
Source: Bloomberg, CIBC

But remember, all that the inversion signals are that investors believe that policy rate cuts are in the offing. That could be because they judge rates high enough to cause an unwanted slowing, and expect an adjustment by the central bank to ward that off. That's exactly what we saw in 2019, when the inverted 2s-5s US curve correctly anticipated that the Fed would ease rates in the face of a slowing pace to growth and the absence of an inflation threat. There was no recession, and one didn't appear in the offing until Covid-19 hit. We saw the same phenomenon in mid-1998 (Chart 3). It wasn't until after a Fed ease that year, then a subsequent tightening cycle that re-inverted the curve, that we saw the US head into recession in 2001.

Still, in other cases, a curve inversion did accurately presage a recession. Even then, you have to be well into a rate hike cycle for a very flat or inverted curve to send a message about growth risks. Short rates have to be high enough to credibly threaten to tip the economy into recession, and usually we've already seen a lot of growth deceleration when the curve inverts. For some perspective, in the last 35 years, the earliest the US economy tipped into a recession tied to monetary policy came in 1990 after a three-year rate hiking cycle, and recession-inducing moves typically entailed a cumulative climb of more than 300 basis points.

In this case, we have yet to see the even first hike by either the Fed or the Bank of Canada, which is why the curve is not yet that flat, let alone inverted. It's hard to spin the story that the curve is even thinking about a recession when neither central bank has yet shown that it's being excessively aggressive on rate hikes.

Chart 4: UK had extended periods of 10-30s curve inversions



Source: Bloomberg, CIBC

Moreover, some of the curve flatness surely reflects the distortion cause by unprecedented volumes of quantitative easing. The very purpose of all of those Fed bond purchases, as well as those by the Bank of Canada, was to pull down longer term rates more than the easing in overnight rates could promote, in order to lower borrower costs for mortgages and other term debt.

Both the Fed and the Bank of Canada will soon be reversing that process, initially by not reinvesting the holdings that mature, which particularly in Canada, where there will be a lot of fresh government supply at the long end, should stand in the way of an inversion until short rates are much higher. If the curve remains very flat, it would be a green light for the central bank to actively sell some of their holdings, since if long rates aren't much above short term rates, pushing them higher through debt sales would not represent a large additional drag on growth.

The curve can also be very flat, or inverted, due to factors other than an expected recession. If North American inflation is seen as elevated in the near term, but expected to be lower further out, two-year nominal yield yields might be lifted for the need to compensate for inflation in shorter terms, but ten-year bonds would see less of an impact.

Or there can be institutional reasons for inversions in parts of the curve. The long end of the UK curve spent much of the decade starting in the mid-1990s moving in and out of inversion, due to structural demand for long duration product relative to its supply (Chart 4).

In sum, if we see a curve inversion or extreme flatness, and we're well into a rate hike cycle that is causing evident pains in interest-sensitive sectors, it might be time to start a recession watch. If that's not the story, better to look for other reasons why the curve looks the way it is.

## Contacts:

Avery Shenfeld  
416 594-7356  
[avery.shenfeld@cibc.com](mailto:avery.shenfeld@cibc.com)

Benjamin Tal  
416 956-3698  
[benjamin.tal@cibc.com](mailto:benjamin.tal@cibc.com)

Andrew Grantham  
416 956-3219  
[andrew.grantham@cibc.com](mailto:andrew.grantham@cibc.com)

Katherine Judge  
416 956-6527  
[katherine.judge@cibc.com](mailto:katherine.judge@cibc.com)

CIBC Capital Markets  
PO Box 500  
161 Bay Street, Brookfield Place  
Toronto, Canada, M5J 2S8  
Bloomberg @ CIBC

[economics.cibccm.com](http://economics.cibccm.com)

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