Economics

IN FOCUS

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Central bankers are not robots

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We have some issues with the current market pricing of the future trajectory of US and Canadian policy rates. The main one is the fact that the market is currently pricing in a terminal rate of 3.25% for the Fed and 3.40% for the Bank of Canada. This appears to be very aggressive. Note that in the last tightening cycle, the Bank of Canada stopped at 1.75% and, in fact, was toying with the idea of easing as the economy started to respond negatively to that rate of interest.

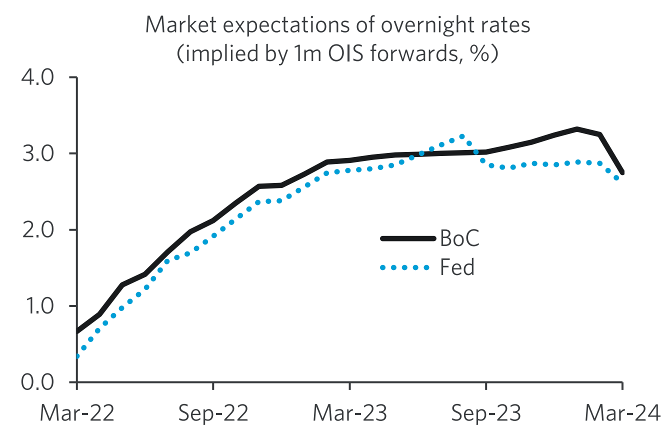
The other issue is the speed at which the market is expecting both the Fed and the Bank to move at. At this point, the market is pricing in a rapid hiking trajectory, with both central banks expected to reach 85% of their respective terminal rates in the coming 12 months (Chart 1). We think that's way too rapid.

If inflation is accelerating, won't a robotic central bank hike until inflation is back to where it belongs? Monetary policy is not Economics 101. It's much more complex, and central banks aren't robotic in practice.

Despite some monetary policy slips over the decades, the Fed and the Bank of Canada deserve some credit for acting on the realization that, as opposed to media headlines, their job description really entails focusing on medium-term inflation risks and not on today's CPI readings.

Chart 2 provides some examples of situations in which the Fed paused or even started easing policy while still facing a relatively high rate of core inflation. From mid-1989 to early

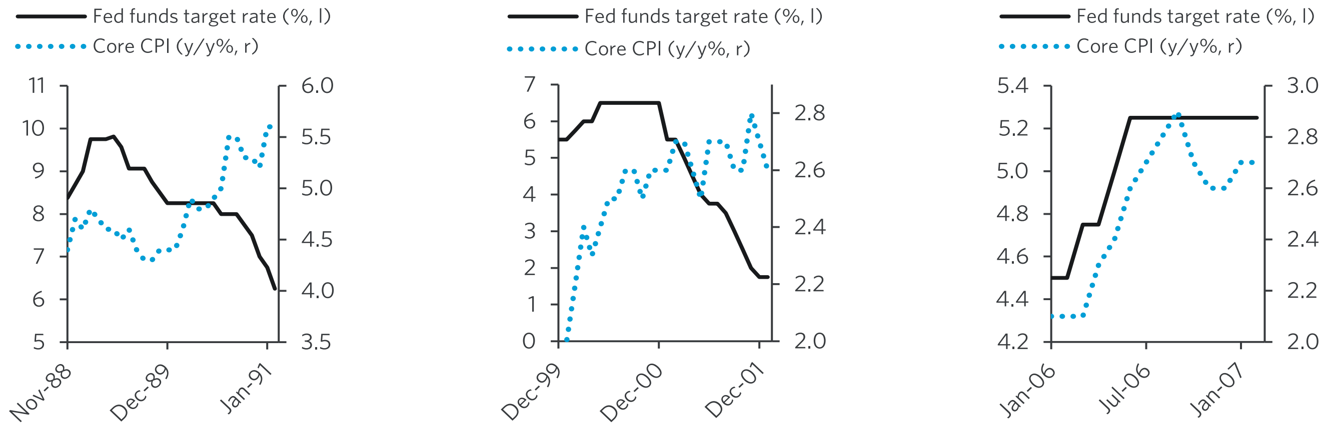
Chart 1: Markets pricing in aggressive Fed and BoC hiking trajectories



Source: Bloomberg, CIBC

1991, core inflation accelerated from 4.5% to 5.6%. Still, the Fed eased policy during that period by no less than 300bps, and that call was proven right in a subsequent deceleration in inflation. Ditto for early 2001 when the Fed initiated an aggressive easing cycle despite the fact that inflation remained

Chart 2: Fed has started cutting or paused while still facing accelerating inflation



Source: FRB, BLS, CIBC

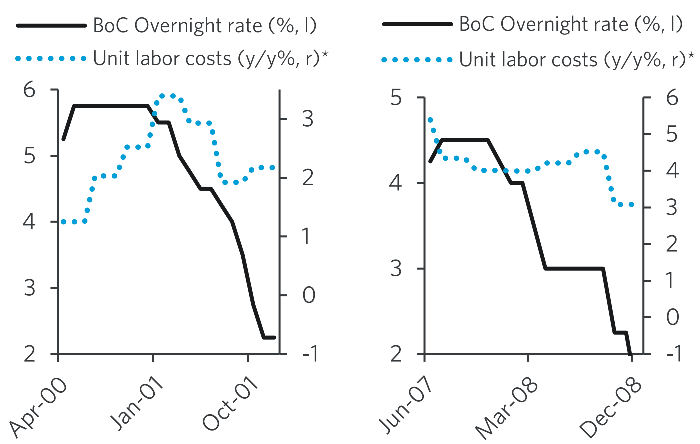
elevated. And in 2006, the Fed shifted into neutral despite inflation accelerating to almost a full percentage point above target.

Many point to the increase in unit labour costs as a reason for the Fed and the Bank to be aggressive. But the reality is that on a few occasions in the past, the Fed and the Bank of Canada paused and even cut rates while still observing a cyclically high and accelerating pace of growth in unit labour costs, as policymakers correctly foresaw an impending slowdown in economic activity (Chart 3).

What triggered those monetary policy heroics was the realization that inflation usually lags the business cycle, and that it would be more prudent to pay close attention to the fact that in 1989, 2000, and even in 2007, the economy was quickly starting to lose momentum. That fact is clearly illustrated in Table 1. On average since the 1980s, it has taken almost six months after the start of a recession for core inflation to peak.

We suggest that the aggressive tightening trajectory currently priced in by the market is ignoring these past lessons, and incorrectly assumes that both the Fed and the Bank of Canada will chase inflation until the bitter end. While central banks are now committed to higher rates, we see a much earlier pause to the hiking cycle as Powell and Macklem start to pay closer attention to a slowing economy, as opposed to continuing to chase a lagging indicator. Just to be clear, the Fed and the Bank don't need to see a full recession coming in order to pause a rate hiking cycle. A slowdown in growth would suffice, and that can happen at rates below where the market is currently pricing, as we explored in our In Focus: Canadian rate hikes: Where's the finish line?

Chart 3: BoC has eased despite elevated unit labour cost growth in the past



Source: BoC, StatCan, CIBC. *Unit labour costs correspond to the previous quarter.

Table 1: Inflation doesn't peak until several months into recessions

Recession start date	Peak core inflation date	Number of months to peak core CPI after recession starts
Feb '80	Jun '80 (13.6%)	5
Aug '81	Sep '81 (11.8%)	2
Aug '90	Jan '91 (5.6%)	6
Apr '01	Nov '01 (2.8%)	8
Jan '08	Jul 08 (2.5%)	7

Source: BLS, NBER, CIBC

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