<u>Poloz Caught Between Debt and an Oil Price</u>

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Events in the world economy, combined with recent data released from the Bank of Canada, reveal why conducting monetary policy is so difficult. We may not need to feel sympathy for Bank of Canada Governor Stephen Poloz, but we should at least understand and appreciate how conflicting economic forces can complicate his policy decisions.

The first major force is the massive decline in the world price of oil, from $105 per barrel in June to below $60 per barrel today. As is the case for most changes in important market prices, the decline in the world price of oil creates both losers and winners in Canada.

For those directly involved in the production of oil, concentrated in Alberta, Saskatchewan and Newfoundland, the price decline leads to an immediate and large reduction in income. And as oil producers scale back their investment plans, the negative impact spreads to the many industries supplying the oil patch. On the other hand, for consumers across the country, and for businesses that use oil intensively, the decline in the price of oil is a financial windfall. Not surprisingly, economic activity in Ontario and Quebec, which are still the heart of Canadian manufacturing, will benefit significantly.

Offsetting economic fortunes across industries and regions caused by fluctuations in relative prices are nothing new for Canada, but monetary policy can do little or nothing about them. The Bank of Canada needs to focus on the aggregate level of economic activity, and make policy decisions accordingly. And since Canada is a large net exporter of oil, it follows that the decline in the world price of oil is a net negative for Canadian GDP, as Mr. Poloz has repeatedly said.

Taken alone, the decline in oil's price would lead the Bank to have looser monetary policy than would otherwise be the case. At a minimum, this would mean delaying the time of interest rate increases; depending on how long oil prices remain low, it could even lead to reductions in the already-low policy interest rate.

But there is another major force complicating things for the Bank of Canada. Ongoing increases in household debt, and the rising house prices associated with it, have been a topic of discussion in this country for several years. In the latest *Financial System Review*, the Bank points out that household debt is at an all-time high of 163 percent of disposable income; more worrying is that 40 percent of total debt comes from the 12 percent of households who have debt in excess of 250 percent of their income.

Much of this debt is being used to purchase home mortgages, and the Bank notes considerable growth in riskier "non-prime" (i.e., "sub prime") mortgage lending, especially from the smaller commercial banks. The Bank also raised eyebrows by publishing its estimates showing that, on a national basis, houses are between 10 and 30 percent "overvalued"; the 20 percent midpoint of the estimated overvaluation is exactly where we were in 1990 – just before a sizable housing crash.

The danger, of course, is that if house prices do decline sharply, balance sheets around the country, which are already chock full of debt, will be weakened considerably. Given the current Canadian context, such a combination may not lead to a massive recession, but it would certainly worsen an already-tepid economic recovery.

Taken alone, the rising debt and rising house prices would probably lead the Bank of Canada to raise its policy interest rate sooner than would otherwise be the case. An alternative would be for the Minister of Finance, in an effort to take some steam out of that market, to take further actions on adjusting the terms and conditions of residential mortgages or mortgage insurance. Yet Joe Oliver appears less willing than Jim Flaherty was to take such actions.

Where does all of this leave Stephen Poloz and his deputies? In addition to the hundreds of other variables they are studying, they are thinking carefully about these separate major forces – falling global oil prices and rising domestic debt and house prices – and figuring how they "net out" to determine the Bank's best policy actions. This requires a great deal of both analysis and judgment.

So, the next time you hear Governor Poloz discuss these many economic forces and then announce that he's holding the policy interest rate unchanged, you'll understand why he claims that sometimes it takes a lot of work to do nothing.

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