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Interest rates have jumped, but old rules of monetary policy suggest they still have much further to go

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Bank of Canada Governor Tiff Macklem speaks at a news conference in Ottawa on June 9.

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Central bankers have shocked stock markets and homebuyers with big interest rate increases over the past few months, but policy-makers are still far behind where they should be in the battle to control inflation, according to some simple rules of monetary policy.

One venerable guide to setting policy known as the Taylor rule suggests the Bank of Canada and the U.S. Federal Reserve should currently have their benchmark rates set close to 9 per cent. A broad set of rules tracked by the Federal Reserve Bank of Cleveland isn't quite so harsh, but still indicates that central bank rates should be around 3.9 per cent.

The interest rates suggested by the rules are far higher than the levels that prevail in reality. They underline the possibility that interest rates may have to rise higher, and stay there longer, than most investors and homeowners now expect.

Decoding the Bank of Canada's supersized interest rate hike

Granted, monetary-policy rules aren't necessarily better at assessing a complex economic situation than the humans who actually run central banks. Humans start with the same data as the rules, but can also apply their own judgment of a complex situation.

In contrast, rule-based approaches reflect a strictly by-the-numbers analysis of the facts. This is more limited than human decision-making, but also less prone to errors of judgment.

Right now, the rules are saying that central banks have a lot of ground to make up as they attempt to quash the biggest outburst of inflation in decades.

The Bank of Canada surprised markets with a supersized hike of a full percentage point earlier this month, but the move still left the bank's policy rate at only 2.5 per cent. With inflation running at 8.1 per cent, interest rates remain well below zero in real terms.

In the United States, the Federal Reserve has its benchmark rate set at 1.5 to 1.75 per cent. It is widely expected to boost the rate by 0.75 percentage points after its meeting on July 27, but that would still leave it pretty much where the Bank of Canada is now.

In both countries, monetary policy is lagging well behind the levels that would prevail if interest rates were set by automatic rules. These rules dispense with human judgment and consider only cold, hard economic data.

John Taylor, an economist at Stanford University, devised one of the first such rules back in 1993. Other economists have since suggested their own rules. Their approaches differ in details, but most reflect similar concepts.

They often begin with the notion that there is a neutral rate that would keep inflation steady over the long run in an economy operating at full capacity. They then add to this rate if inflation is running above target. They reduce it if the economy is operating below potential, with high unemployment or other unused resources.

Differences in how models handle these various factors can result in a wide range of recommended interest rates. The Cleveland Fed maintains a page that tracks seven simple monetary policy rules. The Federal Reserve keeps tabs on five rules. There is no agreement on which rule is best or how closely policy-makers should follow them.

What is clear, however, is that central banks' interest rates are currently well below what most rules would suggest. In its monetary policy report to Congress a month ago, the Fed acknowledged that the five rules it tracks would have prescribed benchmark rates of 4 to 7 per cent during the first quarter of this year.

Rates that high seem inconceivable to most people at the moment. Futures markets indicate investors expect both the Bank of Canada and the Fed to top out their rate-hiking cycle at around 3.5 per cent early next year, then start cutting rates quickly as inflation fades and economies slow.

However, the rules may not be as far off the mark as most people appear to think. Some observers are already warning that rates will have to go higher, and remain elevated longer, than futures markets expect.

Joseph Zidle, chief investment strategist in the private wealth solutions group of asset manager Blackstone Inc., told Bloomberg this week that he expects the Fed's benchmark rate to rise above 4 per cent. He said he would not be surprised if it gets close to 5 per cent.

Similarly, Roberto Perli, head of global policy at investment bank Piper Sandler, argued in a note this week that anyone expecting quick cuts to interest rates because of an impending recession is likely to be disappointed.

Inflation is now running higher than at any time since the 1980s, he argues, and controlling inflation remains the Fed's top priority even if the economy starts to buckle. For that reason, drawing comparisons to past Fed behaviour during times of slowing economic activity is difficult.

“We are not saying that the Fed would ignore the effects of a recession – it certainly wouldn’t,” Mr. Perli wrote. “But we are saying the Fed’s response to a recession that comes with high inflation and a tight labor market will be much more delayed and slower than in the past.”

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