What has to go right for the economy before BoC hikes rates

By David Parkinson
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After nearly seven years without a Bank of Canada interest-rate increase, seeing a rate hike on the horizon has all too often been like seeing a rainbow. "This time is different" is something we've heard too many times to not be cynical.

But this time is different. The conversation has shifted discernibly in the past couple of weeks – from what might convince the Bank of Canada to start raising rates, to what's going to stop them.

Critically, the central bank is convinced that the oil shock – that massive road block that forced a two-year economic adjustment, setting back Canada's long recovery from the 2008-09 Great Recession – has been removed.

What has emerged is an economy firing on most, if not all, of its cylinders. Growth has averaged a blistering 3.5 per cent, annualized, over the past three quarters. Employment has risen by 187,000 over the past six months. Goods-export volumes and business investment, two problematic areas for the economy during the postoil-shock adjustment, look to be on the upswing. Consumer spending remains buoyant.

In an upbeat speech on Monday that caught the attention of financial markets, Carolyn Wilkins, the BoC's number-two official, said the bank is seeing "signs that growth is broadening across regions and sectors." This new found "diversity" of growth, as she put it, suggests that growth is on a more sustainable track.

With all that in mind, Ms. Wilkins's speech made it clear that the Bank of Canada is now pondering "whether all of the considerable monetary-policy stimulus presently in place is still required." After all, the bank cut its key rate in half in 2015, to 0.5 per cent, to help the economy weather the oil shock; with that in the rear-view mirror, the economy may no longer need monetary policy to be pressing so heavily on the gas pedal.

But that doesn't mean a rate hike is imminent – indeed, even the most hawkish forecasters see it as six months away. As the years of false starts have taught us, a lot of things are going to have to go right in those six months for the central bank to finally see its way to its first rate increase since 2010. To wit:

Housing: The overheated housing markets in the Toronto and Vancouver regions may provide motivation for the central bank to move sooner, rather than later, on rate hikes. The bank has long pointed to housing and household-debt excesses as a serious potential risk to the stability of Canada's financial system, and it well knows that higher interest rates would have a cooling effect. But until recently, the weaknesses in the broader economy have pulled monetary policy in the opposite direction, demanding lower rates. Last week, Bank of Canada Governor Stephen Poloz acknowledged that the twin forces of economic growth and housing-related risk are pulling in the same direction now.

But housing bubbles (if we can call them that) can be very fragile things. In its semi-annual Financial System Review last week, the Bank of Canada essentially acknowledged that they are susceptible to hard-to-predict downturns. The negative economic consequences of a sharp correction, coupled with the pressures on indebted households in those regions, would almost certainly sideline rate hikes.

Inflation: Ultimately, the Bank of Canada uses an inflation target of 2 per cent as its guide for whether the economy needs higher interest rates. And despite the evidence of economic recovery, inflation is nowhere to be seen. The Bank of Canada's three measures for core inflation – the underlying price pressures in the economy, looking through temporary, sector-specific gyrations – range from 1.3 to 1.6 per cent, and have generally been falling in the past few months, not rising. The strengthening and broadening growth is expected to push inflation higher; but until the central bank is convinced that is happening, interest rates aren't going anywhere.

Trade: For an export-heavy economy, trade is critical to the recovery. Even as the trade numbers have generally improved in recent months, the gains have remained uneven and unpredictable. The outlook ahead is brighter, amid improving U.S. and global growth. But the protectionist threats from U.S. President Donald Trump, and the prospect of a reopening of the North American free-trade agreement, leave trade as a massive wild card hanging over Canada's economic outlook.

Business investment: After a long journey in the wilderness, businesses are finally in the mood to spend again, most notably in the battered energy sector. That investment in new capacity is critical to sustaining economic momentum. But it's still very early days. A downturn in commodity prices could stop it in its tracks. The uncertainty over Mr. Trump's economic and trade policies also threaten businesses' long-term investment decisions; if that continues to linger, spending and growth may suffer.

All that said, the mere fact that the Bank of Canada is talking about this stuff publicly right now is pretty strong evidence that it wants rate hikes to be part of the market's conversation. It could have waited for its quarterly Monetary Policy Report, to be published a month from now, to discuss its latest views on the economic recovery, as is its usual custom. Instead, it used Ms. Wilkins's speech to publicly update its view.

And that view is that the light ahead has turned green – but it's still well down the road. A lot could still happen between here and there.