Bank of Canada bets on growth with interest rate hike

By Jeremy Kronick and Steve Ambler
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Canadian monetary policy has just seen one of its most significant U-turns in recent years. On May 24, the Bank of Canada announced that it was holding its overnight rate steady. The tone of the announcement was less dovish than the previous one, but contained nothing to indicate impending rate increases. Shortly after the May announcement, markets were predicting a 5-per-cent chance of a rate increase in July. However, in the days preceding Wednesday's announcement, that probability surpassed 90 per cent. With the bank increasing rates on Wednesday, how did we get so quickly from there to here?

Highlights from the Bank of Canada's rate hike announcement (The Globe and Mail)

Let's start with the case for the rate hike. Unemployment has fallen to 6.5 per cent, GDP growth in the first quarter of 2017 was robust at 3.7 per cent – and broad-based instead of concentrated on the housing sector – exports have been growing smartly and the June employment numbers came in stronger than expected. Furthermore, business investment has picked up and the Bank of Canada's latest Business Outlook Survey prefigures more good news on that front.

The Bank's own models are now projecting that the Canadian economy will be at full capacity by the end of 2017, earlier than before, with inflation reaching the 2-per-cent target by the middle of 2018. This would suggest that a return to levels of interest rates compatible with full employment and 2-per-cent inflation should start sooner rather than later to avoid having to increase rates too sharply later on, or risking a substantial overshooting of the inflation target.

What about the case against? The bank uses its forward-looking indicators and its forecasting models to set an interest-rate path that will return inflation to target within six to eight quarters. It has been doing this since it adopted an explicit inflation target in 1991. But inflation has been consistently below 2 per cent for the past five years. The latest reading for May (released on June 23) was 1.3 per cent, lower than market expectations of 1.5 per cent, and well below the 2-per-cent target. This persistent undershooting of the inflation target supports waiting until inflation was clearly increasing before initiating a tightening cycle.

Additionally, projections in the bank's Monetary Policy Report were based on a price of oil in the range of $50 to $55 (U.S.). The actual price has been fluctuating in the mid-forties, which does not bode well for a strong recovery in Alberta (and, to a lesser extent, in Saskatchewan and Newfoundland-Labrador).

Other uncertainties point in the direction of holding rates steady in the short run for insurance purposes. Inflation in the U.S., like in Canada, is weak, and this may lead the Fed to hold off on its planned rate hikes. Impending NAFTA renegotiations are a cloud hanging over the evolution of Canada's exports.

The market itself shrugged off these competing views on the Canadian economy and responded abruptly to a series of speeches and interviews by Governor Stephen Poloz and members of the bank's governing council. As the press and markets latched onto the more overtly hawkish tone by the bank, the market probability of a rate increase moved up. The bank decision to hike rates, in the end, reflects a belief that the positive news will continue, eventually causing inflation to take hold if action is not taken.

As for what will happen going forward, the wording of Wednesday's announcement was ambiguous. On the one hand, the announcement stressed that the bank expects the output gap to close by the end of 2017, earlier than previous estimates. Such an occurrence, with inflation at target, would entail more rate hikes as we move toward a so-called “neutral rate” somewhere between 2.5 and 3.5 per cent.

However, the bank also ended its press release stating that future changes to the overnight target rate will occur only if economic data warrant such moves. With the bank having made one U-turn since the previous announcement, the odds of another look slim.