Rate hike shows BoC balking at its own inflation rules

By David Parkinson
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The Bank of Canada, a famously inflation-targeting central bank, is raising interest rates in defiance of its own inflation measures. At least for a while.

The central bank's willingness to seriously bend its own rules on inflation suggests a couple of possible explanations. One is that it has given up waiting for inflation to do what inflation is supposed to do in an economic recovery, and is turning to other economic signposts to guide its policy decisions. Another is that it has other reasons to lift rates off their floor and it is jumping through a window of opportunity before it starts to close.

I'd suggest it's a little from column A, a little from column B.

The decision Wednesday by the central bank to raise its key rate to 0.75 per cent from 0.5 per cent comes at a time when Canada's consumer price index inflation rate is a mere 1.3 per cent – nowhere near the Bank of Canada's official target of 2 per cent. The bank's own preferred measures for core inflation – which are supposed to cut through transitory gyrations and inherently volatile sectors to gauge the underlying inflation colouring the economy more broadly – also show an average reading of 1.3 per cent.

The Bank of Canada doesn't believe these inflation measures are giving us an accurate accounting of inflation in this country. It's now looking at an output gap (the difference between what the economy is producing and what it is capable of producing at full capacity) that it expects will close by the end of this year – several months sooner than it projected in its last quarterly outlook in April – reflecting what looks like a sustained and broad-based pick-up in economic growth this year.

Normally, inflation would signal when an economy is nearing capacity, by rising. That's precisely why the Bank of Canada started targeting inflation more than a quarter-century ago, because it serves as a timely monthly proxy of capacity pressures. It's not doing so now. The bank is, essentially, declaring inflation to be wrong – at least temporarily.

Inflation has looked wrong to this central bank many times during this unusually long and decidedly weird post-Great-Recession recovery. It has swung from signalling a false low to a false high and back again. The central bank even adopted three new measures for core inflation late last year, to try to see through temporary distortions and get to true underlying inflation; now it is saying that those, too, are tainted by temporary distortions.

So Bank of Canada Governor Stephen Poloz has decided to wait no more for inflation to show its head, amid mounting statistical evidence of the economic upturn's staying power. While the apparent rapid closing of the output gap may justify the decision, there may be other reasons why the country's monetary policy brain trust is impatient to get going on rate hikes.

Frankly, any central bank with near-zero interest rates right now should be concerned about getting their rates off the floor before the next economic slowdown comes. With the U.S. economy already running very close to full employment, its expansion might be lucky to have two years left in it. Canada might have a little longer, as its recovery was delayed by the oil shock, but even the Bank of Canada expects growth to slow significantly in 2019.

If the bank were to wait until inflation found its way back to the 2-per-cent target – which it projects for mid-2018 – that would leave it with precious little time to restore rates before growth may start to slow again. Should a slowdown turn into an outright recession, a late start on rate hikes would leave it with very little room to provide help to such a flagging economy. Alternatively, a late start might force it to raise rates more quickly, which would ratchet up the pressure on a highly sensitive area for Canada's economy – its perilously high household debts.

"There is clearly an advantage to adopting an earlier and more gradual rate hike path, to allow a more gradual adjustment to higher rates in the highly leveraged household sector," Royal Bank of Canada senior economist Nathan Janzen said in a research note this week. "To achieve that, rates have to begin to rise before the economy is overheating and inflation pressures have emerged."

We can certainly expect one more rate hike in the second half of the year. The bank believes the economy has largely completed its adjustment to the oil price collapse, which implies that, at very least, it no longer needs the two rate cuts it made in 2015 to speed up that adjustment. A second quarter-point increase would succeed in removing that oil-shock stimulus.

After that, the route is still upward, but the path gets a bit foggy.

A closing of the output gap around year end would justify further hikes, to keep the economy from overheating. But Mr. Poloz suggested the labour market still has slack that, if tapped as demand grows, could give the economy more potential output and delay reaching full capacity a little longer.

More crucially, the bank signalled it isn't comfortable ignoring inflation for long. Indeed, the rate announcement explicitly tied future rate-hike decisions to "incoming data as they inform the bank's inflation outlook."

If inflation doesn't shake off its doldrums in the next few months, the bank may have to decide again whether to follow its inflation-targeting mandate, or follow its gut. It's unclear how many times it can go to that well before it has discredited its inflation target beyond repair.