Bank of Canada keeps rate options open with cautious tone

By Barrie McKenna
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The Bank of Canada remains in cautious mode about its next interest rate hike, even as the key pieces of a healthy recovery are falling into place.

Governor Stephen Poloz and his central bank colleagues kept the benchmark overnight rate unchanged at 1 per cent Wednesday in its final rate decision of 2017.

Canada's central bank has already hiked interest rates twice this year – in July and September – as it tries to gradually return rates to more normal levels.

"While higher interest rates will be required over time, [the bank] will continue to be cautious, guided by incoming data in assessing the economy's sensitivity to interest rates, the evolution of economic capacity, and the dynamics of both wage growth and inflation," the bank said in a statement accompanying its rate decision. That sentence repeats nearly word-for-word the language of its statement in October, when the bank also left rates unchanged.

Mr. Poloz is choosing to keep his options open even though most of the economic conditions are now in place for a resumption of rate hikes, Toronto-Dominion Bank economist Brian DePratto said in a research note.

"Despite things seeming to line up for further near-term tightening, Governor Poloz has chosen to maintain his optionality," Mr. DePratto said. "Things continue to point to a hike sooner rather than later. However, as [Wednesday's] statement shows, nothing is a done deal until the day of the decision."

Royal Bank of Canada, however, expects the central bank to remain in a holding pattern on rates until next April.

"That will give them some time to evaluate the impact of this summer's two rate hikes," RBC economist Josh Nye said. "They'll also, hopefully, have a better idea of how one of the most significant risks facing the economy, the NAFTA renegotiation, is evolving."

The bank also repeated a warning that the global outlook is clouded by "considerable uncertainty, notably about geopolitical developments and trade policies." The possible failure of talks with the United States to renegotiate the North American free trade agreement has put a chill on business investment in Canada, particularly in the manufacturing sector.

The rest of the bank's latest statement is mainly about how the economy is pivoting towards more sustainable growth. The bank pointed out that GDP growth will remain "above potential" in the second half of this year, job gains are "very strong," wages are improving, consumer spending is "robust," government infrastructure spending is becoming "more apparent," and export growth is picking up again.

The Canadian dollar gave up early gains in the wake of the statement, falling from morning highs to trade around 78.16 cents (U.S.).

Even inflation, which has remained stubbornly below the bank's 2-per-cent target for years, is showing signs of life amid "diminishing" labour market slack, according to statement.

"Inflation has been slightly higher than anticipated and will continue to be boosted in the short term by temporary factors, particularly gasoline prices," the bank said.

One outlier in the otherwise bullish outlook is the slowing housing market. But a cool down of the hottest housing markets in Toronto and

Vancouver is exactly what the central bank wants in the face of record household debt. Canadians owe $1.68 for every dollar of disposable income.

Many economists expect the Bank of Canada to resume hiking interest rates in 2018, possibly as early as its next slated rate announcement on Jan. 17. The bank is also slated to release its first quarterly set of forecasts at that time.

The Canadian economy grew at an annual pace of 1.7 per cent in the third quarter, dramatically slower than in the first half of the year. Most other economic indicators, including job gains and exports have improved.

The bank's take on the global economy is also relatively upbeat. The bank said growth is strengthening in other developed countries, oil prices have moved up and financial conditions are improving.