Economy primed for rate hike. Now it's up to Poloz

By Barrie McKenna
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Bank of Canada Governor Stephen Poloz likes to remind people that he takes his cues for setting interest rates from the flow of economic data.

If that's the case, Canadians should brace for a third hike in six months when the central bank makes its next scheduled rate announcement on Wednesday.

Canada's economy, which generated an impressive 420,000 jobs last year, is on track to grow roughly 3 per cent in 2017 – the best among Group of Seven countries – and perhaps 2.5 per cent this year. At 5.7 per cent, unemployment hasn't been this low since 1976. Even wages are starting to creep up after years of stagnation, and companies are busier than they've been since the last recession, based on the central bank's most recent survey of business leaders.

All this suggests an economy that's running flat out, and is well primed for higher borrowing costs.

Investors are betting the data will prompt Mr. Poloz to hike the bank's benchmark rate this week to 1 1/4 per cent, up from 1 per cent.

The bond market is pricing in a roughly 80-per-cent probability of a rate increase this week, a move that will likely push up commercial rates on mortgages and other loans, as well as deposits. Several of Canada's Big Six banks have already increased mortgage rates in recent days.

The C.D. Howe Institute's shadow monetary-policy council is similarly calling for a quarter-point rate on Wednesday, plus two more hikes later this year. The "strong Canadian labour market, and a judgment that inflation is likely to come in on target," at near 2 per cent, suggest it's time to hike.

The strong economy creates "both an opportunity and an obligation to bring the current period of extraordinarily low short-term interest rates and resulting speculative excesses to an end," according to the council, made up of 12 leading Canadian economists.

But Wednesday's rate decision is hardly a slam-dunk, in spite of the data.

Mr. Poloz has a reputation as a micro tinkerer when it comes to monetary policy. Rather than obsessing over the latest monthly job numbers, he's more likely to be monitoring estimates of the output gap or esoteric labour market readings generated by the bank's sophisticated computer models.

And Mr. Poloz has generally tended to favour letting the economy run hotter and the Canadian dollar drift lower, rather than pre-emptively cooling things off with higher rates.

The Bank of Canada may also have to deal with the negative fallout from a possible decision by the Trump administration to pull out of the North American free-trade agreement. This could send the Canadian dollar sharply lower, and over the longer term, hurt exports to the United States and business investment on this side of the border.

Several other threats are hanging over the economy, including the impact of new stricter federal standards for uninsured mortgages and a higher minimum wage in Ontario and elsewhere.

"Even amid the dizzying array of conflicting headlines, the reality is that the labour market is tightening rapidly and financial conditions are highly stimulative in the here and now," Bank of Montreal chief economist Douglas Porter argued in a research note. "And that is the reality that is likely to drive the Bank of Canada rate decision.”

A rate hike this week may already be a forgone conclusion.