Bank of Canada hikes rates again, but warns of NAFTA fallout

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The Bank of Canada is raising its key interest rate for the third time in six months as the Canadian economy gathers steam, but it warned that its next moves may hinge on the fate of NAFTA.

Governor Stephen Poloz and his central bank colleagues raised the benchmark rate by a quarter percentage-point to 1.25 per cent Wednesday. The move follows similar rate hikes in July and September.

“Recent data have been strong, inflation is close to target and the economy is operating roughly at capacity,” the bank said in statement accompanying its rate decision.

While economic conditions look good now, the bank expressed growing concern about the future of the North American free-trade agreement – the foundation of Canada’s trade with the United States. The bank said speculation the U.S. may pull out of the deal is already holding back business investment in Canada and it poses a threat future exports.

“Uncertainty about the future of NAFTA is weighing increasingly on the outlook,” the bank said.

The growing uncertainty over NAFTA may temper expectations of quick further rate increases, CIBC chief economist Avery Shenfeld said in a research note.

“We share the Bank of Canada’s view that higher rates will be needed over time,” Mr. Shenfeld said. “But perhaps not as fast and furious as the market was starting to think.”

The central bank’s latest forecast, also released Wednesday, predicts economic growth will slow significantly to 2.2 per cent this year and 1.6 per cent in 2019, down from an estimated pace of 3 per cent in 2017. The projections are roughly in line with the bank’s October forecast.

The latest projections reflect the bank’s “negative judgment on business investment and trade,” according to the statement.

Trade uncertainty is already affecting investment by U.S. and European companies, which the bank said have been making fewer new investments in Canada since mid-2016. The bank estimates that trade uncertainty will cut business investment over the next two years by 2 per cent. That translates into a 0.3 per cent per year drag on growth – a slightly larger hit than the bank estimated in October.

“At this stage, it is difficult to predict the possible outcomes of trade negotiations and the timing, incidence and magnitude of their effects,” the bank added in its Monetary Policy Report.

The threat of greater protectionism remains the most significant risk to Canada’s export-dependent economy, the bank said. The bank pointed out that roughly half of Canada’s exports to the U.S. benefited from preferential NAFTA tariffs in 2016. The U.S. buys roughly three-quarters of what this country exports.

The recent move by the U.S. to slash business taxes cuts both ways for Canada, creating a small net positive for the economy. Tax relief will boost U.S. growth, driving Canadian exports higher, but also cause some companies to shift investment south of the border to take advantage of those tax breaks, according to the Bank of Canada.

Many economists expect the central bank to raise rates at least two more times this year.

But the bank said it remains “cautious” about raising rates further.

"While the economic outlook is expected to warrant higher interest rates over time, some continued monetary policy accommodation will likely be needed to keep the economy operating close to potential and inflation on target," according to the statement.

The central bank judges that 3 per cent is the neutral level for its overnight rate – the point where interest rates are neither revving up growth nor applying the brakes.

Beyond the NAFTA uncertainty, most economic pieces are falling into place for the Bank of Canada. Inflation has inched up to near the bank's 2 per cent target and should stay close to that level over the next two years, in spite of "temporary" fluctuations in energy prices in the months ahead, the bank said.

Meanwhile, strong job gains are driving consumer spending and housing investment. The bank also highlighted "promising signs" in capital investment, company formation, and more workers joining the labour force.

Canada's economy generated an impressive 420,000 jobs in 2017. At 5.7 per cent, unemployment hasn't been this low since 1976. Wages are starting to creep up after years of stagnation. And companies are busier than they've been since the last recession.

The bank also pointed out that Canada's economy is getting a lift from higher oil prices, now at more than $60 (U.S.) per barrel for many grades. But those benefits are being "diluted" because of a widening spread between Canadian and world crude prices.

Going forward, the engines of growth for the economy will be business investment and exports, rather than consumers and home construction, according to the bank. That's largely because of higher interest rates and new tighter mortgage rules put in place this month.