U.S. rate hikes heighten need for Bank of Canada to tread carefully

By David Parkinson
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The new-look U.S. Federal Reserve, which had its coming-out party Wednesday, has brought with it increased prospects for more aggressive interest-rate increases over the next year. That only strengthens the case for the Bank of Canada's caution on its own rate hikes.

New Fed chairman Jerome Powell, in his first rate decision since taking over from Janet Yellen last month, made his debut with a one-quarter-percentage-point increase in the benchmark federal funds rate – the most important interest rate in the world. The Fed's range for the rate is now 1.5 to 1.75 per cent, the highest it has been in a decade.

The rate hike itself was no surprise; the Fed raised rates three times last year, most recently in December, and had signalled before Mr. Powell took the reins that there were more hikes to come. Still, with a new boss in charge, and with substantial turnover on the Fed's policy-setting Federal Open Market Committee (FOMC) since the start of the year, this rate announcement and the accompanying update of the Fed's economic and interest-rate outlook had the potential for a change in tone.

The change was subtle, as all changes tend to be with the Fed, an institution where shifts in the message are measured by the word. But it was unmistakable to any Fed watcher.

An entire sentence was added to the Fed's largely boilerplate rate-decision statement, noting, point-blank: "The economic outlook has strengthened in recent months." It backed that up with an upgrade to its economic projections, increasing its forecasts for real gross domestic product growth this year and next while lowering its outlook for an unemployment rate that is already at a 17-year low.

In doing so, the FOMC raised its outlook for interest rates over the next two years, and leaned ever so close to calling for four quarter-point rate hikes this year (the median projection among FOMC participants remained at three hikes, but just barely).

It's unclear how much of that had to do with new members casting the votes, but the economic reality facing the Fed certainly backs up the modestly more aggressive stand. Donald Trump's administration has tossed tax cuts and spending increases into an economy already running at or very near full employment – a recipe for accelerated growth and, in turn, a stronger Fed response.

The view at the Fed looks increasingly divergent from that of the Bank of Canada, which, despite raising its own rate by a quarter-point as recently as January, looks more likely to slow its rate hikes for the rest of the year. Slowing economic growth, coupled with an assortment of uncertainties and risks (most conspicuously the unpredictable North American free-trade agreement negotiations), have kept Canada's central bank preaching caution. Most observers now expect only two more quarter-point hikes from the Bank of Canada before the end of the year, likely well spaced out; voices favouring only one hike have been growing with each disappointing economic indicator.

The accelerating Fed outlook is itself a substantial justification for the yellow light flashing at the Bank of Canada. The U.S. rate expectations have already been raising rates in Canada, without the BoC having to lift a finger.

Because U.S. government bonds serve as a benchmark against which other bonds around

the world are priced, rising U.S. interest rates typically raise the tide for bond-market rates elsewhere – and particularly in Canada, with its close economic ties to the U.S. marketplace. This rate-hiking cycle is no exception: The yield on Canada's five-year government bonds has risen by more than half a percentage point in the past four months, nearly matching the rise in the U.S. five-year yield, even as the Bank of Canada has signalled a much slower pace of rate increases this year than the Fed has. That has essentially cooked an extra quarter-point hike into Canada's market interest rates.

The rising bond-market rates translate into upward pressure on mortgages and lending rates – something to which the Bank of Canada is acutely sensitive. Statistics Canada recently reported that Canadian household debt, relative to disposable income, remained near its record high in the fourth quarter, at just over 170 per cent – a source of ongoing angst at the central bank. Given the Bank of Canada's own rate hikes in the past year and the tightening of Canadian mortgage regulations that have already applied the brakes to the Canadian housing market, the spillover effect of the impending U.S. rate hikes heightens the need for the Canadian central bank to tread very carefully on its own rate path, lest the country's overly indebted households be tipped over a dangerous edge.

Given the evident moderation in Canada's economy in recent months, there is also another clear advantage to the Bank of Canada embracing a divergence between its pace of rate increases and that of the Fed: The effect on the Canadian dollar. Although the loonie appreciated on Wednesday – likely driven by rising optimism over the NAFTA trade negotiations and by higher oil prices – the prospect of faster U.S. rate hikes and a slower Canadian pace ultimately dampens the Canadian currency against the U.S. dollar.

That should give a boost in the coming months for Canadian exporters, stimulating a key source of growth that would go a long way toward improving the Bank of Canada's own economic outlook – and smoothing its own path to gradually ratcheting up interest rates.