Fed rate decision could foreshadow Bank of Canada's stand

By David Parkinson
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For the first time in years, the central banks of the United States and Canada are playing from a remarkably similar playbook. So perhaps the U.S. Federal Reserve's decision to hold steady on its key interest rate – while making it quite clear that its next increase is so close you can almost touch it – foreshadows what could be a near carbon-copy message from the Bank of Canada in its rate decision later this month.

The Fed elected to keep the target at 1.5 to 1.75 per cent, just six weeks after it raised the target by a quarter of a percentage point for the second time in three months. But the statement it issued gave every indication that conditions for a rate hike are even stronger now than they were six weeks ago.

Most notably, the Fed (at long last) is no longer waiting for inflation to join the U.S. economic recovery. It noted that both overall and core inflation measures have moved close to its 2-per-cent objective – and it expects them to stay there "over the medium term."

That's huge for the Fed, which has a dual mandate in setting monetary policy: maximizing employment and maintaining price stability around its 2-per-cent objective. The U.S. economy reached something very close to full employment as much as a year ago, and the Fed began raising rates accordingly. But the lack of inflationary pressures were a nagging worry and a strong justification for the Fed's caution on rates for most of the second half of 2017. But now the inflation signal has turned green, so there's little standing in the way of the Fed steadily marching its still relatively low rate back to normal.

A rate hike at its next meeting, in June, is all but a lock. The bond market has already priced it in.

Still, the Fed remains in no particular hurry. It has been talking about "gradual" increases to its policy rate ever since it began inching rates up from their financial-crisis floor in late 2015, and it repeated that position in Wednesday's announcement. Even at its most confident, it has taken one-meeting breathers between rate hikes and has shown a willingness to sit longer on the sidelines when warranted. As long as it continues to use the word "gradual," the market will continue to assume it will only raise rates at every other meeting.

The Bank of Canada's key word of choice – "cautious" – appears to have a much less specific meaning than the Fed's "gradual." Governor Stephen Poloz and his colleagues already showed a willingness, in January, to raise rates in the same breath with which they profess caution about raising rates.

Nevertheless, the Bank of Canada is in a similar boat. It is operating in an economy running essentially at full capacity. Inflation has returned to its 2-per-cent target, and it looks like it's here to stay. In a speech in Yellowknife Tuesday, Mr. Poloz reiterated that the central bank has grown increasingly "confident" that rate hikes are warranted.

And yet its message, much like that of the Fed, is that while conditions absolutely warrant higher rates, it won't be rushed.

Both central banks point out that while their economies are humming along pretty nicely, they are still relying on historically low interest rates to do so. With growth moderating in both countries this year and inflation having only just edged past 2 per cent, no one wants to be needlessly hasty in kicking that crutch out from under the economy – especially with uncertainties on the road ahead.

The Bank of Canada has flagged trade-policy uncertainty, and the resulting lack of traction in export growth and business investment, among its key worries. In that light, the Fed's pace on rate increases may have a bigger influence than usual on the Bank of Canada's next rate decision.

The Bank of Canada can't do a thing about the NAFTA talks. But it's keenly aware that a competitive Canadian dollar can help grease the export wheels while we wait. If the Bank of Canada were to raise rates while the Fed is taking a pause, it runs the risk of triggering a surge in the Canadian currency – undermining hopes for an export recovery. But if it waits until its July rate decision, and lags the Fed a bit, it mutes the impact of the rate hike on the currency.

For a "cautious" Bank of Canada, that may be as good a reason as any to follow the Fed's lead and hold steady for now, while flashing the "go" sign for a summer rate hike.