Economy can tolerate higher interest rates, Bank of Canada's Wilkins says

By Barrie McKenna
September 6, 2018 – *The Globe and Mail*

The Bank of Canada is doubling down on its pledge to continue gradually raising interest rates in the months ahead in spite of the continuing trade turmoil.

The Canadian economy is on "solid footing" and can deal with higher borrowing costs, senior deputy governor Carolyn Wilkins said in a speech in Regina on Thursday.

"The economy is adjusting well and can adapt to higher interest rates," she said. "The gradual approach we have been following is still appropriate."

The comments by Ms. Wilkins, who said the bank debated the idea of accelerating the pace of rate hikes, helped push the Canadian dollar up nearly half a cent to US76 cents Thursday.

Canada's central bank opted not to raise its key rate on Wednesday, citing the uncertainty over continuing talks in Washington to renegotiate the North American free-trade agreement and recent tit-for-tat tariffs. The bank has raised the rate four times since mid-2017, most recently in July, taking it to 1.5 per cent.

Most economists expect the central bank to resume hiking at its next rate-setting meeting on Oct. 24, by another quarter percentage-point.

At 1.5 per cent, the rate is well below the bank's estimated neutral rate of 3 per cent – the level at which it is neither slowing down nor speeding up economic activity. The rate sets the trend for other short-term lending rates, including mortgages.

Ms. Wilkins highlighted several hopeful signs, including an economy that is running near capacity, a "stabilizing" housing market and a drop in the number of homeowners taking on massive new mortgage debts.

Ms. Wilkins confirmed that the trade environment was "front and centre" in its decision not to hike rates again this week. But she said trying to forecast the fallout from trade-related investment uncertainty, new protectionist tariffs and the possible failure of the NAFTA talks is a complicated exercise. The effects don't just lower growth prospects for Canada's export-reliant economy, they can also spark more inflation, she said.

"Protectionist measures create risks to the upside for inflation, especially when the economy is operating near full capacity," she said. "In weighing these trade-offs, you can be sure [the bank] will not lose sight of our primary mission. Low and stable inflation will help reduce at least one source of uncertainty for companies and households."

Over all, the bank estimates that higher tariffs and lower investor confidence will knock two-thirds of a percentage point from Canada's gross domestic product by 2020. Ms. Wilkins said the effects of U.S. steel and aluminum tariffs are already being felt in Canada, as are Canada's retaliatory tariffs on a number of U.S. consumer products.

She added that the bank is bracing for inflation to push above its 2-per-cent target in the second half of this year, in part because of higher gasoline prices and air fares. And she acknowledged that the bank will likely have to boost its short-term inflation expectations when it releases its next quarterly forecast in October.

But she said the spike will likely be short-lived.

"The factors that are pushing inflation to the top of our target band appear to be temporary and not signs of excess demand," she said. "These factors mean that inflation could turn out to be higher over the next couple of quarters than we had expected in July, but will most likely fall off afterward barring any new price shocks."