Bank of Canada raises key rate again, hints at more frequent increases ahead

By Barrie McKenna
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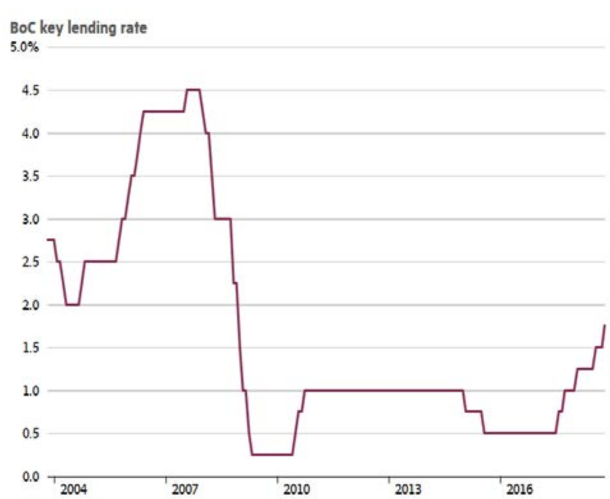
The Bank of Canada is raising its key interest rate again amid easing trade tensions with the U.S. and it's signaling that it may speed up the pace of future rate hikes.

Governor Stephen Poloz and his central bank colleagues hiked the benchmark rate by a quarter percentage-point to 1.75 per cent on Wednesday – its fifth rate hike since mid-2017.

The bank dropped its recent pledge to take a "gradual" or "cautious" approach to rate increases. The go-slow message has been a fixture of the bank's statements for the past year. Its removal now suggests the bank could break with its recent pattern of hiking on every second rate announcement date, and will now consider moving more frequently.

The Bank of Canada also issued a reminder that the bank's key rate will eventually have to reach the so-called "neutral" level to keep inflation on track with its 2-per-cent target. The bank estimates that neutral – the point where monetary policy neither speeds up nor slows down economic activity – is in the range of 2.5 per cent to 3.5 per cent.



The Canadian dollar shot up immediately after the bank's announcement, heading toward but still shy of 77 US cents.

Before Wednesday's move, some economists had expected as many as four more quarter-point increases by the end of 2019, taking the central bank's key rate to 2.75 per cent.

Going forward, the bank said it will be keeping a close eye on Canadians' ability to cope with higher interest rates and how the economy reacts to global trade developments.

CIBC chief economist Avery Shenfeld said the statement opens the door for another rate hike at the bank's next meeting on Dec. 5.

"The tone was more hawkish than we expected [by] dropping the reference to 'gradual' for hikes ahead … and asserting that rates will have to keep climbing to 'neutral,'" Mr. Shenfeld said in a research note.

The Bank of Canada said the new U.S.-Mexico-Canada Agreement is an "encouraging" development for the Canadian economy. The tentative deal, which must still be ratified by the three countries, "will reduce trade uncertainty in North America, which has been an important curb on business confidence and investment," the bank said.

The bank had previously estimated that uncertainty over the outcome of the trade talks would cut GDP growth in Canada 0.7 per cent per year by 2020. The drag is now estimated at just 0.1 per cent.

The Bank of Canada upgraded its forecast for both exports and business investment due to the new trade deal and the recent go-ahead of a $40-billion liquefied natural gas terminal and pipeline project in B.C.

And yet the bank's latest forecast for GDP, included in its latest Monetary Policy Report, remains largely unchanged. The bank said it expects the Canadian economy to grow 2.1 per cent both this year and in 2019, before slowing to 1.9 per cent in 2020. That compares to its earlier July forecast of 2 per cent, 2.1 per cent and 1.9 per cent growth over the three years.

The threat of trade upheaval could hang over the Canadian and global economies for some time, the bank warned.

"Trade conflict, particularly between the United States and China, is weighing on global growth and commodity prices," the bank said.

The two countries are embroiled in an escalating trade war, imposing tariffs on hundreds of billions of dollars of each others' imports, with more threatened. The showdown is now the biggest threat to global growth, the bank said.

If those tariffs were made permanent, they would subtract 0.2 per cent from U.S. GDP and 0.5 per cent from Chinese GDP by 2020, according to the bank. It would have "a significant and lasting impact on the global economy," the bank said.

On balance, the U.S.-China showdown will be mildly "negative" for the Canadian economy. Yes, Canada will gain new customers in China because of tariffs there on U.S. goods. But that will be offset by weaker U.S. demand and lower commodity prices, according to the bank's Monetary Policy Report.

Commodity prices, outside the energy sector, have fallen 10 per cent since July.

The bank also warned that it may be underestimating the real risks of the U.S.-China standoff, particularly if the trade showdown causes a "breakdown" of global corporate supply chains.

On the home front, the central bank said "housing vulnerabilities are edging lower in a number of respects" due to the combination of higher interest rates and stricter mortgage lending rules introduced in 2016 and 2017. The bank pointed out that households are borrowing less and the "quality" of new mortgages has continued to improve.

And yet the central bank warned that the housing sector will continue to pose a risk to financial stability "for some time" given the large number of heavily indebted households in Canada.