Economy has ‘welcome degree of resilience’ to weather possible trade shocks, Bank of Canada says

By Bill Curry
September 5, 2019 – *The Globe and Mail*

The Bank of Canada says the unexpected strength of the domestic economy and the fact that inflation is right on target were the main reasons for keeping interest rates unchanged this week.

In a speech delivered one day after the bank announced its key interest rate would remain at 1.75 per cent, Lawrence Schembri, a deputy governor at the bank, said the Canadian economy has enough momentum to weather a potential slowdown caused by global trade tensions.

Providing a window into the bank’s recent internal discussions, Mr. Schembri said the rate decision was influenced by data showing the Canadian economy is operating close to full potential, the unemployment rate is near historic lows and inflation is right at the bank’s target of 2 per cent.

“The economy has clearly gotten past its earlier soft patch, the labour market has been strong and housing markets have begun to rebound,” he said, according to an advance copy of his prepared remarks. “Although household debt levels remain high, mortgage underwriting rules are helping to contain financial vulnerabilities. The solid starting point means the economy has a welcome degree of resilience to possible negative economic developments. That said, we agree that the data show some areas of concern.”

Weak consumption data, a drop in business investment and the ongoing trade war between the United States and China were listed as the main challenges for the Canadian economy.

In his speech to the Halifax Regional Chamber of Commerce, Mr. Schembri went on to highlight the fact that Canada’s current policy rate is a half percentage point below the U.S. federal funds rate.

Thursday’s speech did not contain any explicit indication of where the bank is leaning in terms of future rate decisions. Mr. Schembri said the current degree of monetary policy stimulus “remains appropriate.” However, the deputy governor’s generally upbeat tone is likely to confirm this week’s assessment by economists that the bank is not as keen to cut rates as many had thought ahead of Wednesday’s rate decision.

While the bank had been widely expected to stay on the sidelines this week, many economists had thought the bank would cut rates later this year and possibly as soon as its next announcement in October. The general reaction from economists Wednesday was that the language released with the rate announcement was not as dovish as expected.

The argument for a rate cut this year would be to get out ahead of the expected negative shocks to the Canadian economy that could result from the ongoing trade war between its two largest trading partners.

The bank acknowledged Wednesday – and again Thursday – that the economic damage from that trade war has so far been worse than expected.

Nonetheless, Mr. Schembri pointed out that Canada has been dealing with trade uncertainty for some time.

“Given Canada’s reliance on international trade, we agreed that the trade war remains our primary concern and the biggest risk to our forecast,” he said. “Trade policy uncertainty has been weighing on business investment and exports for a couple of years now. And things

could certainly get worse internationally, which would deliver a complex shock to our economy affecting both supply and demand."

Talk of a U.S. recession – which would drag the Canadian economy down with it – has heated up in recent months as historical indicators of a recession have started to generate concern. One of the main indicators – an inverted yield curve – has generated particular attention. (An inverted yield curve means short-term interest rates are higher than long-term rates, which is not the norm.)

Mr. Schembri challenged some of the recent analysis on this front.

"Historically, an inverted yield curve has been viewed as a sign of a future recession, especially in the United States," he said. "Today, with interest rates so low to begin with, an inverted curve is more likely a sign that investors foresee weaker long-term growth."

The bank is also weighing the relationship between interest rates and household debt. Mr. Schembri pointed out that current low rates, along with strong labour income growth, contributed to unexpected recent growth in the housing sector.

"In fact, most people renewing a five-year fixed-rate mortgage today are paying a lower interest rate than they did five years ago," he said. "Housing is once again contributing to growth, with resales and starts catching up to underlying demand. High levels of household debt remain the main risk to financial stability, but with tighter mortgage rules in place, the quality of the stock of household debt should continue to improve."