What explains Canadas higher interest rate?

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The Bank of Canada announced on Wednesday that it was holding its overnight rate target constant at 1.75 per cent. By coincidence, the U.S. Federal Reserve announced its rate decision on the same day, and cut its target to a range of 1.5 to 1.75 per cent.

While neither decision was a surprise, the resulting configuration of central-bank policy rates leaves the Bank of Canada in a prominent – some might say exposed – position. Canada's policy rate is now the highest of the countries to which we usually compare ourselves. The Reserve Bank of New Zealand's rate sits at 1 per cent, as does the Reserve Bank of Australia's. The Bank of England has a rate of 0.75 per cent, the European Central Bank is at zero, and the Swedish Riksbank, the Bank of Japan, and the Swiss National Bank all have rates below zero. What is going on? And what does it signal about the future direction of Canadian interest rates?

Canada's relatively high overnight rate mainly reflects the Bank of Canada's success in achieving its 2-per-cent inflation target. The latest year-over-year headline inflation number (for September) is 1.9 per cent; it has been at 1.9 per cent or above since March, 2019. By contrast, inflation in the United States is 1.7 per cent, forcing the Fed into a lower overnight rate. This lower rate environment is exacerbated by the Fed's dual mandate of inflation and maximum employment, where the latter is a much more uncertain and constantly changing target, and subject to more political pressures (see Trump, Donald).

But the United States is not alone with inflation below target. Inflation in Australia, New Zealand, Britain and Sweden currently ranges from 1.5 per cent to 1.7 per cent. In the euro area, inflation is even lower (0.8 per cent), and in Japan and Switzerland, it is barely above zero (respectively 0.2 per cent and 0.1 per cent).

What this means is that real short-term interest rates (adjusted for inflation) in these areas are much closer to their Canadian equivalent than nominal short-term interest rates. Moreover, short-term real interest rates adjusted for expected inflation are also closer to their Canadian equivalent than nominal rates, since expected inflation in Canada is very stable and very close to the bank's target, while it is much softer in other countries.

The economic conditions underlying the bank's rate announcement can be summarized as relative domestic strength and weakening performance and uncertainty abroad. While similar to September's announcement, the bank notes a worsening of the outlook for global growth, and an unwinding of temporary factors that gave a boost to the domestic economy in the second quarter. In terms of positives, the Canadian economy created almost 54,000 jobs in September, and unemployment dropped to 5.5 per cent, in line with its historical low of 5.4 per cent in May. Wage growth was up from 3.8 per cent (year on year) in August to 4.3 per cent in September.

If Canada's relatively high rate makes sense in the context of Canadian inflation and a steady economy, what besides an unexpected rise or fall in inflation might make it move in the months to come? People often expect relatively high nominal interest rates in Canada to exert upward pressure on the Canadian dollar. And, indeed, the loonie has been the best performer of all currencies in the Group of 10 area, with a

4.4 per cent appreciation with respect to the U.S. dollar this year.

Further appreciation will cause both lower inflation, because the cost of imported goods falls, and a decrease in economic growth as aggregate demand for exports tumbles.

As we wrote in September, typically when the Fed moves its overnight rate, a good chunk of that change gets reflected in the Bank of Canada's policy rate. The Fed has now cut three times in 2019 (by 25 basis points each time) while the bank has held steady all year. If the Canadian dollar starts to appreciate more steadily, a rate cut by the bank in December may very well be in the cards.