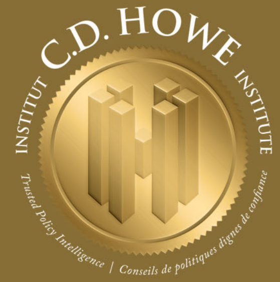
Intelligence MEMOS



From: Steve Ambler and Jeremy M. Kronick

To: Canadian Inflation Observers

Date: September 20, 2022

Re: **How Fast to Move? Assessing the Bank's Way Forward.**

The Bank of Canada continued its tightening cycle this month with a 75-basis-point increase in its overnight rate target. That target is now above the top end of the Bank's estimate of the "neutral rate" of 2 to 3 percent.

How fast will the rate move from here?

The neutral rate is the one the Bank thinks would be appropriate for an economy producing at full capacity, with inflation running at 2 percent. Most economists and market-watchers believe the overnight rate needs to go beyond neutral to fight inflation. Despite a drop in the year-over-year inflation from 8.1 percent in June to 7.6 percent in July, inflation is a long way beyond the top end of the 1-to-3 percent target range, let alone the 2-percent target itself.

There is much less consensus, however, on whether the Bank should continue to hike aggressively or take a more cautious approach. There are good arguments on both sides.

The more aggressive approach: Though GDP growth is slowing, it was still strong in the second quarter (3.3 percent annualized) and running above its full capacity. And though headline inflation fell, two of the three core measures of inflation, which strip out the more volatile CPI components, ticked up in July, while the third, "CPI-trim," barely budged. These core measures ranged from 5 to 5.5 percent – well above the target range.

The drop in headline inflation was due largely to gasoline prices, with other components of the CPI accelerating, particularly services. And these other components are within the Bank's control, meaning it has a long way to go to bring inflation back down.

The more cautious argument: Previous rate hikes have clearly started to bite. Housing markets have already cooled considerably since the beginning of the year. Increases in monthly mortgage payments will only occur with a lag as many Canadians have either fixed rates or fixed payments. But increases are coming and will inevitably lead to belt-tightening by consumers, which will feed through to demand.

Moreover, the growth of monetary aggregates, measuring everything from cash to bank deposits to Canada Savings Bonds, has slowed considerably in recent months. Over the last few decades, money has fallen out of favour with central banks as an indicator of future inflation. But, as we **recently** argued, it is a better predictor of future inflation when inflation is unsettled – as it is now. This slowing of money growth will likely dampen inflation further down the road.

Finally, the arithmetic: The Bank's target is year-over-year inflation, which largely reflects price increases that happened six months or more ago. Even if all consumer prices levelled off completely starting this month, headline inflation would remain above target until well into next year. The Bank's monetary policy framework is designed to aim two years down the road, which means it must look past year-over-year inflation numbers, analyzing what month-over-month numbers are saying as well. The drop in the latest month-over-month number was driven by energy prices but it did come in below an annualized 2 percent.

The Bank has come down on the side of significant front-end loading of interest rate increases, and the announcement accompanying the last hike suggests more are to come. One reason the Bank has avoided even larger bumps is that getting inflation back to target is an inexact science. There has been significant change in a short time and it is only prudent to see how the economy reacts.

The announcement discusses the many reasons why the Bank tightened as much as it did, but to us one rationale stands out – inflation expectations. July's Monetary Policy Report estimated inflation would return to the top end of the target range (i.e. 3 percent) by the end of 2023 and return to target by the end of 2024, or in roughly two years. But the latest Bank data on 24-month inflation expectations, compiled in the Business Outlook Survey for the second quarter, suggests almost **80 percent** of respondents think inflation will remain above 3 percent in two years.

The third-quarter survey on expectations, which is due in mid-October, will be a good indicator of whether the two most recent rate hikes – totalling 175 basis points – have changed the expectation calculus. If expectations are down and if the actual inflation numbers for August – both year-over-year and month-over-month – show broad indications of cooling, it will be time to slow rate hikes. Otherwise, the Bank will have to maintain or even pick up the pace.

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