Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Bank of Canada Observers

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Re: **FIVE REASONS THE INFLATION WORST IS OVER**

The Bank of Canada met market expectations with its last interest rate hike, lifting its policy rate by 25 basis points, to 4.5 percent. The Bank also changed its tone from hesitant caution to guarded optimism. Hikes might just be over, it said in its guidance last month, a message reinforced in a **speech** last week.

In December, the Bank made clear that any further tightening would depend on the data. This time, it stressed that if inflation declines in key sectors to the extent it forecast in its latest Monetary Policy Report, it will hold the policy rate steady and pause to assess the impact of its cumulative rate hikes. A terminal peak of 4.5 percent would also be in line with the **most recent** C.D. Howe Institute Monetary Policy Council recommendation.

We expect – as most Canadians likely hope – that the Bank will conclude it has done enough.

For much of the past year, it has been fighting inflation far above target, peaking at 8.1 percent in June. The pace of rate hikes has been correspondingly (and appropriately) remarkable. The challenge in this fight is always knowing when to stop. Monetary policy works with a lag, both when the Bank lowers its policy rate and when it raises it. People don't necessarily feel the effects of rate changes right away and predicting exactly when they will hit is difficult.

This is why we think inflation will work its way back to 2 percent with no need for more increases:

First, as it has been since July, the month after inflation peaked, the yield curve on Government of Canada debt is inverted: the return is higher on two-year than 10-year bonds. Inverted yield curves often portend slowdowns in economic growth. Markets tolerate low long-term interest rates only if they believe long-term inflation rates will also be low.

Second, the Bank's rate hikes last year have already slowed spending on interest-sensitive goods, including houses and automobiles, and the effects are spreading to other sectors, such as services and travel.

Third, because monetary policy works with a lag it is always critical to look at leading indicators. The OECD has a composite leading indicator index that combines a series of economic variables, including consumer confidence and business hiring, that best predicts turning points in the business cycle. Since May, the Canada index has been both below its long-term average and continuing to decline. That suggests a slump is coming.

Fourth, money growth is on the decline, with the growth of broader money (M2++) as low as it has been since 2003, while narrower money (M1+) is actually shrinking. When inflation is unanchored from its target, money growth becomes a **good predictor** of where prices are headed. Less money in the economy can temper the demand for goods and services, which helps reduce inflation.

Finally, as we have **argued** before, the headline or year-over-year inflation number is mostly old news. The latest, 6.3 percent in December, includes monthly inflation over the first half of the year, which, as mentioned, peaked in June at 8.1 percent. More recently, the CPI actually fell by 0.1 percent month-over-month between November and December.

A single month's number can be a fluke, of course. But the three-month annualized inflation rate from September to December, though still high at 3.4 percent, was not far above the Bank's target range of 1 to 3 percent. The National Bank of Canada calculates a three-month core inflation rate that excludes not only food and energy, but also mortgage interest costs. It was running at 2.4 percent in December and, more importantly, falling fast.

The big banks are now predicting real GDP will decline for at least one quarter this year. The Bank of Canada predicts instead that GDP growth will "stall" through the middle of 2023, which could mean one quarter of negative growth offset by positive growth in the other quarter. Either way, further rate hikes could push us into – or deeper into – recession.

In our view, the Bank's wait-and-see approach is welcome. It is navigating the delicate balance between showing it is committed to bringing inflation back to target and assessing whether its hikes are now sufficient to attain this goal. We think it has that balance right.

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