C.D. Howe Institute Monetary Policy Council Says Bank of Canada Should Raise Overnight Rates to 5.00 Percent until Early 2024, Cut to 4.25 Percent by July of 2024

July 6, 2023 – The C.D. Howe Institute's **Monetary Policy Council** (MPC) recommends that the Bank of Canada raise its target for the overnight rate, its benchmark policy interest rate, to 5.00 percent on July 12th. The MPC further recommends that the Bank keep the target at 5.00 percent at least until January of 2024, then reduce it to 4.25 percent by July of 2024.

The MPC provides an independent assessment of the monetary stance consistent with the Bank of Canada's 2 percent inflation target. **William Robson**, the Institute's CEO, chairs the Council.

Council members make recommendations for the Bank of Canada's upcoming interest-rate announcement, the subsequent announcement, and the announcements six months and one year ahead. The Council's formal recommendation for each announcement is the median vote of members attending the meeting.

The Council also offers a view on whether the Bank should accelerate, maintain or slow the planned reduction in its holdings of Government of Canada bonds. On this occasion, a strong majority voted for the Bank to maintain its planned pace of reduction.

The sentiment in favour of a higher overnight-rate target in the near term was strong: seven of the nine Council members attending the meeting called for a 5.00 percent target on July 12th, and one of those seven called for a 5.25 percent target at the subsequent announcement on September 6th. Although the median vote for the January 2024 announcement was still 5.00 percent, four members called for a lower target by then. In a year's time, the range of recommendations around the 4.25 median was quite wide, with one member calling for a target of 3.75 percent at the low end, and one calling for a target of 5.25 percent at the high end (see table below).

The Bank of Canada's current policy with respect to its holdings of Government of Canada bonds is to buy nothing and let its holdings shrink as the bonds mature. Eight of the nine members called for the Bank to maintain that schedule, while one called for it to accelerate the reduction in its holdings, emphasizing that the Bank should not be holding real-return bonds.

The strong sentiment among Council members in favour of a higher overnight-rate target over the summer months reflected the continuing strength of domestic demand in Canada, and doubts that inflation will drop back to the Bank's 2 percent target without further monetary restraint. Members emphasized the robustness of growth in the United States, strong consumer spending, the resilience of residential construction to higher interest rates, the tight labour market, and fiscal policy, both in the United States and Canada, that is adding fuel to the fire. The group acknowledged that inflation had declined in line with the Bank of Canada's forecast notwithstanding the robust economy, and that forecasters had generally been raising their projections for GDP while maintaining their projections for inflation. But some members noted that gasoline prices and less favourable base effects will limit further near-term declines in inflation, and many felt that the combination of strong growth in demand and limited growth in the economy's productive capacity will work against further reductions later this year and into 2024.

The limited response of residential construction to higher interest rates was a major point of discussion in the meeting. Among the reasons cited by members for the surprisingly small decline in activity to date were high household saving since the pandemic, the slow feedthrough of higher mortgage rates to monthly payments, and how experience during the financial crisis and pandemic, combined with regulatory changes, had reduced exposure among households and financial institutions to higher interest rates. Some members speculated that changes in the housing market might have made it less responsive to interest-rate changes in general; others – who tended to be less enthusiastic about hikes in the overnight rate – argued that those and other changes were likelier to have changed the timing of the responses more than their magnitudes.

Concerns about slow growth in the Canadian economy's productive capacity featured prominently in the discussion, with low business investment, constraints related to climate-change policies, protectionism and labour-market constraints all getting mentions. While noting some vulnerabilities abroad – with the potential vulnerability of the US banking system to further policy-rate hikes by the US Federal Reserve being an important one, and another being the potential for setbacks in China – the dominant theme of growth in demand outpacing growth in supply tipped the group toward recommending a higher overnight rate before declining inflation will justify a lower rate in a year's time.

Votes of MPC Members and the Council Median for Each Announcement (*percent*)					
MPC Members	**12 July, 2023**	**6 September, 2023**	**January 2024**	**September 2024**	**Reduction in Bond Holdings**
Steve Ambler Université du Québec à Montréal (UQAM)	4.75	4.75	4.50	4.25	Maintain
Beata Caranci TD Bank Group	5.00	5.00	5.00	4.00	Maintain
Ted Carmichael Ted Carmichael Global Macro	5.00	5.00	5.00	5.00	Maintain
Michael Devereux University of British Columbia	5.00	5.00	4.75	4.50	Maintain
Angelo Melino University of Toronto	5.00	5.00	4.75	4.25	Accelerate
Douglas Porter BMO Capital Markets	5.00	5.00	5.00	4.75	Maintain
Pierre Siklos Research Fellow	5.00	5.25	5.25	5.25	Maintain
Stephen D. Williamson Western University	4.75	4.75	4.25	3.75	Maintain
Craig Wright RBC	5.00	5.00	5.00	4.25	Maintain
Median Vote	5.00	5.00	5.00	4.25	N/A

The views and opinions expressed by the participants are their own and do not necessarily reflect the views of the organizations with which they are affiliated, or those of the C.D. Howe Institute.

The MPC's next vote will take place on August 31, 2023, prior to the Bank of Canada's overnight rate announcement on September 6.

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