Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Monetary Policy Observers

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Re: **In Praise of the Pause**

The Bank of Canada held its policy rate at 5 percent last week – a smart move.

Although the Bank's governing council may have made its decision ahead of the weak GDP the week before, those numbers underlined the reasons to hold. Real GDP contracted at an annualized rate of 0.2 percent in the second quarter and fell 0.2 percent month-over-month in June (annualized as well). Looking ahead, Statistics Canada's advanced estimate for July was flat. The household consumption the Bank has been battling finally seems to be flagging. Data on Bank deposits and job vacancies also testify to an economy losing steam.

Monetary policy works with a lag, and these latest figures suggest that the painful hikes of the past year and a half are working, slowing economic growth and allowing potential output to catch up.

On their face, high headline inflation numbers make it look like the Bank's job is not finished, which may suggest the Bank should have hiked its policy rate again. The Bank's mandate is to hit the 2-percent inflation target. From that perspective, headline inflation ticking up from 2.8 percent in June to 3.3 percent in July was bad news. The year-over-year core measures also remained stubbornly high, with CPI-trim inflation (which excludes the most volatile items) barely falling from 3.7 percent to 3.6 percent between June and July and CPI-median remaining unchanged at 3.7 percent.

But there is a strong case that inflation is falling faster than the year-over-year numbers reveal.

A perverse short-run impact of higher interest rates on headline inflation runs through mortgage interest costs. The last Statistics Canada report on inflation showed mortgage interest costs up 30.6 percent year-over-year, a new record. Although those costs have a weight of less than 4 percent in the overall consumer price index, stripping them out gives an inflation rate of only 2.4 percent, not that much above target.

The National Bank's inflation calculator, which strips out energy, food – much higher than overall inflation for some time – and mortgage interest costs, was 2.3 percent year-over-year in July and 1.6 percent (annualized) over the past three months, considerably under target.

Including mortgage interest in the calculation of inflation is problematic for two reasons. One, it is obviously tightly linked to the rise in the central bank's policy rate – when the Bank raises it, in the short run mortgage interest costs on average go up. Two, higher mortgage rates, like higher interest rates generally, reduce demand for credit and slow the growth of money and spending.

The year-over-year increase is also heavily influenced by base effects. The biggest single increase in the Bank's policy rate during this cycle was in July 2022, from 1.5 to 2.5 percent. The effect on mortgage interest cost increases was correspondingly large in the early summer of 2022 and has continued since. This year-over-year increase will soon drop out of the calculation of mortgage interest cost inflation and will bring this number down. By pure arithmetic, headline inflation will also come down.

A crude measure of the Bank of Canada's real interest rate – the policy rate of 5 percent minus current headline inflation of 3.3 percent – is 1.7 percent. This rate exceeds the bank's own latest estimate of the real neutral interest rate – the rate at which the economy is operating at its potential and inflation is sustainably at 2 percent. The Bank currently estimates this rate to be somewhere between 0 and 1 percent. That would make the Bank's monetary policy currently quite restrictive, and even more so as inflation decreases. As that 3.3-percent headline number continues to fall, the gap with the 5-percent target will grow and the real interest rate will increase. In other words, the Bank can leave its policy rate where it is and continue to squeeze economic growth, which will bring inflation back down.

With the economy continuing to weaken and inflation moving in the right direction, when we probe more deeply, the Bank was right to keep its policy rate on hold.

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