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From: Jeremy M. Kronick and Steve Ambler

To: Interest Rate Watchers

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Re: **No Rate Cut Yet. Here's Why**

Headline inflation in January moved back into the Bank of Canada's 1 to 3-percent target range. Yet last week, the Bank again held steady on its overnight rate.

Why is the Bank reluctant to cut? There are two main impediments: Core inflation, and concerns over expectations. Both are fair reasons to keep rates where they are, but both measures are easing or should ease soon. An April rate cut may therefore be in the cards.

The Bank's mandate is to target 2-percent headline inflation. But headline inflation contains a number of volatile items, such as energy, so central banks use measures of core inflation that strip out those elements to get a sense of underlying price pressures. The Bank of Canada's preferred core measures are CPI-trim (excluding the most volatile items) and CPI-median (focusing on the price change at the 50th percentile).

Both core indicators have been sticky throughout this tightening campaign and remain well above their targets at 3.4 percent and 3.3 percent, respectively. It is reasonable for the Bank to seek more clarity that those underlying price pressures are easing.

Expected inflation might be trickier to deal with given previous inflation rebounds during this tightening cycle. If the Bank were to cut rates and inflation reverses course again – perhaps as a result of a housing market that seems coiled and ready to go – expected inflation might increase. That in turn would lead to greater price increases by companies and higher wage settlements for workers, feeding back into increased inflation.

Notwithstanding the Bank's valid concerns about both core inflation and inflation expectations, we see signs that easing is upon us, or should be soon.

Over the past three months, CPI has increased at an annualized rate of only 1.8 percent, below the Bank's target, and the seasonally adjusted CPI actually fell between December and January. Three-month numbers are still elevated for CPI-trim and CPI-median. However, an alternative measure of core inflation known as CPIX, which strips out eight of the most volatile components and excludes the effects of indirect taxes, was only 2.4 percent in January, year-over-year, and just 1.6 percent at an annualized rate over the past three months.

These declines in inflation mean that the Bank's real policy rate (the nominal policy rate minus the inflation rate) has become more restrictive over this time. Since the overnight rate target reached its 5-percent peak last July, inflation has dropped 0.4 percentage points. So, in real terms, monetary policy has become 0.4 percentage points more restrictive, which should further restrain demand.

Although the GDP growth headline late last month was a positive surprise, domestic demand was weak. Growth was almost entirely driven by an increase in exports, a nod to a strong US economy.

Whether the United States can continue to buoy the Canadian economy is unclear. In part, this is because the Federal Reserve may not be as close to cutting rates as the Bank of Canada. The Fed uses the Personal Consumption Expenditure price index as its primary measure of inflation – targeting 2 percent, as we do here. That measure has been falling, hitting 2.4 percent in January. However, the Fed has focused during this tightening cycle on what it calls supercore inflation – inflation from core services excluding housing – and this measure increased markedly in January.

That means the Fed is still talking tough, even tougher than the Bank of Canada. If the US economy begins to finally slow with rates remaining elevated, what's left of our GDP growth might fade away. This will feed through into core inflation and expectations.

We understand the Bank's hesitancy to lower rates too soon. But, with the economy teetering, core inflation should continue to fall, and expectations that the Bank will get inflation back to 2 percent will firmly re-anchor. When we hear next from the Bank in April we may see the rate cut many have been waiting for.

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