Intelligence MEMOS

From: Steve Ambler and Jeremy Kronick

To: Canadian Interest Rate Watchers

Date: December 13, 2019

Re: **The Bank of Canada's Data-driven Balancing Act**

The Bank of Canada announced last week that it was holding its overnight rate target constant at 1.75 percent. Many analysts had been predicting a lowering of the rate since at least Oct. 30, when the bank also held the rate steady and the US Federal Funds Rate dropped a quarter point.

A majority of forecasters now expect the Canadian central bank to hold its rate constant right through the end of 2020, according to a recent **Reuters poll**. That will, of course, depend on the behaviour of inflation.

In 2018, the bank was engaged in a tightening cycle and seemed to be on a path toward its long-run "neutral" rate in the range of 2.25 percent to 3.25 percent (compatible with an economy at full capacity and inflation steady at 2 percent), having raised the overnight rate five times between June 2017 and October 2018.

However, earlier this year, with persistent economic uncertainty, it appeared the bank would join a host of other developed world central banks in cutting rates. Yet, we now seem to be in a holding pattern. Why? And what might we expect as we look ahead?

The main reason the bank has remained on hold is that inflation has been at or close to the bank's 2 percent target for the past two years, and the overall resilience of the Canadian economy has allowed the bank to chart its own course.

Moreover, it is challenging to assess where the balance of pressures lie – up or down.

In terms of upward pressures, the latest reading for the unemployment rate was 5.9 percent, which is very low by historic standards. The Bank of Canada's labour-market indicator, which historically has shown greater labour-market slack than the unemployment rate, stands at 5.6 percent.

Wages are accelerating while productivity growth has been relatively weak. Average hourly earnings grew by 4.2 percent year-on-year in the third quarter of 2019, and 4.3 percent in October, up from 2.2 percent in the first quarter of this year.

This combination of more rapid wage growth and slow productivity growth indicates that nominal wage increases have less to do with rewarding workers for being more productive, and more to do with labour-market tightness. High productivity tends to result in lower prices as it becomes more efficient for businesses to produce goods or supply services. Therefore, if productivity has been weak, this wage growth is more likely to feed through to increases in headline inflation.

If headline inflation does go up beyond the 2 percent target, should the bank increase the overnight rate?

Perhaps, but there is room for the bank to remain sanguine in the face of modest increases in inflation above 2 percent. A period of above-target inflation would make up for the frequent inflation undershoots over the past several years.

Since 2012, inflation has averaged 1.6 percent. There are no signs that inflation is headed towards 3 percent, the upper limit of the bank's target range. Moreover, the current strength of the Canadian dollar (the strongest performer of industrialized-economy currencies against the US dollar in 2019, largely because the bank's policy rate is now higher than its counterparts') will relieve some of the upward pressure on inflation by making imports cheaper.

In terms of downward pressure, a series of economic uncertainties exist both at home and abroad.

Trade continues to be a huge source of preoccupation, with the US-China dispute at the fore. Indeed, the lowering of policy rates by many central banks is largely to take out insurance against this uncertainty.

Domestically, personal insolvencies have climbed, reaching the highest point in more than a decade and up 13.4 percent year-over-year. If this has negative knock-on effects on the demand for housing and consumer durables, all bets may be off.

There are always many variables that are used by the Bank of Canada's governing council to make a call on the overnight rate. As it looks ahead it will have to deal with indicators that are pushing inflation in both directions.

But, as the bank has made clear in its announcements, incoming data will play a major role. As it should.

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