Bank of Canada Should Hold Overnight Rate at 0.50 Percent Next Week; Hike to 1.00 Percent by May 2018: C.D. Howe Institute Monetary Policy Council

May 18, 2017 – The C.D. Howe Institute’s Monetary Policy Council (MPC) said the Bank of Canada should keep its target for the overnight rate, the very short-term interest rate it targets for monetary policy purposes, at 0.50 percent at its next announcement on May 24, 2017. Looking ahead, the Council said the Bank should hold the target at 0.50 percent over the next six months, and hike to 1.00 percent by May of 2018.

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 President and 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 the members attending the meeting. (In the event that the median vote is not a multiple of 25 basis points, as happened this time for the target six months out, the formal recommendation is rounded in the direction of no change.)

All eight of the MPC members attending this meeting called for an overnight rate target of 0.50 percent at the upcoming setting and at the setting in July. For the setting six months out, four called for a target of 0.50 percent, three called for 0.75 percent, and one called for 1.00 percent. One year out, one called for 0.75 percent, five for 1.00 percent, and two for 1.25 percent (see table below).

A common theme in all MPC members’ recommendations was that the overnight rate should be higher in twelve months, but that the Bank should not raise it before July. This pattern reflected a view that Canada is likely to enjoy growth of spending and output fast enough to absorb any remaining disinflationary slack in the economy, and that the overnight rate should move toward a level consistent with steady growth and 2 percent inflation – but that several uncertainties rule out a hike in the near term.
The erratic behaviour of the US President hung over the session, more than offsetting what otherwise would have been an improving global economic backdrop. Among the concerns voiced by members were the uncertain prospects for growth-enhancing reforms in the United States, the effects of that uncertainty for financial asset prices, and the continued prominence of protectionist threats, not least against Canada. The importance of US growth for Canada, and the increased difficulty in predicting how much and when the US Federal Reserve will raise its policy rate in this fraught environment, made many members argue for the Bank of Canada to hold steady for now.

Recent developments in the housing market also inclined many members to recommend against an immediate rate hike by the Bank. Several felt that the Ontario government’s measures to damp price increases were having an effect. The problems afflicting a major mortgage lender, and possible repercussions in the mortgage market were another concern. Several members pointed out that the impact of an overnight rate increase on effective mortgage rates would be muted and gradual, but on balance, MPC members felt these circumstances reduced the pressure on the Bank to raise its rate to restrain the housing sector.

Looking further ahead, the group devoted considerable attention to the appropriate level for the overnight rate in 2018 and beyond. Several members argued that a neutral level would be less than the 3.5 percent implied by the Bank of Canada’s calculations. This level reflects an assumption of 1.5-percent real growth and 2-percent inflation: some members thought that growth was likely to be lower than that; others thought that inflation will be slow to return to target, and that the neutral rate that is relevant over the forecast horizon should therefore be lower.

Notwithstanding those uncertainties, many members judged that Canadians needed clearer communication from the Bank of Canada about the balance of probabilities around a change in the rate, and several remarked that the Bank of Canada’s communique should help Canadians anticipate an eventual increase.
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 July 6, 2017 prior to the Bank of Canada’s interest rate announcement on July 12, 2017.

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