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Bank of Canada expected to raise interest rate in the face of mixed signals

MARK RENDELL || JULY 10, 2023

The Bank of Canada headquarters in Ottawa on June 1, 2022. ADRIAN WYLD/THE CANADIAN PRESS

A month after surprising markets by restarting interest rate hikes, the Bank of Canada is widely expected to ratchet up borrowing costs again this week, despite the continuing decline in inflation and mixed signals about the strength of the economy.

The central bank ended a five-month pause on monetary policy tightening in June, pushing its benchmark interest rate up to 4.75 per cent, the highest level since 2001. Most Bay Street forecasters believe the bank will proceed with another quarter-point hike on Wednesday before moving back to the sidelines.

Until recently, few economists expected rate hikes to be on the table this summer. The majority thought the Canadian economy would be in, or near, a recession by now, squeezed by the most aggressive interest rate-hike cycle in decades.

But consumer spending and labour markets have proven remarkably resilient to higher borrowing costs, complicating the Bank of Canada's efforts to get inflation under control. Governor Tiff Macklem and his team are trying to bring economic growth to a standstill to reduce upward pressure on consumer prices.

Inflation has fallen considerably, reaching an annual rate of 3.4 per cent in May. But the bank's governing council concluded in June that the economy was still experiencing "excess demand" and that rates needed to move higher to prevent inflation from getting stuck "materially above" the bank's 2-per-cent target. The question for policy makers this week is whether an additional increase is needed to finish the job.

"We're not convinced that the economy needs further tightening. But what it comes down to is that five weeks ago the bank told us that policy at 4.5 per cent wasn't restrictive enough," said Taylor Schleich, director of economics and strategy at National Bank of Canada NA-T **+0.27%** "Holistically, if the bank thinks that things weren't restrictive at 4.5 per cent, 4.75 probably isn't the number either."

Financial markets are lining up behind a move. Interest rate swaps, which capture expectations about future rate decisions, are pricing in a roughly 70-per-cent chance the central bank will deliver a quarter-point hike on Wednesday, according to Refinitiv data. Market pricing suggests the bank will then remain on hold through the fall.

Another rate hike would mean more pain for mortgage holders, particularly homeowners with variable-rate mortgages or fixed-rate mortgages that are coming up for renewal. It could also put a chill on the summer housing market. Real estate activity in several large markets, including Toronto and Vancouver, slowed notably in June, which some economists chalked up to the rate hike at the start of that month.

Central banks around the world are facing a similar cocktail of economic resilience and persistent inflation. The Bank of England and Norway's central bank both delivered larger-than-expected half-point rate increases last month, while other central banks, including the European Central Bank, continued tightening and warned of further rate hikes ahead.

The U.S. Federal Reserve held its policy rate steady last month, but committee members indicated they expect to raise rates two more times this year.

Although analyst and market sentiment is firmly behind a rate increase by the Bank of Canada this week, the case for further tightening has, in some ways, weakened over the past five weeks. Economic data were uniformly strong ahead of the June decision. They are now more mixed.

The June jobs numbers provide the strongest argument for another hike. Canadian employers added 60,000 positions last month, Statistics Canada reported Friday, three times what Bay Street was expecting. That reversed a slight decline in May and extended Canada's remarkable job creation streak, which has added nearly 300,000 jobs over the first half of the year.

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At the same time, there are signs of cooling in the labour market. The unemployment rate ticked up to 5.4 per cent from 5.2 per cent, as job creation failed to keep pace with rapid population growth driven by immigration. And the pace of hourly wage growth, a key variable for inflation, particularly in the service sector, slowed to 4.2 per cent from 5.1 per cent in May.

Other data suggested that rate hikes are starting to bite. Consumer delinquencies are up, job vacancies are falling, and the central bank's latest business survey found that many companies expect sales to slow and cost pressures to ease.

Consumer price index inflation continues to march lower, dropping to 3.4 per cent in May from 4.4 per cent in April. That's a long way from the four-decade high of 8.1 per cent reached last summer, and only a few ticks above the upper end of the central bank's inflation-control band.

Still, the decline in inflation owes mostly to year-over-year comparisons for oil prices. Measures of "core" inflation, which strip out volatile components such as energy and food, are proving stickier.

"The slowing in inflation that we've seen recently, it's largely coming from energy – you're not seeing the same big increases at the pump that we had last year," said Leslie Preston, senior economist at Toronto-Dominion Bank TD-T **-1.10%.** "So headline inflation is coming down. But the less volatile inflation that the Bank of Canada targets is still well above three per cent and it's not coming down as quickly."

Interest rate increases work with a considerable lag. That raises the risk that the Bank of Canada will overdo it, stepping on the monetary policy brakes just as the economy is taking a turn for the worse.

Andrew Grantham, senior economist with Canadian Imperial Bank of Commerce CM-T **-0.98%,** said he doesn't think another rate is necessary to guide inflation back down to two per cent. However, he believes the central bank will raise rates again this week, based on its hawkish communications at the June meeting and the strength of the latest jobs data.

"We have to forecast what the bank will do, not what we think they should do necessarily," Mr. Grantham said. "And it seems to me that they're erring on the side of doing too much rather than too little with the knowledge that they can always cut interest rates next year if the economy slows down more than anticipated."

The central bank will publish a new forecast for economic growth and inflation on Wednesday alongside its rate announcement.