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Posthaste: Here's what it will take for the Bank of Canada to cut rates — and when it might happen

Reaching the bank's 2% inflation target might not be necessary, Desjardins economists say

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People walk past the Bank of Canada building in Ottawa. Desjardins economists expect the central bank to cut interest rates in the second quarter of 2024. PHOTO BY SEAN KILPATRICK/THE CANADIAN PRESS

The Bank of Canada could start cutting interest rates before inflation reaches its two per cent target, but only if the labour market co-operates, economists at Desjardins Group say.

A balancing in the labour market that brings the unemployment rate to 6.5 per cent combined with an inflation rate at or below three per cent is likely the magic formula that prompts a Bank of Canada interest rate cut, Desjardins economists Royce Mendes and Tiago Figueiredo said in a note on Nov. 20.

If the economy stays on its current path, that move to cut rates could happen as soon as the second quarter of 2024. The Bank of Canada's key policy rate is sitting at five per cent, the highest level in 22 years.

Mendes and Figueiredo said policymakers are closely watching the labour market for signs of rebalancing, and eyeing in particular the vacancy-to-unemployed ratio — a measure of job openings versus unemployed people — for clues as to when that will happen. Vacancies have been falling just as the number of people without jobs rises, bringing the current ratio to just above 0.5, a level last seen before the pandemic. That ratio is expected to fall to 0.5 early next year if job openings keep declining and unemployment continues to rise. At that point, unemployment will be at about six per cent, the economists said.

But that still won't be enough to prompt a rate cut, with bankers wanting to "err on the side of caution so they don't ease prematurely," Mendes and Figueiredo said. That means the bank will want to wait until the vacancy-to-unemployed ratio hits 0.4, which would amount to a 6.5 per cent unemployment rate. Wage pressures will also be weaker at that point, they said.

Of course, the inflation rate also plays a critical role in the decision to cut interest rates. An easing of labour market conditions is strongly correlated with lower price pressures, the economists said, helping to drive the rate of inflation at or below three per cent, which is still short of the bank's two per cent target. But the economists said the Bank of Canada might not bother waiting until the two per cent target materializes to bring rates lower, thanks to the outsized impact of shelter costs on inflation.

The Bank of Canada expects housing costs to drive inflation for the next six months. Dejsardins forecasts concur, showing that shelter will weigh heavily on inflation well into 2024. But because shelter costs can only improve with an increase in housing supply, which will take some time to achieve, the Bank of Canada may exclude shelter costs from its inflation reading entirely.

"The fact that central bankers view this as a supply problem, not a demand issue which they can control, is key to understanding why governor (Tiff) Macklem finally said what we've been forecasting for some time: the central bank will not wait for reported inflation to reach two per cent to cut interest rates," the economists said.

The annual rate of inflation slowed in October, coming in at 3.1 per cent versus 3.8 in September, Statistics Canada said on Nov. 21. Desjardins forecasts inflation to continue on its downward trend, reaching the Bank of Canada's two per cent target by 2025.

Still, if the labour market reaches an unemployment rate of 6.5 per cent and inflation eases to around three per cent, Desjardins expects the Bank of Canada to cut interest rates in the first half of 2024. Both those criteria could be met as early as April, the economists said.

“Assuming BOTH of our thresholds are met, the Bank of Canada could begin trimming rates in the second quarter of 2024 to better calibrate policy to the reality the central bankers will have done what they can to conquer inflation,” Mendes and Figueiredo said. “What’s left to hit two per cent will just be time.”