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Bank of Canada issues a warning, but not a speeding ticket

by **Avery Shenfeld** avery.shenfeld@cibc.com (416 454-4982)

The Bank of Canada had reason to play the good cop today, issuing only a warning rather than a speeding ticket for an economy in which prices and wages are still moving too fast for its liking, but with brakes on both now being applied. While leaving the overnight rate unchanged at 5%, it didn't declare a formal pause, let alone announce that rates had peaked. That said, while forecasts are always uncertain, economists are much better at knowing what's already happened, and recent signs of flagging demand growth and cooling labour markets were good reasons for the Bank to step to the sidelines today, and in our view, will end up showing that the current 5% overnight rate is as far as we'll need to go to bring inflation to heel.

- When it returned to hiking rates after a pause earlier in 2023, the Bank had cited persistent tightness in the labour market, and signs in Q1 growth that households were able to shrug off higher rates, and even a bump in housing activity. Recent data has undercut these arguments for additional monetary tightening. Today's statement from the Bank noted that labour market slack is beginning to open up, as has been apparent in a 0.5%-point climb in the unemployment rate, alongside a drop in job vacancies and in job switching by workers.
- That upside surprise in Q1 growth has now been offset by a marginal drop in GDP in Q2. While that was impacted by fires and other disruptions, it also included weakness in consumption and housing, making it apparent that interest rates were indeed cooling the economy where they typically hit the hardest. In sum, as the statement notes, the lagged impacts of monetary policy seem to be kicking in, and that was happening at rates that prevailed before the last two hikes, a very good reason to avoid hiking again today.
- The Bank took pains to remind us that its radar gun shows that the economy is, for now, still speeding along in terms of current readings on prices and wages. The BoC is clearly not a fan of inflation measures that strip out the impact of soaring mortgage interest costs (MIC), choosing to mention both the uptick in headline inflation to 3.3%, and the fact that its core measures are still trending near 3.5% in 3-month and year-on-year terms. While MIC is a big factor in these trends, the Bank must feel that if not for that pressure from higher mortgage payments, household spending power would be pushing inflation in other components at a faster pace.
- That argument is supported by the fact that wage inflation, which the statement notes is running in the 4-5% range, is still too hot to be consistent with a 2% inflation target, due to its implications for both costs and household spending power. But looking ahead, there are good reasons to anticipate a cooling on that front with only a bit more labour market slack than is now apparent. The current unemployment rate is only a few ticks lower than what seemed to be non-inflationary in the prior cycle, and other wage determinants, including job vacancies and workers quitting to look for better pay, are in the process of normalizing. A couple more quarters of modest growth, coupled with population increases, should see the jobless rate moving above 6% and quelling wage gains in the process.
- Still, that's all in the forecast, and to help support expectations that we're going to get to its 2% inflation target, the Bank underscore that it needs to see more evidence of an economic cooling to tell Canadians that's its definitively done with rate hikes, let alone begin to think about an easing in policy. So its concluding comments were loaded up with warnings that it's prepared to hike again if necessary, that it's "concerned" about current price pressures, and that it will be "resolute" in getting to its target. We'll need to see a further easing in labour markets, and a continuation of

sluggish growth in the second half of 2023 for the Bank to definitively drop such warnings and admit that rates have, as we expect, already peaked.

Re: Economic forecast — We see overnight rates at a plateau at current levels through Q1 of next year. By Q2 of 2024, we should have spent enough time with some slack in the labour market to have wage gains cooling off, allowing the Bank of Canada to begin paring interest rates in the spring. Still, if the economy achieves a soft landing, that also implies that it won't need rescuing with very stimulative monetary policy any time soon. Our end--of-2024 forecast for a 3.5% overnight rate would still be twice the rate that marked the peak of the prior business cycle, and not particularly low in real terms if at that point inflation is near the 2% target.

Re: Markets — Today's decision was widely expected, particularly in the wake of the Q2 GDP data which even a hawkish central bank couldn't ignore. We don't see any reason for forecasters or investors to alter whatever views they had prior to today's news.

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