Economics

IN FOCUS

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Bank of Canada: Faster? No, Higher? No, Stronger? Yes

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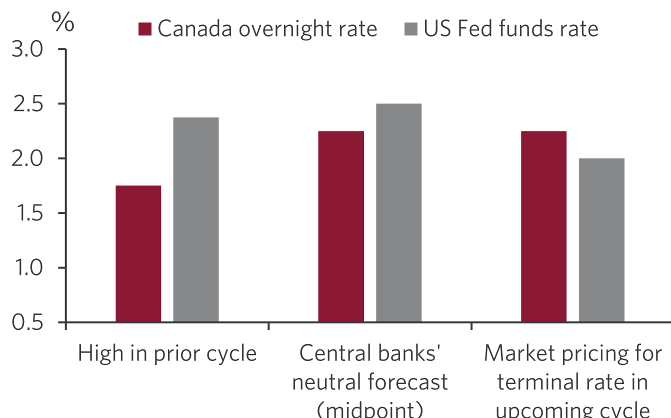
The market is human. The market can err. A year ago, it was pricing with confidence a situation in which the Bank of Canada would make its first move a full year ahead of the Fed. That call didn't make much sense even back then, with the US economic recovery well ahead of Canada's. Now, the same market is pricing in a terminal rate of 2¼% for Canada — 25bp higher than what is priced in for the US. The market was wrong about the timing, and, we suggest, it is now wrong about the relative magnitude of interest rate increases.

Indeed, with the Bank of Canada holding the stronger policy tool, the risk is that the path higher for rates will be slower and lower, not faster and higher, in Canada relative to the US.

What is the market thinking?

A higher terminal rate in Canada relative to the US would represent quite a difference compared to the prior couple of cycles and to where central banker's themselves currently view a long-run, or neutral, rate to be. While the Bank of Canada initially moved well ahead of the Fed after the financial crisis, the peak overnight rate reached, a mere 1.75%, was more than 50bp shy of the peak reached stateside. The mid-point of the Bank of Canada's current neutral rate forecast (2.25%) sits slightly below the FOMC's long-term rates view (2.5%) (Chart 1).

Chart 1: Markets priced for a very different terminal rate in this cycle than the prior one



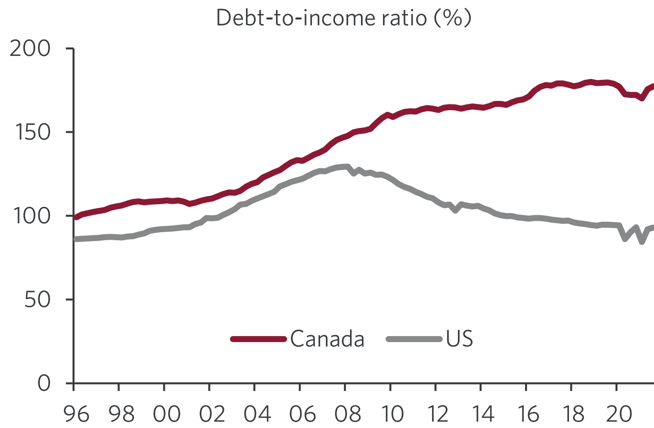
Source: Bloomberg, CIBC

The reasoning for the market's current view is not crystal clear. It's possible that investors believe Quantitative Tightening (QT) will be a more powerful tool in the US than in Canada, which would restrict the need for traditional interest rate hikes. However, that is almost impossible to quantify and, even if it could be, would be unlikely to account for the full swing in thinking on the US versus Canadian terminal rates. Also, some of the impact of QT in the US would be "imported" into Canada anyway as bond yields here could get dragged higher by US rates.

Another justification for a higher Canadian terminal rate was provided by Bank of Canada Governor Tiff Macklem a couple of weeks ago in his speech on business investment and productivity. In it he reminded us that, without increasing potential supply through increased productivity, inflationary pressures would be generated earlier and interest rates would, all else equal, need to be higher. So far, post-pandemic, the shortfall in productivity growth in Canada has been even greater than it was before Covid-19 struck. However, that's at least in part due to more stringent public health restrictions, which have left service sector workers with fewer customers to look after in Canada and should reverse as those restrictions are lifted.

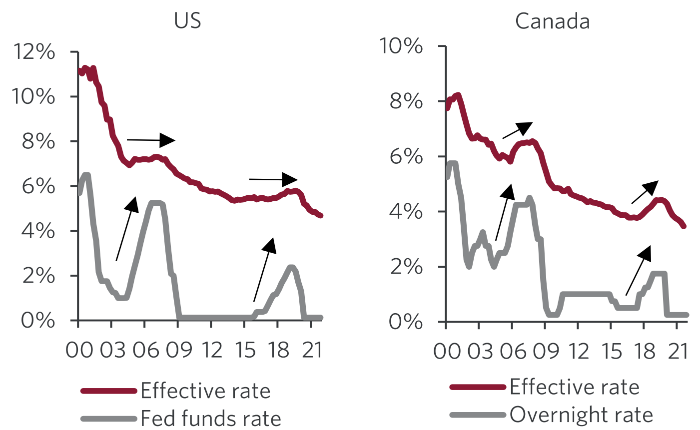
Moreover, all of the other factors that impact a neutral or terminal interest rate are not necessarily equal, either between the two countries or relative to their pre-pandemic levels. Indeed, a number of them continue to point to a Canadian terminal rate that should still be below that of the US.

Chart 2: Debt to Income ratio — spot the difference



Source: Federal Reserve Board, Statistics Canada, CIBC

Chart 4: Effective rate less responsive to higher policy rates in US



Source: BEA, Federal Reserve, Statistics Canada, Bank of Canada, CIBC

The Bank of Canada is more powerful than the Fed

The main factor behind our assertion is the simple fact that, at this point, when it comes to the effectiveness of monetary policy, the Bank of Canada is mightier than the fed. That divergence in monetary policy power was originated in the 2008 financial crisis which led to the mother of all deleveraging in the US. Canada, being a second hand smoker during the crisis, experienced the opposite trend. You have probably seen Chart 2 thousands of times, so one more time, as a reminder, will not hurt.

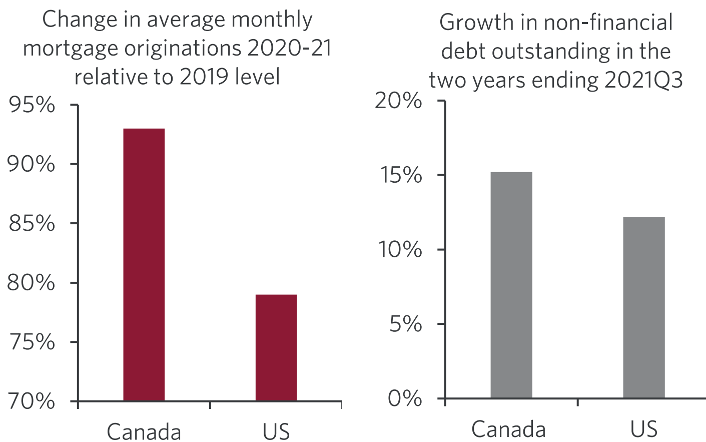
And this divergence has accelerated during covid, with both mortgage originations and corporate debt outstanding rising faster in Canada. The fact that debt accrued in a period of extremally low interest rates will work to hurt Canadian households more as rates rise (Chart 3).

And that lower level of debt south of the boarder won't necessarily be impacted by higher interest rates, with the vast majority of mortgages coming with 30-year fixed rates.

Chart 4 tales the tale. You don't have to be an economist to see the difference in the response of the effective rate (actual interest payment as a % of debt outstanding) to changes in the official rate. First, in both countries the effective rate is very responsive to lower rates (due to refinancing activity) and less responsive when official rates rise. But a closer look reveals that the effective rate in the US is much less responsive than seen in Canada. The massive hiking by Greenspan in the years heading to the financial crisis was neutralized in part by the creative imagination of American banks (remember NINJA mortgages?). And the increase in the effective rate following the 2017-18 hikes was much more muted than seen in Canada.

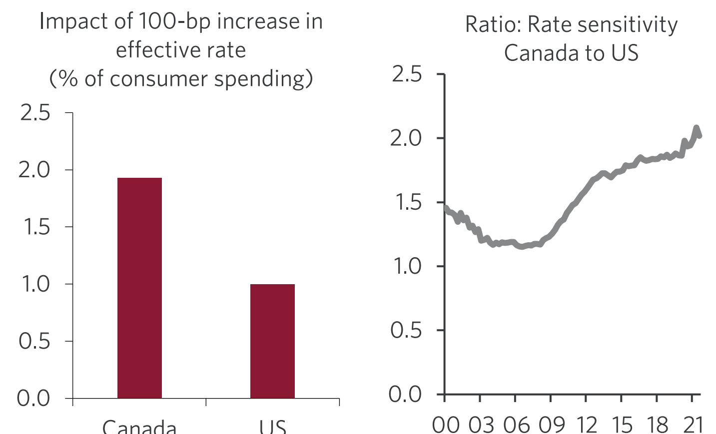
But the argument goes beyond that. Not only is the effective rate in the US less sensitive to changes in policy rates, but the higher level of household debt in Canada also means that every basis point increase in that effective rate has a greater impact in slowing economic activity relative to the situation in the US. Chart 5 illustrates that point. We estimate that as of now, a 100-basis point increase in the effective rate in Canada will have no less than double the impact on consumer spending

Chart 3: Mortgage originations and corporate debt have risen faster in Canada during Covid



Source: BEA, Statistics Canada, CIBC

Chart 5: Canada more sensitive to higher rates than the US



Source: BEA, Statistics Canada, CIBC

relative to the same increase in the US. And that gap in effectiveness has risen notably over the past decade.

Of course, savings built up by households during the pandemic could help soften the blow to household finances from higher interest rates. However, as we have discussed in the past, pinning down just how excessive these savings are is difficult — particularly for Canada. While the household savings figures within the quarterly GDP reports suggests excess savings of up to 20% of annual household disposable income, that total will include money that has subsequently been invested, gifted or placed as down payment for a house. The excess money floating around in savings and checking accounts relative to its pre-pandemic trend is worth a more modest 5% of disposable income. Such a discrepancy isn't as evident in the US, likely due to the hotter housing market in Canada during the pandemic.

More than meets the eye for supply

In terms of influencing demand, it is pretty clear that interest rate hikes in Canada will have a quicker and larger impact on growth than in the US. That was a key reason for a lower terminal rate in Canada during the prior cycle, and if anything, that divergence has grown over the course of the pandemic.

Moreover, on the supply side, while lower productivity implies an earlier onset of inflationary pressures and higher interest rates in Canada, another factor is helping pull in the opposite direction. Individuals can only be productive and add to overall supply in the economy if they turn up to work, and labour force participation is one area where Canada has long had an advantage over its southern neighbour. And, with many American's choosing early retirement during the pandemic and immigration flows into Canada increasingly tilted towards young adults near the start of their working lives, Canada's advantage in this area has increased (Chart 6). The US is already seeing the results of this, with wage growth pushing up consumer prices in a number of service industries — a trend not seen to the same extent in Canada.

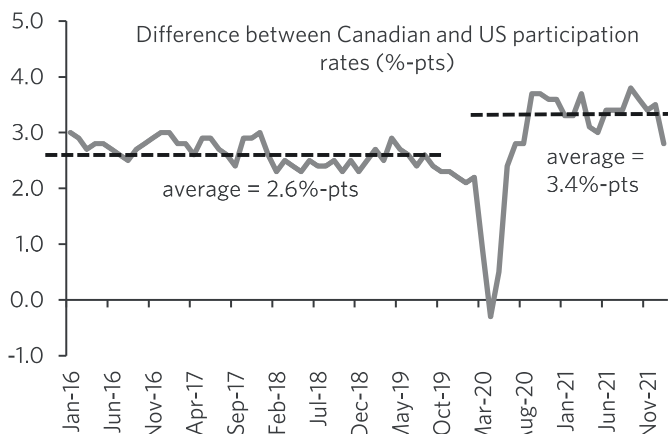
The final factor we need to think about is whether a terminal rate this cycle could, or should, be above whatever the prevailing neutral rate is. While supply constraints have meant that, in the here and now, inflation has run much hotter than traditional output gap measures would suggest, that shouldn't be the case by the end of next year. At that point in time, a positive projected output gap could be a sign that interest rates may have to briefly rise above neutral.

However, because the US economy is already well ahead of Canada in this recovery, and because interest rate hikes will start to impact growth earlier here than they do stateside, we project a much smaller positive output gap by the end of 2023 (Chart 7, left). That would also be the case using the somewhat more positive consensus or central banks' own forecasts. Also, important to note is that this already accounts for a slower potential growth rate in Canada due exclusively to weaker productivity (Chart 7, right).

Not so different

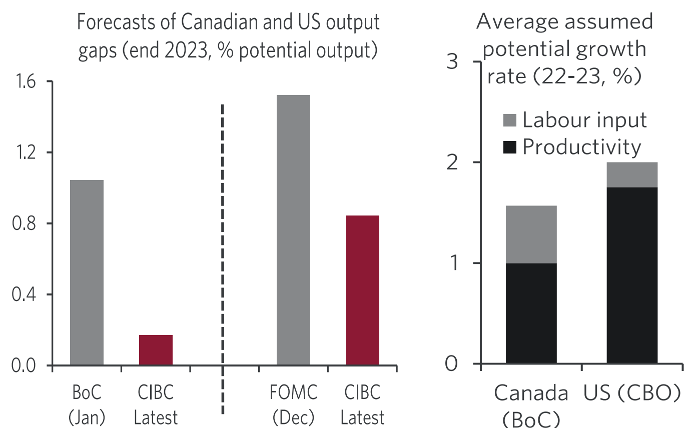
Market pricing for a higher terminal rate of interest in Canada relative to the US appears out of line with most factors that determine such a destination. We forecast that interest rates in both countries will top out just north of 2%, which for the US would be a little higher than current market pricing. For Canada, the risks are tilted toward a lower terminal rate than the one currently priced. Moreover, due to the timing of when interest rate changes start to affect economic activity, the path towards that rate may need to be more gradual in Canada, particularly later this year and in 2023. At that time the market will be forced into reassessing its current view that Canada, not the US, will have a higher terminal rate in this cycle.

Chart 6: Canada's advantage in labour force participation has grown post-pandemic



Source: BLS, Statistics Canada, CIBC

Chart 7: Overheating by the end of 2023 more likely in the US (L), Even accounting for weaker productivity and potential in Canada (R)



Source: BEA, Statistics Canada, CBO, BoC, CIBC

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