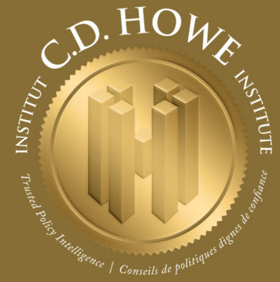
Intelligence MEMOS



From: Jeremy M. Kronick and Steve Ambler

To: Interest Rate Watchers

Date: April 26, 2024

Re: **No Rate Cut Yet. Here's Why There Should Have Been**

The latest **data** indicate that the battle against inflation is almost over. Despite this, the Bank of Canada again **held** its policy rate at 5 percent this month.

What gives?

The Bank, like many other central banks, was slow off the mark to raise rates as inflation took off. We worry it runs the risk of falling behind the curve again.

First, let's examine why the Bank might be hesitating to cut – the housing market and fiscal policy. Then, let's examine why, in our view, that's not enough.

Year-over-year headline inflation dropped inside the Bank's 1-3-percent range in January and continued to fall in February before ticking back up to 2.9 percent in March. Core inflation, which strips out more volatile prices, has also fallen over the last three months. Of the Bank's preferred measures – **CPI-trim** and **CPI-median** – the former was just above the target range in March (3.1 percent) while the latter dropped to 2.8 percent.

While the downward trends are both positive, the Bank's target is 2 percent, so they suggest more to do.

First-quarter results for the Canadian housing market seem set to **surprise** on the upside. And this seems likely to continue. Part of why households are ready to buy links back to why spending, in general, was so difficult to tame during the Bank's rate hikes over the last two years – namely, savings accumulated during the pandemic. Generous government transfers during extended lockdowns led to a savings overhang that people were able to draw on for much of the Bank's tightening campaign. Only now, with saving rates increasing, are there signs it is biting. A lowering of interest rates would reverse this effect.

On the fiscal side, Ottawa and **many provincial governments** are set to continue spending in an inflationary fashion, where deficits are driven not by lower tax revenue but by higher expenditures. Lower interest rates that stimulate more demand elsewhere will only add fuel to the inflationary fire.

These are valid concerns – and **others agree** with the Bank. But we believe the following concerns are weightier.

First, looking at year-over-year measures is increasingly misleading. Headline inflation over the preceding three months (where we convert the three-month change into an annualized number to make comparable to the year-over-year numbers) was just 1.3 percent in February and 1.0 percent in March. The Bank's preferred measures of core inflation have now dropped below target over the last three months: Trim inflation was 1.4 percent and Median inflation was 1.1 percent. Even food price inflation has slowed. While still above 2 percent year over year, food inflation was just 1.3 percent in the three months to February and non-existent in the three months to March. Food prices actually decreased slightly from January to February.

The major exception has been shelter costs, which have increased at an annualized rate of 4.8 percent over the last three months. These costs have been driven by mortgage interest costs (which depend in a very direct way on the Bank of Canada's policy rate). When mortgage interest costs are stripped out of the CPI, the index was lower in February 2024 than in July 2023 (although it ticked up again in March), meaning that this measure of inflation was negative over that period.

Other **macro indicators** are suggestive of an economy running out of steam. The unemployment rate is up again, now at 6.1 percent – it was 5.1 percent last March. Business bankruptcies are on the rise and job vacancies continue to fall. And the Bank's Business Outlook Survey showed a normalization in business pricing behaviour – both in terms of frequency and magnitude of changes.

We think the latter considerations outweigh concerns over the housing market and our governments' collective spending behaviour. As of now, it looks like the Canadian economy has achieved a proverbial "soft landing," with inflation returning to target without a painful recession. However, the Bank of Canada's real policy rate (its policy rate minus inflation) is now higher than at the beginning of the millennium (its nominal rate was 5.75 percent in January 2001 when inflation was 3 percent). Based on year-over-year inflation, the real rate is above 2 percent. Based on inflation over the last three months, it is now equal to 4 percent, which is restrictive monetary policy by any measure.

If the Bank has in fact fallen behind the curve, it will have to follow its expected June cut with several more in quick succession.

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To send a comment or leave feedback, email us at blog@cdhowe.org.

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A version of this Memo first appeared in The Globe and Mail. *Some numbers have been updated.*