

October 17, 2022

C.D. Howe Institute Monetary Policy Council Calls for Bank of Canada to Raise Overnight Rate to 3.75 Percent

October 17, 2022 – The C.D. Howe Institute’s **Monetary Policy Council** (MPC) recommends that the Bank of Canada raise its target for the overnight rate, its benchmark policy interest rate, by 50 basis points to 3.75 percent on October 26, and maintain the current pace of reduction in its holdings of Government of Canada bonds. The Council recommended that the Bank raise the overnight rate target again in early 2023, before lowering it back to 3.75 percent in a year’s time.

The MPC provides an independent assessment of the monetary stance consistent with the Bank of Canada’s 2 percent inflation target. **William Robson**, the Institute’s CEO, chairs the Council.

Council members make recommendations for the Bank of Canada’s upcoming interest-rate announcement, the subsequent announcement, and the announcements six months and one year ahead. The Council’s formal recommendation for each announcement is the median vote of members attending the meeting. When the median vote is not an increment of 25 basis points, as occurred this time with the December 2022 setting, and the mean of the recommendations does not break the tie, the recommendation is rounded in the direction of the previous setting.

The Council also offers a view on the Bank’s balance sheet. On this occasion, members voted on whether the Bank should accelerate, maintain or slow the planned reduction in its holdings of Government of Canada bonds.

Four of the six members attending the meeting favoured a 3.75 percent target for the overnight rate at the upcoming announcement; the other two favoured a target of 3.50 percent. The centre of gravity of the recommendations was higher for the December announcement, with three members favouring 3.75 percent and three favouring 4.00 percent. By April of 2023, four members favoured 4.00 percent, moving the median up to that level, while one favoured 3.75 percent and one favoured 3.50 percent. In a year’s time, two members each favoured targets of 4.00 percent, 3.75 percent and 3.50 percent, moving the median back down to 3.75 percent (see table below).

The Bank of Canada’s current policy with respect to its holdings of Government of Canada bonds is to buy nothing and let its holdings shrink as the bonds mature. Five members called for the Bank of Canada to maintain that schedule; one commented that the Bank should eliminate its holdings of real return bonds ahead of their maturity dates.

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The MPC's consensus in favour of further hikes in the Bank of Canada's overnight rate target reflected the fact that inflation continues to run well above the Bank's 2 percent target. Notwithstanding the possibility that the consumer price index report for September that will appear on October 19th may show signs that inflation is ebbing, a key theme in the discussion was that the Bank cannot yet declare victory. Canada may be nearing the peak of this interest-rate cycle, and the MPC's call for a cut in the overnight rate target between April and December of 2023 reflects some optimism about inflation declining. Several members remarked, however, that their expectations of a less overheated economy and falling inflation were contingent on the Bank following through on its previous guidance about further overnight rate increases in the near term.

In looking at economic activity abroad and domestically, the group noted signs of deceleration globally, and declines in house prices and evidence that consumers are cutting back in Canada. Several members expressed optimism that supply constraints affecting key commodities are easing. One underlined that employment in Canada is no longer growing rapidly, but population is, with positive implications for the over-tight labour market. Many members noted, however, that several damping influences on activity in Canada, mortgage rates in particular, reflected expectations of further tightening by the Bank of Canada, and with various measures of inflation all pointing to continued readings above 2 percent for some time to come, the Bank needed to raise its overnight rate further before pausing or lowering it again.

One point of uncertainty in the discussion was the impact of recent movements in the Canadian dollar on prices. Some members pointed out that higher import prices resulting from its depreciation against the US dollar should be offset by lower prices from its appreciation against other currencies; others noted that the prevalence of US-dollar pricing in international trade meant that the depreciation would boost prices.

Another point explored by the group was the level of real interest rates. Some members were inclined to emphasize the gap between short-term rates and recent measures of price increases, arguing that real rates are too negative to be consistent with progress toward lower inflation. Others were inclined to emphasize how much longer-term rates have risen – which, combined with expectations of lower inflation further out, means that interest rates are now positive in real terms for many borrowers.

A final important theme in the conversation was the possibility that current tightening by most major central banks may have a reinforcing effect – a reverse of the simultaneous easing that sparked current inflation. Several MPC members underlined the financial stresses that have emerged in many countries, notably the United Kingdom. Their concerns about unexpectedly strong contractionary forces came out most clearly in their discussion of the Bank's quantitative tightening. While one member urged the Bank to eliminate its holdings of real-return bonds, which yield more when inflation is higher and therefore do not belong in the Bank's portfolio, the majority said the Bank should not surprise the market with bond sales, and should continue to let its holdings shrink as the bonds mature.

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Votes of MPC Members and the Council Median for Each Announcement (*percent*)

MPC Members	Oct 26, 2022	Dec 7, 2022	Apr 12, 2023	Oct 25, 2023	Reduction in Bond Holdings
Steve Ambler Université du Québec à Montréal (UQAM)	3.50	3.75	3.50	3.50	Maintain
Michael Devereux University of British Columbia	3.75	4.00	4.00	3.75	Maintain
Stéfane Marion National Bank of Canada	3.75	4.00	4.00	3.50	Maintain
Angelo Melino University of Toronto	3.50	3.75	4.00	4.00	Accelerate
Avery Shenfeld CIBC	3.75	4.00	4.00	4.00	Maintain
Stephen D. Williamson Western University	3.75	3.75	3.75	3.75	Maintain
Median Vote	3.75	3.75	4.00	3.75	N/A

The views and opinions expressed by the participants are their own and do not necessarily reflect the views of the organizations with which they are affiliated, or those of the C.D. Howe Institute.

The MPC's next vote will take place on December 1, 2022, prior to the Bank of Canada's interest rate announcement on December 7.

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