Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Inflation Watchers

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Re: **The Last Spike for the Bank?**

Last Wednesday, the Bank of Canada increased its policy rate to 5 percent, a level not seen since March 2001. Citing continuing tightness in labour markets and still-firm consumer spending, the Bank reasoned there is still excess demand in Canada's economy, and last week's rate hike was necessary to continue to bring activity in line with productive potential.

But if that adjustment is already happening, this hike may turn out to be one too many.

Among the many challenges a central bank faces in a fight against high inflation is the mixed signals it gets as it brings inflation back down. In Canada, headline inflation fell to 3.4 percent in May. However, most of that was driven by a fall in prices at the gas pump. Similarly, although the Bank's preferred core inflation measures fell from 4.2 to 3.8 percent and 4.3 to 3.9 percent (trim and median respectively), so-called "supercore" inflation (which looks at service inflation excluding shelter) is running much higher at 4.7 percent.

GDP growth slowed in April, but the preliminary estimate for May looks to be quite strong. Yet the Bank's Business Outlook Survey from the second quarter pointed to an easing of labour shortages, April job openings were at their lowest level in two years, and consumer insolvencies rose in May almost to their pre-pandemic levels.

The Bank's job is to sift through all this data and determine what overnight rate would bring inflation back to target over the next 18-24 months. And it is this lag between rate hikes and economic activity that raises red flags about this most recent hike.

When the Bank raises the overnight rate – the rate banks borrow and lend with each other in the overnight market – other interest rates adjust as well. As these rate hikes take hold, new borrowing becomes more difficult, and existing borrowing becomes more expensive. Households and businesses spend less, which slows economic activity.

However, these rate increases don't affect everyone at the same time.

Take the household mortgage market – an area that gets much attention in Canada because of our indebted households and expensive housing markets. Canada has the G7's **highest** household debt to GDP ratio: 102 percent. Yet this ratio tells us nothing about the ability of individual households to service that debt. The debt service ratio sat at 14.9 percent in the fourth quarter of 2019, the last pre-pandemic quarter. It fell as the pandemic set in and interest rates crashed. In the first quarter of 2023, it was back at 14.9 percent. Maybe we just haven't seen these hikes work their way through to the consumer yet.

Only **one third** of mortgage holders have seen payments increase since the Bank started its rate-hike journey in the first quarter of 2022. If only **35.5 percent** of Canadians hold a mortgage, this means, as a rough estimate, only 12 percent of Canadians have seen their mortgage payments increase. Many more will face hikes soon as renewals continue through 2025 and 2026.

Another reason to think the adjustment is already under way is changes in household saving, which provide clues about future consumption. From 2015 to 2019, household net saving was approximately $528 billion. In the three years since the pandemic began, that figure jumped to just about $1.9 trillion. Saving rates averaged 2.25 percent from 2015 to 2019 and 9.79 percent since 2020. Net worth shot up. Excess saving takes time to draw down, but there are signs this is now occurring, with net saving levels not far off the fourth quarter of 2019, money growth falling, and net worth below its 2022 first quarter peak.

Delays on the timing of mortgage renegotiations, and uncertainty about how households will behave with all that excess saving make it hard to gauge what overnight rate level will reduce demand sufficiently to get inflation sustainably back to its 2-per-cent target. Moreover, if inflation continues to fall, monetary policy becomes tighter in real terms even with a constant overnight rate. Add all this to the fact that we have just experienced some the fastest rate hikes many of us have ever seen, and there was a strong case for caution in the Bank's latest setting. If the adjustment was already under way, the overnight rate may now be at its peak, and the Bank's next move will be a cut.

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