

Intelligence MEMOS



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To: Interest Rate Watchers

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Re: **MORE RATE CUTS COMING: HOW FAR AND FAST ARE NOW THE QUESTION**

The Bank of Canada finally pulled the trigger last Wednesday and reduced its policy rate by 25 basis points. Forecasters were split between a June or July cut, but overall, the data were just too strong in favour of a cut – or too weak, as it were, considering the latest GDP numbers.

This marks the beginning of a cycle of easing policy rates. The question for most commentators, investors, and consumers is now: How far and how fast?

The Bank cut its policy rate from 5 percent to 4.75 percent. Despite the cut, a strong case can be made that monetary policy is more restrictive now than it was at the Bank of Canada's last announcement on April 10. This augurs well for further declines in inflation and further rate cuts. Over time, our still above-target inflation – both headline and the Bank's preferred core inflation measures, CPI-Trim and CPI-Median, which strip away volatile components of the price index – should continue to fall back towards the 2 percent target, giving the Bank more room to cut.

We say the Bank's monetary policy is more restrictive because what matters is not the nominal policy rate, 4.75 percent, but the real policy rate – the nominal policy rate minus inflation.

In April, when the nominal policy rate was 5 percent, the real policy rate, after subtracting headline inflation, was 2.2 percent, while it was 1.8 percent for CPI-Trim and 1.9 percent for CPI-Median. Today, with the cutting of the policy rate to 4.75 percent, while the real policy rate for headline inflation is more stimulative 2.05 percent, it is more restrictive for CPI-Trim and CPI-Median at 1.85 percent and 2.15 percent respectively.

A more restrictive monetary policy in real terms gives the Bank added space to continue cutting. Even with headline and core inflation measures now inside the upper bound of the Bank's target band (3 percent) and actually below the target over the last three months (at annualized rates), real rates will likely justify further cuts.

The timing and depth of those cuts are now the questions.

To answer it, we need to estimate the neutral rate that the Bank aspires to reach in the long run. While definitions differ, for our purposes, it is the Bank's policy rate compatible with inflation steady at its 2 percent target and an economy at full employment. This rate is not directly observable. However, the Bank of Canada regularly updates its best estimate.

Most recently, the Bank stated that this rate lies within a range of 2.25 percent to 3.25 percent – 25 basis points higher than its April 2023 estimate. Taking the midpoint of the range (2.75 percent) as the base case, the Bank's current policy rate is two full percentage points higher than the neutral rate, signalling that up to eight more rate cuts of 25 basis points are in the pipeline.

With the exception of the recent rate hikes, we have not seen a policy rate as high as 2.75 percent since October 2008. The policy rate is very unlikely to go lower than this unless the Bank needs to fight a deflationary recession, so Canadians will likely have to get used to an era of higher interest rates.

The speed of the cuts is also in question. Rate cuts will be tempered by domestic factors, e.g. population growth and fiscal stimulus in the form of government spending, but also by what is happening south of the border. There, inflation seems to be stuck above the Fed's preferred level, and in response, it is talking tough, leaving markets uncertain about when the easing cycle might begin. A certain amount of divergence between the Bank of Canada's and the Fed's policy rates is okay, especially as the Canadian economy becomes more services-oriented where domestic factors matter more for pricing. However, there is a limit, as this divergence puts downward pressure on the Canadian dollar, which, among other things, is inflationary because it boosts the price of imports. The robustness of the US economy will be important to watch.

Whether the cuts come sooner or later will depend on many factors, not least of which is what happens south of the border. But the rate cut was justified this time, and there are more to come.

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