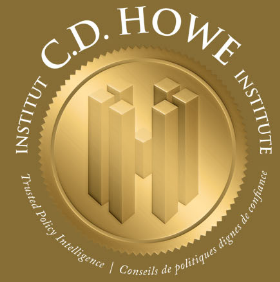
Intelligence MEMOS



From: Jeremy M. Kronick and Steve Ambler

To: Interest Rate Watchers

Date: July 30, 2024

Re: **There's Every Reason to Keep Going with Rate Cuts**

When headline inflation increased to 2.9 percent in May, up from 2.7 percent in April, there was much speculation that the Bank of Canada would pause its rate cuts. However, inflation ticked back down to 2.7 percent in June. That, plus a weakening labour market and stagnating per capita GDP, made it practically certain the Bank would cut last Wednesday. And it did.

Whether the Bank has entered an easing cycle is no longer the question. The only question left is how far and how fast the Bank of Canada continues to cut interest rates.

There are several upside risks to inflation in the near future that could cause the Bank to pause. We think it shouldn't. Here's why.

The first risk comes from volatility in the shorter-term inflation numbers. This is due to certain components of the consumer price index (CPI). For example, energy prices in general and especially gasoline prices fluctuate a lot depending on conditions in the rest of the world, both economic and geopolitical.

A shorter-term indicator – inflation over the last month, or over the last three months – has the advantage of excluding what was happening to inflation more than six months ago – which the year-over-year measures the Bank targets cannot. Therefore, it can sometimes give a better indication of where inflation is headed in the near to medium term. Unfortunately, these numbers can vary quite a bit from month to month.

Overall CPI inflation throughout the last month was under 1 percent (all inflation numbers annualized), which is encouraging, but was above 3 percent in both March and May, after having fallen below zero in the first month of this year.

Even core inflation, which is supposed to abstract from the more volatile components of inflation, has been moving month-to-month. Both CPI-Median and CPI-Trim inflation over the last month – the core numbers followed closely by the Bank – were high (2.9 percent), and both were over 4 percent in May.

This is where longer-term trends matter. The six-month rates can move us away from where things were six months ago, giving us a more accurate picture of where things stand today, and can also deal with the volatility of month-over-month or three-month inflation measures. And here CPI-Trim and CPI-Median are clearly on a downward trend, at 2.2 and 2.1 percent respectively in June. The Bank should ignore the short-term swings and focus on the trend.

The second upside risk comes from some CPI components that have shown persistently high inflation. One of the most important of these is shelter, which was above 6 percent over the last 12 months, and 3.7 percent over the last month.

Two components have driven this – rent and mortgage interest costs. Rent is driven by structural factors like immigration and barriers to supply, e.g. zoning restrictions, that are out of the Bank's control. The rise in mortgage interest costs, on the other hand, is entirely driven by the Bank's rate hikes over the last two years that will, eventually, fall out of the calculation. Without mortgage interest costs, inflation is 1.9 percent, right at target.

Finally, there are substantial upside risks to inflation stemming from geopolitics. The most notable of these is the possibility of Donald Trump after the US November election, which would bring added peril to the 2026 review of the Canada-United States-Mexico trade agreement (CUSMA) and a continued push for de-globalization. Tariffs by the US, and retaliatory measures from Canada and/or other countries from which we import, would increase inflation.

Such an increase would be temporary as prices would shift to a higher level, and then inflation would continue as before but on a higher price path. The Bank of Canada can do nothing about this kind of inflation, short of a monetary policy restrictive enough to push prices down in order to compensate for the one-time impact of the tariffs. If it does not want to do this – the right answer – the Bank can use its communication tools with the public to explain why it is looking past this temporary effect.

The bottom line: the Bank of Canada needs to carry on cutting as inflation gradually subsides. Otherwise, in real terms, i.e. after adjusting for inflation, its monetary policy will become gradually more restrictive even if it leaves the overnight rate where it is. This would risk pushing the economy into a recession.

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