Intelligence MEMOS

From: Steve Ambler and Jeremy Kronick

To: Canadian interest rate watchers

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Re: **THE ROAD NOT TAKEN**

The Bank of Canada held its overnight rate constant at 1.75 percent last week. Markets had completely priced this in, but nevertheless, there are reasons to be surprised by this decision, and perhaps even consider it a missed opportunity.

Let's start with the state of the Canadian economy. Economic growth is rebounding in the second quarter after a sluggish first quarter. Some of this is because of temporary factors such as increased oil production. However, other factors, including the labour market, appear quite strong.

Average hourly earnings have grown in five consecutive months, peaking at a growth rate of 3.8 percent in June. May unemployment fell to 5.4 percent, the lowest rate since Canada began tracking unemployment statistics. Exports grew by a healthy 4.6 percent in May, and were up by 8.6 percent year-over-year.

The Bank of Canada's own Business Outlook Survey contained a series of positive numbers: The percentage of firms expecting faster sales growth was up, and firms' intentions to invest and hire more workers were strong. Housing starts rose substantially in June and were higher in every province.

Most importantly for the Bank of Canada, not only was headline inflation above target at 2.4 percent, but also two of the bank's three core measures were above 2 percent.

All this suggests the Canadian economy is doing quite well. Output is likely near or at capacity, and with inflation above target (even though some of that is because of temporary factors), central banks would typically look to raise rates. This is especially true with an overnight rate sitting a full 75 basis points below the low end of the bank's own estimate of the nominal neutral rate – the rate at which the economy is neither overheating nor underperforming.

So, why didn't the bank increase the overnight rate? Its announcement highlighted a double whammy of headwinds blowing in from the global economy: a generalized slowdown of economic growth and an increase in economic uncertainty. The two phenomena are closely related, and, unfortunately for the bank, both are beyond Canada's control.

Canada is a small, open economy and benefits from opportunities to trade. Competition in our domestic markets by foreign companies has helped to keep costs low and is one of the reasons that Canadian inflation has remained low during the recovery from the last recession. However, this also exposes Canada to the weaknesses and uncertainties of other economies.

Global conditions have already led the US Federal Reserve to signal a softening of its monetary policy stance. And Fed chairman Jerome Powell said last week that uncertainties around trade tensions and the strength of the global economy continue to weigh on the US outlook.

Markets have already priced in a rate cut by the Fed at the end of July, and the Canada-US exchange rate already reflects both this expected cut and the belief that the Bank of Canada would hold steady. Any further hike by the bank would have put upward pressure on the Canadian dollar, making our exports more expensive.

The bottom line is that, in many ways, holding the overnight rate constant makes sense given these external factors. However, these global headwinds have also deprived the Bank of Canada of the opportunity to give it much needed breathing room to cut rates in the face of a future recession.

Yes, Canada's economy is doing well. But we are now more than 10 years removed from the end of the last recession, meaning we are likely closer to the next one than the last one.

And the state of some of the most significant economies in the world suggests we may be closer to it than we hope. As a small player on a big stage, Canada is unlikely to avoid the effects.

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