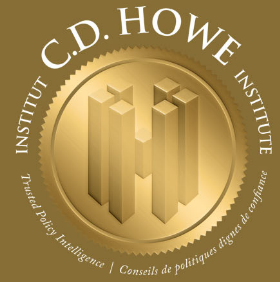
Intelligence MEMOS



From: Steve Ambler and Jeremy M. Kronick

To: Bank of Canada Governing Council

Date: November 7, 2022

Re: **Time to Pause the Interest Rate Escalator**

The Bank of Canada continued its tightening cycle last month with a 50-basis-point increase in its target for the overnight rate. A surprise to those expecting a 75-basis point increase, but still a hefty hike.

It continues the Bank's front-loading of its rate increases, which is intended to reduce the scale of future rate hikes. In our view, this latest increase was needed – both to reduce the harm of further increases and to re-anchor inflation expectations – and now the time has come to pause and reflect.

Since the Bank's September rate boost, the consumer price index (CPI) numbers for August and September had been published. Headline inflation ticked down only a little, from 7.6 percent in July to 7.0 percent in August and 6.9 percent in September. And, as the Bank pointed out, inflation continues to be broad-based, with two-thirds of the items tracked in the CPI experiencing year-over-year inflation above five percent.

On the other hand, because headline inflation measures price increases over the previous 12 months, these numbers mainly reflect changes from the past and have little bearing today.

To get a better feel of what is going on right now, we can look at shorter frequency changes.

One option is to take the month-over-month growth in prices and see what inflation would look like if the latest monthly reading continued for a year. Doing that back in March, April and May would have given us inflation over the next year as high as 13 percent (seasonally adjusted). In June, however, the forecast would have been down to 6.5 percent, in July to 1.6 percent and in August to just 0.8 percent – July and August being below the Bank's official target of 2 percent. In September, however, extrapolating the monthly number for 12 months would have produced 4.8 percent inflation. Excluding food and energy – whose month-to-month changes are especially volatile – annualized inflation fell from 6 percent in July to 3.4 percent in August but rebounded to 5.2 percent last month.

Another option is to look at the three-month growth rate in prices and use that to derive an annualized rate. That eliminates the September bump, with headline inflation coming in at 2.4 percent (seasonally adjusted), though without food and energy it was 4.9 percent. That latest value is high but it does continue a downward trend from the May peak.

That's all very encouraging. Unfortunately, food prices continue to buck the downward trend. Month-over-month they increased at an annualized pace of 14.8 percent, the third month in a row above 10 percent after June's 2-per-cent reading. That said, this increase also contains some inertia: it reflects earlier increases in the costs of inputs such as fertilizer, and the impact of soaring gas prices on the cost of getting food to neighbourhood grocery stores. If these costs have eased, as it seems they have, so should upward pressure on food prices.

There are many signs that the Bank's tightening cycle is having an impact on the real economy. Housing markets have cooled considerably: the price of new housing actually fell in September. And there will be further impacts down the road as fixed-rate mortgages come up for renewal.

Finally, the growth rates of Canada's monetary aggregates have plummeted in recent months. Once again, the month-over-month numbers are more telling than 12-month growth rates. The latest available numbers are for August: M2++ fell at an annualized rate of 1.7 percent, and M1++ at 16.7 percent, which is troubling. Our recent C.D. Howe Institute **Commentary** showed that when the Bank is not consistently hitting its inflation target, money growth gives a strong signal of the future evolution of inflation. Decomposing changes in the CPI also provides useful information, but the money supply is a better guide to how overall demand has and will evolve.

The Bank ignored soaring rates of growth of monetary aggregates in 2020 and 2021, which helped fuel soaring inflation earlier this year. It would be just as bad a mistake to ignore today's negative money growth rates.

The Bank will only have October CPI numbers at its next meeting on December 7, but will have both November and December for its first 2023 meeting on January 25. That will give it plenty of new information to determine whether to resume hiking rates. For all these reasons, we think the Bank should hold the overnight rate at 3.75 percent until then to take stock of how its existing hikes are playing out.

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