Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Interest Rate Watchers

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Re: **Think of the Bank's Latest Rate Cut as Uncertainty Insurance**

After two cuts of 50 basis points at its last two announcements, the Bank of Canada cut its policy rate by 25 basis points last week. If there was no massive trade threat coming from south of the border, it would be unclear whether a cut this time around would have been necessary. However, in the presence of that threat, the Bank was correct in choosing to take out some insurance for the Canadian economy.

It is important to first look at what the numbers tell us.

Start with the Bank's target – 2 percent headline inflation. The most recent reading in December was 1.8 percent, similar to the 1.9 percent in November and 2.0 percent in October. The slight drop was due to the GST holiday, but inflation was only slightly above 2 percent if we remove that impact. The current data seem to suggest the economy is operating in such a way that inflation is comfortably at or close to the Bank's target.

Other indicators of inflation seem to support what we see. Because some of the components that make up headline inflation can be quite volatile, the Bank looks at inflation measures that better capture the underlying trend in price growth. While the Bank's two preferred measures have remained stubbornly high, with Consumer Price Index (CPI) Trim at 2.5 percent and CPI Median at 2.4 percent, they have both fallen over the last couple of months. Plus, the percentage of core CPI components that have grown by more than 3 percent – the top end of the Bank's 1-3 percent inflation target range – is lower today than the average over the period from the beginning of 2000 to the end of 2019 (before COVID-19 hit).

Economic data on real economic activity is more difficult to read. Retail sales were stagnant in November, but according to Statistics Canada's flash estimate, they rebounded in December, likely due to that GST holiday. The jobs report released by Statistics Canada on January 10 was quite strong, as the Canadian economy added the most jobs in one month (December) in almost two years.

The combination of all this data would make us pause in arguing for another rate cut, since 3.25 percent – the rate before the cut – was within the Bank's estimate of the neutral rate range, 2.25 percent to 3.25 percent. This range is where the overnight rate should sit if the economy is operating at potential and inflation is sustainably at 2 percent.

However, there are two major risks to Canada's economic outlook that are on everyone's minds: The threat of significant tariffs imposed by the Trump administration, and the lack of a functioning Parliament, which has been prorogued until the end of March.

The Economic Policy Uncertainty Index, by scholars at Stanford University, Northwestern University, and the University of Chicago, shows a level of uncertainty for Canada that is unprecedented (except for briefly during the early days of the pandemic). The Parliamentary Budget Officer's report on the government's fall economic statement says, "Given the uncertain and volatile global context, the government's economic scenarios downplay risks."

The heightened uncertainty is unlikely to be resolved before the next federal election, and uncertainty is deadly for business investment. And we were at a lousy starting point to begin with. Gross fixed capital formation in real terms is less today than it was in 2014. It has been flat during this entire period except for a dramatic drop in the second quarter of 2020. In the Bank's most recent business outlook survey, 40 percent of firms expected negative effects as a result of the new US administration.

Against such massive uncertainty, one approach is to wait and see how things play out – do tariffs come in at 25 percent, do we retaliate, and does the exchange rate act as a shock absorber? The answers will have an impact on the economy and inflation. Another is to take out some insurance. As we mentioned, at 3.25 percent, its policy rate was at the top of the neutral rate range. By lowering it, it remains in the range, so as to not overheat, but buys a little extra room to help the Canadian economy deal with these threats.

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