ECONOMIC VIEWPOINT

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Hitting the Inflation Mark Means Aiming for a Recession

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How many times have we heard central bankers say they target inflation rates, not interest rates? The Bank of Canada regularly uses this axiom to justify its ambiguity on the future interest rate path. While it might be frustrating to hear, the lack of guidance shouldn't be criticized too heavily given the current environment.

The published neutral rate range is virtually useless when inflation is running at almost 7% and the pandemic has created both severe and persistent distortions in the economy. That means monetary policymakers have to fly this plane without the aid of their typical instrument panel. The evolution of economic releases will determine the flight path from here.

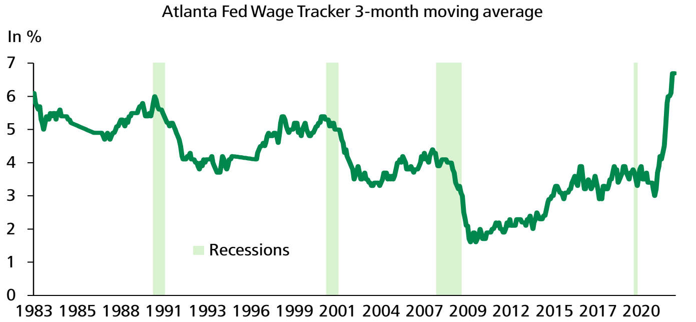
Wages and inflation expectations will be key to charting the appropriate course for rates. While longer-term market-based inflation expectations are off their peaks, the Bank of Canada's September statement drew specific attention to the still-high short-term survey-based measures.

It seems like the Governing Council might have had a sneak peek at the upcoming Canadian Survey of Consumer Expectations and didn't like what it saw. In the Bank of Canada's nightmare scenario, high inflation expectations push employees to negotiate materially higher wages, and employers in turn roll that cost into consumer prices.

The only surefire way to contain that risk is to fly a kamikaze mission. Looking at US wage data (since Canadian numbers don't go back far enough), it's clear that recessions can break this cycle (graph 1).

To hit its inflation mark, the central bank now has little choice but to aim for a recession. A monetary-policy-induced recession in Canada became our base-case forecast early this summer. Recent data releases—and the Bank of Canada's reaction to them—have reinforced that view. While some shops are still debating whether a recession is on the horizon, we're now wondering whether it will be only a mild downturn.

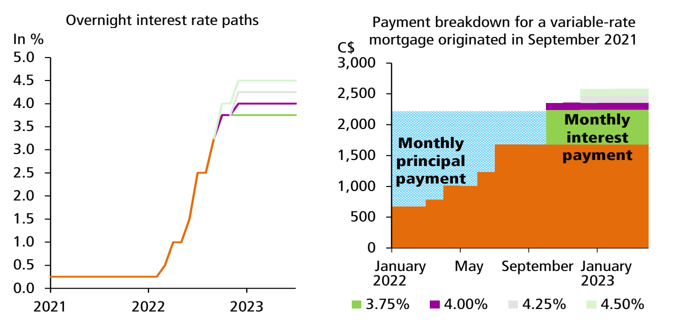
GRAPH 1
Wage growth tends to slow following a recession



Sources: Haver, Atlanta Fed and Desjardins, Economic Studies

Our latest analysis on variable-rate mortgages reveals just how rough things could get if central bankers forge ahead with more rate hikes after a 50bp increase in October. It looks at how a theoretical fixed payment on an uninsured variable-rate mortgage would change under different policy rate paths (graph 2). We assume homebuyers in any given month borrowed at the average variable rate to buy an average-priced house. The graph below shows our simulations for a mortgage that was originated in September 2021.

GRAPH 2
Upcoming rate hikes will spell trouble for some variable rate mortgages



Sources: Bank of Canada and Desjardins, Economic Studies

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Even just a 3.75% terminal rate spells trouble for these borrowers, with the monthly interest owed on the mortgage slightly exceeding the total fixed payment. That said, mortgages originated in September 2021 are far from the worst-placed to withstand the upturn in interest rates. Homebuyers that borrowed after September 2021 would have had even less time to pay down principal while rates were at rock-bottom levels.

Financial institutions will work with these borrowers to help them avoid default. So this isn't necessarily a credit event, but it is an economic event. Borrowers will spend more on interest or a lump-sum payment at the end of their mortgage and less on goods and services.

Make no mistake, the Bank of Canada is very aware of this. We ran a high-level analysis to get a rough picture of these mortgage payments. The central bank has access to loan-level data that can help it identify exactly where pain points lie. At this juncture, it looks like the Bank of Canada's sustained hawkishness is intended to trigger a recession to break the cycle of expectations, wages and inflation.

A recession needs to be priced somewhere along the yield curve. At the short end, 2-year Government of Canada bond yields will remain elevated by central banks that will resist reversing course anytime soon. But if it takes a policy rate of about 4% to bring inflation down from 8% to 2%, then something much lower than that will be appropriate once central bankers have gained control of prices.

If inflationary pressures remain firm, this could result in more inverted 2s10s and 5s10s curves in Canada. Both spreads are short of their record inversions seen in the early 1990s, which just happens to be around the time of the last real housing-led recession in Canada.

Overall, expect central bankers to be more forthright in the coming months. They'll need to recognize the likelihood of a recession while also remaining resolute in their quest to conquer inflation despite that prospect.