Canada: A Rise in Key Interest Rate in January

The Bank of Canada (BoC) published the most recent results of its business survey this morning. Overall, sales growth confidence among Canadian businesses remains high. The survey also shows that pressure is increasing on production capacity and on the labour market, as businesses make many hiring and investment plans.

This good news comes on the heels of other recent positive results for the Canadian economy. Labour market growth has been outstanding for several months, and the jobless rate dropped to a historic low of 5.7% in December. In addition, total annual inflation jumped from 1.4% in October to 2.1% in November, returning to the BoC median target.

Of course, some concerns linger. Real GDP growth by industry was disappointing in October, dampening the increase expected for the fourth quarter as a whole in 2017. However, this growth is expected to be near the Canadian economy’s growth potential, which is not so bad. Concerns surrounding the uncertain future of the North American Free Trade Agreement (NAFTA) are still there, with the March deadline as a result of Mexico’s election fast approaching. Lastly, the impact of tighter mortgage rules on the housing market remains unknown. That said, it will take another several months before these uncertainties ease significantly. Can another key interest rate hike be held off for that long?

IMPLICATIONS

At 1.00%, the current target for the overnight rate is still considerably lower than the neutral rate (assessed by the BoC at between 2.50% and 3.50%). Considering the good economic performance, it is clear that the Canadian economy no longer needs that much stimulation. With the disappearance of excess capacity in the country and signs of accelerating wage growth, the danger is the possible acceleration in inflation above the upper target.

With high household debt, a phased approach to interest rate increases is advisable to make adjustments smoother. However, the longer the BoC takes to raise its key interest rates, the greater the risk there is that its interest rates will jump sharply down the road. Given these circumstances, the BoC should seize the opportunity and raise its key interest rates 25 basis points at its January 17 meeting. Two further increases could subsequently be announced in 2018.

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