Bank of Canada Rate Announcement

July 12 2023

Strong economy and inflation persistence triggers July hike

Constructive inflation patterns in Canada and abroad were insufficient to keep the Bank of Canada on the sidelines today as it hiked policy rate by a quarter point to 5 per cent and maintained its quantitative tightening path. This marked the highest rate since 2001. The hike was not a surprise following its June decision and firm data over the past month, although we have argued unnecessary. That said, the door is yet to close on further hikes.

The Bank's decision to tighten came despite mixed global conditions, with the Bank's statement noting progress in inflation due primarily to energy prices, while services inflation remains persistent due in part to higher wage growth. Economic growth has been strong in the U.S., but faltering in China and Europe, but the latter could see more central bank rate hikes to curb inflation.

Keying in on domestic measures, the Bank saw domestic strength as impeding the path to inflation normalization. Specifically, the economy is deemed in excess demand with consumer spending still robust (5.8 per cent in Q1), and a rebound in housing. In the latter, supply challenges are adding to price pressures – which ironically, higher interest rates could amplify. Cumulative interest rate hikes have been slower to cool the economy and labour market tightness, while loosening with elevated levels of immigration, is still tight. Population growth is also adding to consumer spending. The Bank does expect the economy to grow at a slower pace near 1 per cent in the back half of the year but avert a recession.

The Bank's forecast for inflation has been revised higher. While patterns are easing, the Bank highlighted the challenges of reducing core inflation which has tracked 3.5 – 4.0 per cent since September. It sees less near-term downward momentum and greater difficulty in bringing inflation down to target. The Bank's Business Outlook Survey showed more frequent price increases by businesses. The Bank is now projecting inflation of three per cent for the next year and a return to two per cent by mid-2025, which is a significant pushout from its last outlook. Highlighting this concern from the statement was "*Governing Council remains concerned that progress towards the 2% target could stall, jeopardizing the return to price stability.*"

Today's rate announcement was not too surprising given the flow of data and June's rate decision. That said, we are not convinced of the latest round of tightening given the constructive inflation patterns. Recall that excluding mortgage interest, which is self-induced inflation pain, headline was closer to 2.5 per cent. Moreover, housing supply issues will not be solved by higher interest rates. Nevertheless, the Bank remains concerned about excess demand in the economy and its updated timing for inflation normalizations keeps the door open for further hikes or at least a higher for longer environment. We expect the Bank to pause from here on out before cutting in early 2024 provided there are no major economic surprises.

The Bank issued its latest Monetary Policy Report with today's statement. Highlights included:

Global economy: Economic forecast was revised higher, due to U.S. strength. Global GDP growth for 2023 is projected at 2.8 per cent (+0.2 pp), 2024 at 2.4 per cent (+0.3 pp) and 2.7 per cent in 2025. Growth decelerates with tighter monetary policy and slowdown in U.S. and China. Inflation eases, but service prices remain stubbornly strong.

Canada economy: GDP growth revised higher from previous forecast. The economy has been lifted by stronger consumer demand and housing as cumulative rate hikes have had modest impact. GDP in Q2 is forecast to reach 1.5 per cent (revised up from 1.0 per cent) and Q3 is also forecast at 1.5 per cent. With annual growth pegged at 1.8 per cent for the year, this suggests growth of near 1.0 per cent in Q4. Annual growth for 2023 1.8 per cent was revised up from 1.4 per cent, with a 1.2 per cent growth rate in 2024. The Bank does not project a recession. Slower growth reflects the interest rate impact on consumer spending and investment. Excess demand is projected to persist until early 2024.

Inflation: CPI inflation has been revised higher through the forecast period. Q3 inflation is forecast at 3.6 per cent year-over-year (from 3.3 per cent) and 3.3 per cent in Q4. A return to 2 per cent is projected for mid-2025 which is two quarters behind the previous forecast. Average annual inflation is revised up to 3.7 per cent this year, 2.5 per cent in 2024 and 2.1 per cent in 2025.

Bryan Yu
Chief Economist
Central 1 Credit Union
byu@central1.com