The Case for Higher Interest Rates in Canada

Animal spirits is the term economist John Maynard Keynes used to describe the instincts, proclivities and emotions which will take an economy from stagnation to vibration. After a recession, at some point a feeling of near reckless confidence takes over, and the thing starts walking and running on its own, unaided by external stimulus.

Policy-driven low interest rates are stimulative to economic growth, so interest rate sensitivity is cooked into the the economy like grease into a hotdog. Gradual change is greatly preferred over sudden, so Bank of Canada officials (and other central banks) are very careful to signal their intentions well in advance of changes in order to allow the thinkers and spenders to digest the news without financial indigestion.

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A recent sharp shift in tone from Canadian monetary policymakers has markets pricing in more than 90% odds of a small interest rate hike in the July 12th policy meeting this week, a marked contrast since early June when almost nobody was expecting a July hike. Rates are probably going up, but should they? Below, with help from RBC Economists, we outline a number of considerations which may be at play in the decision. By the time this article hits publication, that decision will be just a few hours old.

- **The Canadian economy is strong, and not just recently**

Although growth in Canada slowed in 2015 relative to the U.S. and other countries as the oil price shock hit, that followed years of outperformance earlier in the economic recovery. The pause in 2015 and, to a lesser extent last year, has clearly ended. Growth over the last three quarters in Canada has led the G7 once again.

- **Labour markets look solid**

Employment has been growing at a solid pace with gains averaging 29k per month over the last year and mostly reflecting full-time job growth. The unemployment rate, at 6.5% in June, has fallen to well-below its 10-year pre-recession average level, a period over which Bank of Canada estimates suggest the economy was operating fully at its long-run capacity. And no, the unemployment rate drop does not reflect discouraged workers giving up their job search. Alternative unemployment rates calculated by Statistics Canada to account for that and other sources of 'hidden unemployment' have actually fallen more than the official unemployment rate. Even in oil producing provinces, labour market slack has started to be absorbed. The 7.4% unemployment rate in Alberta in June was above the Canadian average but still down sharply from what looks to have been a cycle-peak of 9% just 7 months ago in November.

- **Wage growth is showing signs of life**

The soft spot in the labour market data has been weak wage growth but recent trends have improved. Growth in average hourly earnings from the closely-watched monthly Labour Force Survey has admittedly remained weak, averaging just 1% year-to-date in 2017, but other measures have shown more strength. Statistics Canada's estimate of average hourly compensation was up 2.5% from a year ago in Q1.

- **Business investment has started to grow again**

The 'missing piece' of the economic growth pie has re-emerged early in 2017. Business investment jumped by its largest amount in almost 5 years in Q1. Machinery and equipment imports, engineering construction employment and machinery sales from Canadian manufacturers — all of which are indicative of investment spending — have continued to strengthen early in Q2.

- **Uncertainty is still high but the impact is being ‘trumped’ by rising demand**

The election of President Trump has upset conventional political norms and put previously unthinkable U.S. policy moves — for example, the possible outright dismantling of NAFTA — in the realm of the plausible if not probable. While this is a legitimate concern, there is mounting evidence that uncertainty about the outlook is being offset by the need to expand capacity to take advantage of stronger demand today.

- **Low inflation persists but despite strong demand growth**

The strongest argument for the bank to remain on the sidelines is the low and falling rate of inflation in Canada. Measures of underlying inflation growth trends in Canada were all 1.5% or less in May, significantly below the bank’s 2% inflation target. As the Bank of Canada has begun to highlight, however, inflation lags economic growth so weak inflation today is more likely to reflect a lack of demand in the past rather than the present. Other factors may also be at play. For example, competition from internet sales may be temporarily dampening retail price growth. E-commerce retail sales in Canada have risen a whopping 40% year-to-date in 2017 compared to a 6% increase in retail sales overall.

- **There are advantages to an earlier, more gradual rate hiking path**

The Bank of Canada has long argued that elevated levels of household debt and imbalances in housing markets represent key domestic vulnerabilities. One of the key risks associated with both of those vulnerabilities is that a faster-than-expected rise in interest rates would sharply increase the cost of servicing high household debt levels. Given that risk, there is clearly an advantage to adopting an earlier and more gradual rate hike path to allow a more gradual adjustment to higher rates in the highly leveraged household sector.

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