Daily Economic Update

October 24, 2018

Hawkish BoC hikes again, says rates will have to rise to a neutral stance

Today's rate increase was unanimously expected and fully priced in by markets, but once again the Bank of Canada managed to keep things interesting. To emphasize that monetary policy is not on a pre-set course, Governing Council no longer indicted rate hikes will be "gradual". The bank wants to maintain flexibility given two-sided risks to the economic outlook. But while their guidance on the pace of rate hikes was less explicit, the destination is now clearer: the overnight rate "will need to rise to a neutral stance" to keep inflation on target. We think that is a more hawkish signal than simply dropping "gradual" would have been. Currency markets agreed, sending the Canadian dollar half a cent higher following the announcement.

Our forecast assumes two further rate increases in the first half of 2019, followed by a pause that would leave the overnight rate at 2.25% until the end of next year. That is slightly below the BoC's assumed 2.5-3.5% range for the neutral rate. Their forward guidance suggests upside risk to our forecast, though there was no indication of *when* monetary policy needs to be back to neutral. We still think highly indebted households' sensitivity to rising rates warrants a gradual approach to lifting borrowing costs. But with the economy at full capacity and inflation on target, it's also hard to argue monetary policy shouldn't be at a more neutral setting. We think a move in December is unlikely, but the BoC's more hawkish tone today gives a strong indication that rates will rise again early next year.

Highlights:

- To nobody's surprise, the overnight rate was raised to 1.75%—the highest rate in nearly a decade.
- The new USMCA is seen reducing trade uncertainty within North America, but US-China trade tensions are still weighing on the outlook. On balance, the assumed drag from trade uncertainty on business investment and exports was cut in half.
- Overall GDP forecasts were little changed, with growth of 2.1% expected this year and next, and a 1.9% gain seen in 2020. Inflation is seen returning to 2% next year as transitory factors dissipate.
- The bank once again sounded pleased with adjustments in the household sector and rotation toward stronger growth in business investment and trade.
- Governing Council dropped their "gradual" forward guidance, instead indicating that interest rates will have to rise to a "neutral stance" to keep inflation on target. Their estimate of neutral is 2.5-3.5%.

Josh Nye | Senior Economist | (416) 974-3979 | josh.nye@rbc.com

For more economic research, visit our web site at www.rbc.com/economics