Economics

IN FOCUS

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Canadian rate hikes: Where's the finish line?

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We're off to the races for Bank of Canada interest rate hikes, and while we're only in the first lap, investors are already focused on where the finish line sits. In the US, the central bankers provide us with peek at their thinking, since the Fed's policy committee shows their individual and median projections for the fed funds rate over the next few years. In Canada, that's not the tradition, but there will be a strong hint if you know where to look in the Monetary Policy Report due in a few weeks.

The April report will provide the Bank's refreshed estimate for the neutral rate in both the US and Canada, defined as the policy rate that can keep the economy at full employment and stable inflation. That's not a mere academic exercise. While the FOMC sees the US rate temporarily going through neutral, it implies that the overnight rate will settle back in the long run to 2.4%, essentially its estimate for neutral. If so, that becomes a focal point for thinking about where 5- or 10-year bonds ought to trade.

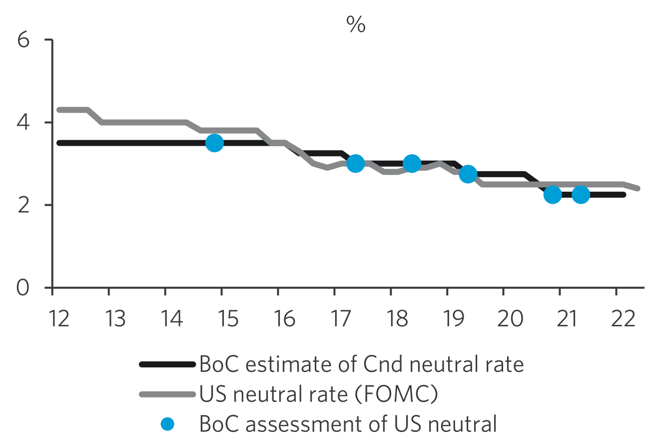
In Canada, if fiscal policy turns somewhat tighter as some of the largest provinces try to pare back debt ratios, the neutral rate could well end up being the peak setting for monetary policy. Inflation isn't quite as heated, the GDP recovery has underperformed that of the US, and we'll have lots of mortgages from 2020-21 coming up for resetting at higher rates towards mid-decade, all reasons why the BoC is unlikely to overshoot the neutral rate.

A sneak peek ahead

Fortunately, we have one very easy guidepost for what the Bank of Canada is likely to settle on, because the US neutral rate, both in theory and practice, is a strong predictor for the Canadian neutral rate. The Bank of Canada uses several models to come up with a range for the neutral rate, but the theoretical grounding of one of them implies that the Canadian neutral rate simply equals the international rate, which the Bank of Canada then sets at the US neutral rate. In two out of three other models used by the Bank, while other variables factor in, the US neutral rate exerts much of the explanatory power.

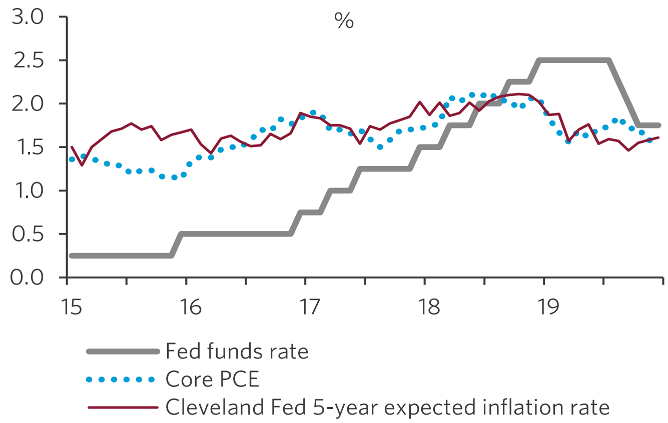
The result is that looking back over the period for which we have published estimates from the BoC, three variables have closely aligned: 1. the US neutral rate as measured by the FOMC's projected "long run" fed funds rate; 2. the BoC's estimate of the US neutral rate; and 3. the midpoint of the BoC's estimate of the Canadian neutral rate (Chart 1). For the most recent estimates, the last of these has tended to be a shade lower than the first, so the April MPR will likely leave the midpoint of the Canadian neutral rate at 2.25%.

Chart 1: BoC neutral rate estimate closely tracks the FOMC's US estimate



Source: Bank of Canada and FOMC

Chart 2: Inflation slipped as fed funds rate hit 2½% in 2019



Source: FOMC, BEA, Federal Reserve Bank of Cleveland

Evidence from the last cycle

In practice, as they begin a tightening cycle, central bankers don't know with certainty where the neutral rate lies, but they know it when they see it. A slowing in the economy that threatens to take the economy away from a starting point of full employment, or a drop in inflation to below target, can be signposts that rates are above neutral.

The fact that the Fed needed to ease in 2019, after the overnight rate hit 2½% may well have been a sign that the central bank had taken rates a bit into restrictive territory. We also saw that inflation and inflation expectations were slipping below the Fed's targets that year (Chart 2).

On the goods side of the economy, normally where we start to see the impacts of rate hikes, manufacturing output and hours worked were also slipping. While the last part of that story may have been driven by the uncertainties of a trade war with China and the threat of one with Europe, there was evident slippage in the factory sector before those trade uncertainties peaked (Chart 3).

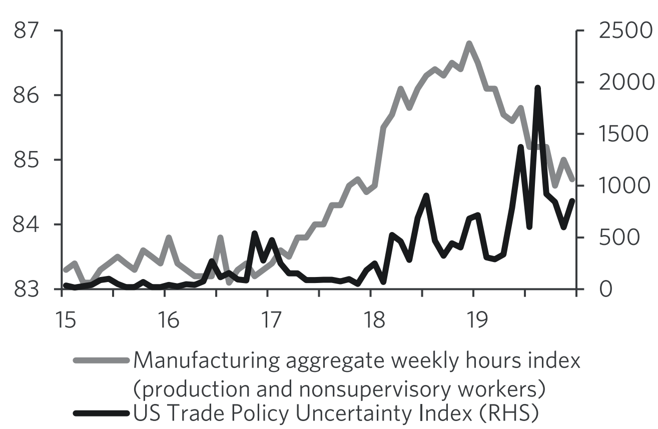
We would caution about reading too much into the fact that Canada's economy slowed with overnight rates only at 1.75%, which ended up being the peak in the last cycle. True, the Bank of Canada might have in fact looked at a small cut in rates in 2020 even if Covid-19 hadn't hit. But Canadian rates might still have been below neutral at that point, since there was a drag on manufacturing coming from a parallel US slowing, and the impacts of the global trade war on Canada's export sector. The drop in Canadian manufacturing output only showed up as the trade uncertainties mounted, unlike in the US. Core measures of inflation like the CPI-trim were not retreating at an overnight rate of 1.75% but were holding right at the BoC's 2% inflation target (Chart 4).

What's changed since then

The last cycle's neutral rates are a good starting point, but there is substantial evidence that neutral rates have changed over time. Most evidently, the ability of the Canadian and US economies to thrive in the last three decades of the prior century, amidst interest rates that would be inconceivable now, is prima facie evidence that neutral rates have fallen dramatically since then. So we need to consider whether anything much has changed since 2019, and the implications for neutral rates ahead.

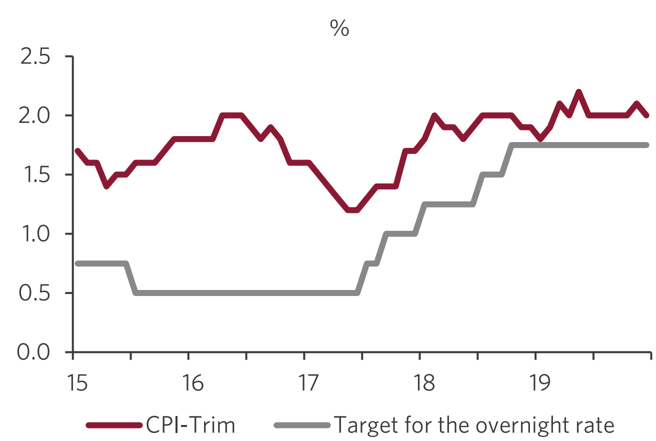
One important driver of the neutral rate, demographics, should be exerting some further downward pressure on the US neutral rate for this cycle. Weaker growth in the working-age population will slow the economy's trend growth rate at full employment, its so-called "potential GDP" pace. Neutral rates will be lower if an economy sees less capital spending at any given rate of interest. Slower growth in trend or "potential" GDP implies less need for businesses to expand capacity to keep up with demand over time, and therefore, a slower trend for capital spending.

Chart 3: Manufacturing hours were falling before trade war uncertainty peaked



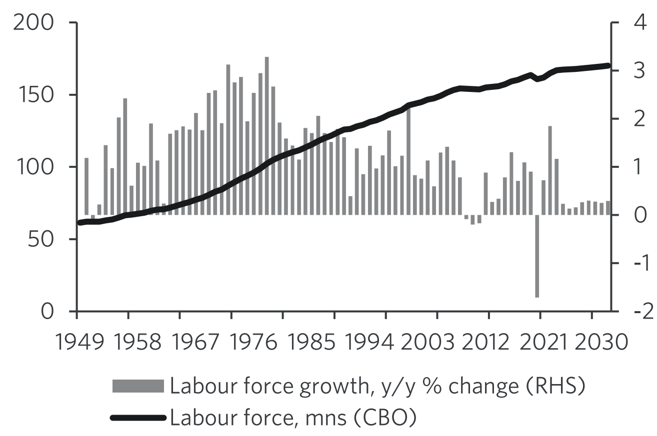
Source: PolicyUncertainty.com, Bureau of Labor Statistics

Chart 4: Canadian core inflation was holding at target in 2019



Source: Bank of Canada, Statistics Canada

Chart 5: Growth in the US labour force is expected to continue falling



Source: CBO July 2021 projections, CIBC

Looking ahead, potential GDP is dependent on the growth in the size of the workforce (in turn reliant on labour force participation and population growth) and on productivity, or output per hour worked. The latter is difficult to forecast in advance, but even if we assume a more complete recovery in US labour force participation than seen thus far, CBO projections show a further deceleration in the size of the workforce (Chart 5).

Estimates from the Congressional Budget Office clearly show that US potential GDP in the last cycle was a far cry from where it was historically, and they see little change from this year to the decade's end (Chart 6). That points to a slightly lower neutral ahead, all else equal.

Structural changes in the economy lean the same way, towards a lower rate of interest needed to get the same capital spending. Today's corporate giants are less likely to be capital-intensive steel mills or oil refineries, but instead are tech companies where the capital (computing and communications power) has plunged in relative price terms. Even in retailing, some expensive, marble-encrusted malls and downtown stores have given way to plain-looking warehouses in suburban fringes operated by e-commerce firms.

In assessing where the US neutral rate is headed, and therefore, a potential direction for the Canadian rate, the Bank of Canada also looks at a few other factors. One of those is risk, or the perceived probability and size of large and rare negative economic shocks. An increase in risk affects the demand for precautionary savings and puts downward pressure on the neutral rate. The pandemic, and now the war in Ukraine, have both raised the perceived probability of these tail events relative to recent years. Finally, the other two factors appear to be tugging in opposite directions and are therefore likely to cancel each other out. The increase in inequality seen in recent years should serve to lower the neutral rate (Chart 7, left), but a higher government debt/GDP ratio leans towards a higher neutral rate (Chart 7, right).

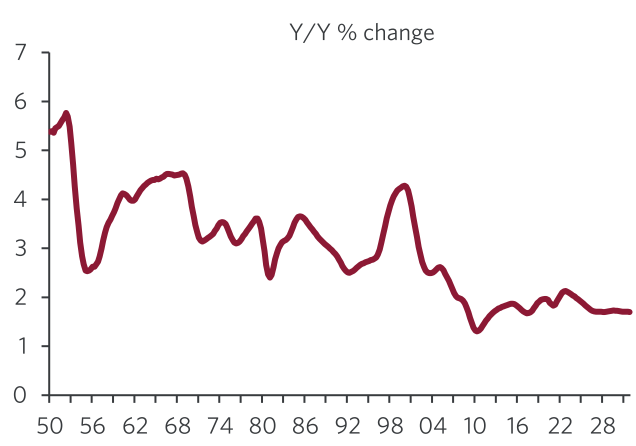
From real to nominal

One final, and important, consideration is how any estimate of the neutral rate is the assumed trend for inflation. Some modelling work centers on estimating the real neutral rate of interest, to which one has to tack on the inflation rate to get an estimate for the nominal neutral rate that we've been discussing here.

Clearly, in asserting that the neutral rate in the US is 2.4%, the FOMC is assuming that inflation will again settle back to the 2% range. If higher inflation persisted, and started to affect longer-term inflation expectations, the nominal neutral rate would have to be commensurately higher than in the last cycle.

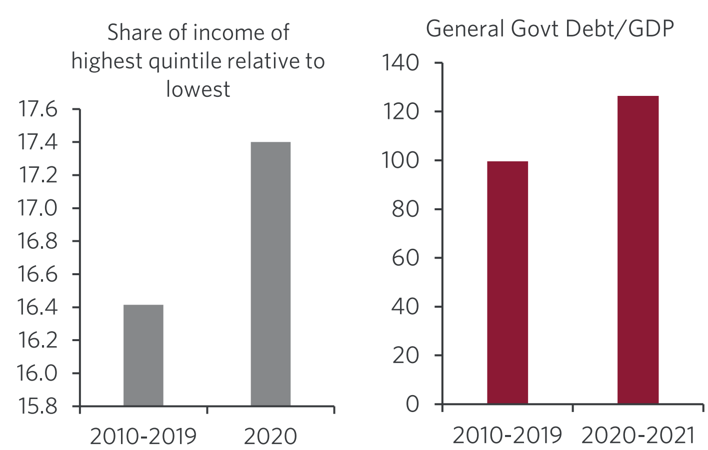
We argued elsewhere (see "Will the *Real* Real Rate Please Stand Up, The Week Ahead, March 11, 2022) that using the inflation rate you expect to reach as interest rates peak makes more sense than taking today's inflation rate as the base. Otherwise, we would be forcing the whole yield curve towards much higher yields, and longer-term rates, which also count for

Chart 6: US potential output growth has been declining for decades



Source: CBO July 2021 projections, CIBC

Chart 7: US inequality is higher, but so is debt



Source: Federal Reserve Board, Census Bureau, CIBC many borrowers, would be extremely high in real terms given that inflation expectations for the out years are much lower than current CPI readings. Indeed, in any discussion of neutral rates, it behooves both the Fed and the Bank of Canada to reassert their conviction that inflation will be brought down to earth over the coming two years.

All of this suggests that the finish line for this tightening cycle in Canada likely lies in the 2.25-2.5% range. The Bank of Canada won't tell us that in April, let alone give out a forecast of the path from here to that target. There is a lot of scope for Governor Macklem's team to adjust the timetable for rate hikes to incoming data on growth and inflation. But we'll pay close attention to its discussion of neutral rates in the US and Canada as a signal of where we're headed at the end of this run-up in overnight rates.

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