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THE GLOBE AND MAIL

Bank of Canada prepares for a long fight against inflation

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Governor of the Bank of Canada Tiff Macklem at the Bank of Canada in Ottawa

Canada is on the cusp of a series of rapid interest-rate hikes, with the central bank poised to start raising the cost of borrowing as early as next week, beginning a sustained push to bring high inflation back under control.

After nearly two years of extraordinarily low interest rates, the Bank of Canada has arrived at a pivot point. Consumer prices are rising at the fastest pace in three decades, straining the bank's credibility as an inflation fighter. Meanwhile, there's growing evidence that the economy is operating at or near full capacity and no longer needs emergency monetary-policy support.

The central bank's governing council faces the biggest decision since Governor Tiff Macklem took charge in June, 2020: whether to pull the trigger next Wednesday and start the process of normalizing interest rates; or whether to hold off until March to provide additional stimulus through the Omicron wave of the pandemic.

Bank of Canada rate hikes are coming, but that doesn't mean a recession will follow

Today's inflation is a problem the Bank of Canada can't tackle alone

The last time the central bank raised interest rates was in October, 2018. The coming rate-hike cycle, which will see the cost of borrowing rise steadily over the next two years, is needed to tamp down rising inflation expectations and to start building up an interest-rate buffer before the next downturn. But it will also test the strength of Canada's economic recovery, as well as the vulnerability of heavily indebted households.

“Private-sector debt is something that the Bank of Canada has to keep an eye on, particularly because the rate hikes that we’ll do in the next two years could affect the rates that people pay in renewing mortgages in 2024 and 2025 that they may have taken out at very low interest rates,” Avery Shenfeld, chief economist at Canadian Imperial Bank of Commerce, said in an interview.

“And while we’ve put households to a [stress] test to ensure that they will be able to pay those higher rates, it will still put a big squeeze on their spending power,” he said.

Bank of Canada officials said in December that they did not expect to raise the policy rate – which has been held at 0.25 per cent since early in the pandemic – until April at the earliest. Since then, however, they have received a string of data releases showing the strength of the labour-market recovery, a record jump in home prices and a sharp rise in expected inflation and wage growth.

A central-bank survey of businesses, released Monday, found that two-thirds of respondents expect inflation to remain above 3 per cent for the next two years – a potent signal for policy makers. Meanwhile, 80 per cent said they intend to raise wages faster next year compared with last year to attract scarce labour. On Wednesday, Statistics Canada reported that the consumer price index rose 4.8 per cent in December, the fastest annual pace of growth since 1991.

This data pushed a number of analysts to revise their interest-rate forecasts. Economists at Bank of Nova Scotia, National Bank and Laurentian Bank pencilled in a rate hike for Jan. 26. Other private-sector economists expect a March liftoff, although most say a rate hike next week is possible.

Market pricing for overnight index swaps suggests an 83-per-cent chance that the bank moves next week, according to Refinitiv data.

“The bank basically has a free option [to raise rates next week],” National Bank rates strategist Taylor Schleich said. “The economy is screaming that we need interest-rate normalization, and now the banks and the markets are kind of allowing them to do it. So you may as well take it.”

Mr. Macklem has not spoken publicly since mid-December. But he used his last speech to tee up a possible shift in January, noting that inflation was “well above our target, and we are not comfortable with where we are” – strong language for a central banker.

The bank’s latest projection shows the rate of inflation falling to close to 2 per cent by the end of 2022, and bank officials believe that many of the supply chain problems that have been pushing up consumer prices will normalize over the coming year.

At the same time, Mr. Macklem and his team expressed concern in December that higher wage growth and rising inflation expectations could feed into “second-round” price pressures and become baked into higher inflation.

The Bank of Canada is not alone in manoeuvring into place for rate hikes. After spending much of last year arguing that high inflation would be relatively short-lived, central bankers in many advanced economies changed their tune in the final months of 2021. The most significant turn came from the U.S. Federal Reserve, which is dealing with the highest inflation of any advanced economy and strong wage growth.

At its December meeting, the Federal Open Market Committee decided to accelerate the end of its massive asset purchase program. Minutes from the meeting released in early January showed Fed officials expected to raise rates “sooner or at a faster pace than participants had earlier anticipated,” setting up a possible March rate hike.

This change in the Fed’s narrative spurred a sharp repricing in global markets. Fixed-income securities sold off in expectation of rate hikes. Equity markets stumbled, with notable declines in growth stocks that greatly benefit from ultralow interest rates when calculating future cash flows.

“The BoC probably does not look to the Fed for validation and they make decisions based on their policy frameworks and analysis,” Jason Daw, Royal Bank of Canada’s head of North America Rates Strategy, said in an e-mail. “But one area that a hawkish Fed makes it slightly easier for the BoC to raise rates is less appreciation pressure on the Canadian dollar than otherwise.”

It’s taken a long time for the Bank of Canada to get to the point where rate hikes are a possibility. It began shrinking its government bond-buying program, known as quantitative easing, in the fall of 2020, and ended the program in October. It is now in what it calls the “reinvestment” phase, where it’s only buying government bonds to replace maturing assets it already owns.

The central bank’s next move depends largely on whether it wants to wait until after the current COVID-19 lockdowns in Ontario and Quebec are lifted, said Mr. Shenfeld of CIBC. He added that the trajectory of rate hikes over the next few years matters more than whether the bank starts hiking in January or March.

“The exact timing of these rate hikes is important to people doing high-frequency trading. But not of that much importance to where the economy ends up a year or two down the road, which is what the Bank of Canada is really targeting,” he said.

Derek Burleton deputy chief economist at Toronto-Dominion Bank, said he expects the bank to bring its policy rate back up to around 2 per cent over the coming years, although policy makers could move haltingly.

“There may be a bit of probing, they may have to hike a few times, see how it plays out on the economy,” Mr. Burleton said.

“I think one of the questions, and this is more directed at central-bank tightening globally, is whether we go through periods of financial-market turbulence, and that could be a factor that could delay a steady tightening.”

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