

ECONOMICS: CANADA PERSPECTIVES—AUGUST 13, 2010

Uncertainty Looms in Canada's Short-Term Interest Rates

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As Canada begins to raise its short-term policy rates, slower domestic economic growth and extremely low US interest rates have made the precise path of Canadian interest rates increasingly uncertain.

Canada's emergency contribution to global recovery, in the form of very low interest rates, is being unwound, after being delayed by the Bank of Canada's earlier promise—or "conditional commitment"—to keep policy rates near zero until this past June. The speed of Canada's early recovery made rate hikes after the June deadline seem highly likely, but the path of interest-rate policy has become more complicated. If US policy rates stay low until risks to the recovery dissipate, how high can Canada raise its rates?

The Pace of Growth Slows

Economic growth in Canada is slowing after a first round of inventory-related recovery. Judging from expenditure-based monthly GDP, output growth appears to be dropping below 1% in the second quarter, down from 1.5% (6.1% annualized) in the first quarter. Based on our analysis, slightly more timely indicators—including car assemblies, the Ivey survey of business expectations and early household employment reports—have been rising, but imply second-quarter GDP growth that remains under 0.8%.

A weaker, though still solid, pace of growth in the second quarter is likely, with momentum weakening in the third quarter—in line with slowing US growth **(Display 1)**.

Tightening credit limits on Canada's burgeoning floating-rate mortgage market may also be dampening economic growth. As Canada held policy rates near zero, in part to compensate for a downward spiral in US home prices, a Canadian housing bubble had been brewing. Low rates unleashed a wave of mortgage lending by Canada's sound domestic banks to those Canadian residents with less leveraged household finances.

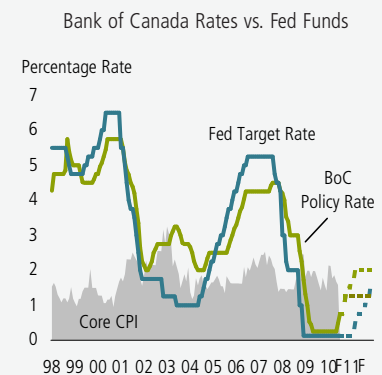
In an effort to take some of the air out of the bubble, regulators have required that borrowers demonstrate not only enough income to service a floating-rate mortgage, but also to service a five-year mortgage. Depending on the exact terms, this requirement could cut the size of the mortgage available to some borrowers by as much as half.

Display 1
Canada Slowing with the US



Source: Haver Analytics, Statistics Canada and AllianceBernstein
As of August 2010

Display 2
Rate-Hike Uncertainty



Source: Federal Reserve Board, Haver Analytics, Statistics Canada and AllianceBernstein
As of August 2010

How High Could Rates Go?

Since June, the Bank of Canada has been raising rates at every meeting by 0.25%. But how high will they go now that both US and Canadian growth prospects have dimmed? It's the first uncertainty faced by Canadian policymakers in the recovery.

Any effort to estimate a "normal" policy rate in Canada is rife with difficulty, but the central bank will approach such a rate with slow, measured steps, ready to change course if the situation changes. In such a dynamic environment, it'll be hard to discern what rate the central bank is aiming for at any given point, but the average interest rate over time should be revealing.

From mid-1995 to mid-2008, before the period of extraordinarily low rates, average policy rates in Canada had been about 3.75%. Over the same period, average core inflation was about 1.75%, implying real, or inflation-adjusted, rates of about 2%. Given that potential trend economic growth may have fallen to about 2%, this positioning would be internally consistent—real interest rates are often said to be at their optimal level when they equal the real rate of economic growth.

Things are very different today, however. If North American economic activity softens further, we would expect Canadian core

inflation to fall to 1%. The Bank of Canada estimates potential real GDP growth at 1.5% in Canada today. Even under these admittedly gloomy conditions, we'd still have a normal policy rate of at least 2.5% (this, minus 1% inflation, would equal real GDP growth). That rate would be far higher than today's 0.75% target overnight bank rate. So, even with softer economic news on both sides of the border, Canadian rates should rise **(Display 2, previous page)**.

The Canadian Dollar Is a Risk

Raising Canadian rates while US rates are stuck near zero could boost the Canadian dollar—something policymakers don't want. In fact, fear of a stronger currency could cause the Bank of Canada to back away before reaching its normal rate, creating a new source of uncertainty in the process.

In our view, other investors are overestimating this risk. For one thing, the Canadian dollar is already relatively strong, in part reflecting the expectations of rate hikes that were put off during the conditional-commitment period. Also, Canadian policy rates have been as much as 1% higher than US rates since 2008, so expectations of higher Canadian rates may have already affected the Canadian dollar. Canadian rates may have to rise beyond 2.5% to meaningfully impact the currency.

Lastly, Canadian policies have been systematically less extreme than those in the US. Canadian rates have tended to stay closer to normal rates than in the US, both on the downside and the upside, probably because Canada is less involved with unstable securitized debt markets than is the US. Early measures in Canada to limit mortgage credit using tools other than interest rates could preserve that relationship, limiting the need for a big rate hike.

An Uncertain Path for Policy Rates

The environment has become considerably less certain for Canadian interest-rate policy, which is reflected in our assessment of the range of reasonable rate-hike paths in Canada. The Bank of Canada will either pause its 0.25% rate hikes when the rate is near 1.25% in November, or it will continue on—pushing rates to around 2%. With developments this week, odds have swung sharply in favor of the lower end of this range: sudden weakness in US trade and economic news can't push US rates below zero, but related weakening in Canadian growth could lead policymakers to pause Canada's rate-hike cycle sooner rather than later. ■

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