



Daily Economic Update

July 11, 2018

BoC raises overnight rate to 1.50%, incorporates trade developments

Today's rate hike was widely expected following some positive data points and louder-than-usual hints from the Bank of Canada. So the bigger question was how the bank's tone might change in the face of new tariffs and growing trade uncertainty. Those developments were taken in stride—the bank didn't waffle on their bias to raise rates gradually and as in May they refrained from using the word "cautious". They did mark down their growth forecasts somewhat more, with tariffs and trade uncertainty now expected to lower Canadian GDP by 2/3 of a percent by the end of 2020 (the impact was expected to be a bit less than 1/2 ppt in April's MPR). But the economy is still expected to grow at a 2% pace over the next few years, slightly ahead of its potential rate. Even with trade issues weighing on business investment and exports, those sectors are expected to make decent contributions to growth this year and next. That will be an important factor offsetting the impact of higher rates and tighter mortgage regulation on consumers and housing. All told, with the economy operating close to full capacity and growth expected to remain above potential, further removal of accommodation was needed to keep inflation in check.

Where do we go from here? Today's relatively positive tone and unchanged tightening bias should reinforce market expectations that today's rate hike won't be the last this year. The trade backdrop will of course remain key to the rates outlook, and the recent direction of global rhetoric suggests the BoC's assumed impact of tariffs and trade uncertainty will remain fluid. But their forecast for slightly-above-potential growth perhaps gives them a bit of leeway on that front. And Governor Poloz was keen to point out that the monetary policy implications of trade actions aren't necessarily clear cut. Overall we remain comfortable with our call for official rates to rise another 25 basis points in the fourth quarter, with two further hikes expected in the first half of 2019.

More on tariffs and trade uncertainty:

- US steel and aluminum tariffs are expected to lower Canadian exports by 0.6 ppts by the end of this year. Canada's retaliatory tariffs will have a similar downward impact in imports, and are expected to raise CPI inflation by 0.1 ppt.
- In addition, the bank expects uncertainty surrounding trade policy will shave 2.5 ppts off business investment through 2020 (previously -2.1 ppts) and 1.2 ppts off exports (was -1.0 ppt).
- Cumulatively, trade actions and uncertainty are expected to lower the level of GDP by 2/3 ppt by the end of 2020.
- On their tightening bias, the bank added that monetary policy will be guided by "the response of companies and consumers to trade actions."
- Governor Poloz reiterated that monetary policy will not be based on "hypothetical scenarios," like the threat of auto tariffs. He also said monetary policy is ill-suited to offset the effects of trade actions, and implications for interest rates would depend on the circumstances (monetary policy is put in a "difficult place" by a potential stagflation in an adverse trade scenario).

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