CURRENT ANALYSIS
July 2017

The case for higher interest rates in Canada

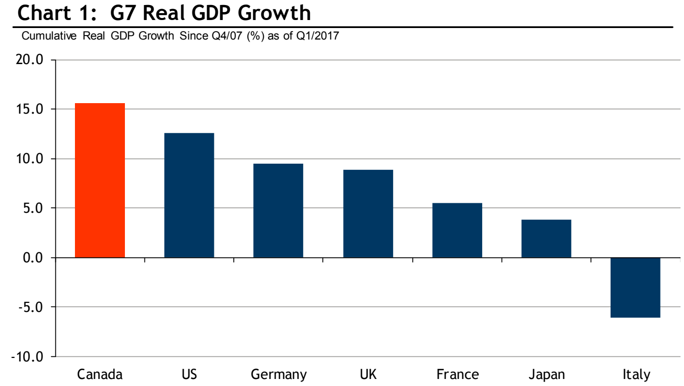
A sharp shift in tone from Canadian monetary policymakers beginning with comments from Bank of Canada Senior Deputy Governor Wilkins on June 12th and echoed as recently as July 4th in comments from Governor Poloz have markets pricing in more than 90% odds of an interest rate hike in the July 12th policy meeting this week. That marked a dramatic shift since early June when almost nobody was expecting a July hike. Although economic data has been strong in Canada, earlier Bank of Canada comments showed little desire to respond with higher interest rates in light of significant uncertainty around the outlook for trade and low inflation. More recent comments suggest those concerns have diminished leaving the recent solid growth data to warrant tightening in policy.

Comments from officials suggest the Bank of Canada very likely *will* hike rates this week but *should* they? Below we outline a number of arguments for why those higher interest rates are indeed warranted. It is important to remember that higher interest rates mean monetary policy will be 'less supportive' of growth not 'more restrictive.' The current 0.5% overnight interest rate is only slightly above the record-low 0.25% rate during the worst of the 2008/09 recession recovery, back when the Canadian unemployment rate was 2 percentage points above current levels. There are still soft spots in the economic data — largely on the consumer price growth side — but it is increasingly clear that emergency low levels of interest rates are no longer needed to support economic growth. At the same time, there are clearly advantages to initiating an earlier and more gradual rate hiking path in terms of allowing a more gradual adjustment in the highly leveraged household sector to higher rates.

- **The Canadian economy is strong and not just recently**

Earlier this year we argued that the common belief that the Canadian economy has been underperforming advanced economy peers is not supported by the economic data. Yes, growth in Canada slowed in 2015 relative to the U.S. and other countries as the oil price shock hit but that followed years of outperformance earlier in the economic recovery. The pause in 2015 and, to a lesser extent last year, has clearly ended. Growth over the last three quarters in Canada has led the G7 once again. Outperformance relative to other G7 countries dating back to pre-2008/09 recession levels never fully reversed over 2015 and 2016 and the gap is growing again (chart 1).

Chart 1: G7 Real GDP Growth



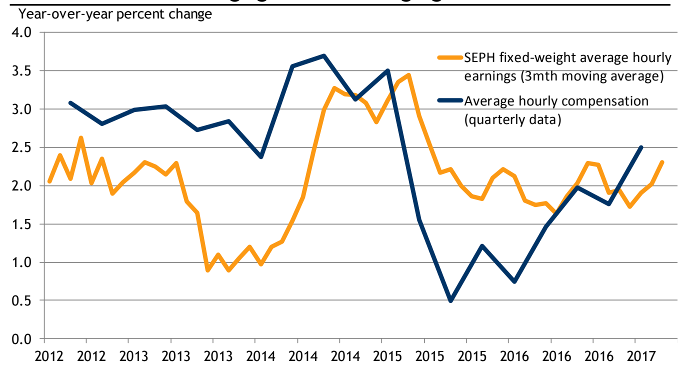
Source: Statistics Canada, Bureau of Economics Analysis, OECD, Economics Research

- **Labour markets look solid**

Employment has been growing at a blistering pace with gains averaging 29k per month over the last year and mostly reflecting full-time job growth. The unemployment rate, at 6.5% in June, has fallen to well-below its 10-year pre-recession average level, a period over which Bank of Canada estimates suggest the economy was operating fully at its long-run capacity. And no, the unemployment rate drop does not reflect discouraged workers giving up their job search. Alternative unemployment rates calculated by Statistics Canada to account for that and other sources of 'hidden unemployment' have actually fallen more than the official unemployment rate. Regional divergence persists but even in oil producing provinces labour market slack has started to be absorbed. The 7.4% unemployment rate in Alberta in June was above the Canadian average but still down sharply from what looks to have been a cycle-peak of 9% just 7 months ago in November.

Nathan Janzen
Senior Economist | 416-974-0579 | nathan.janzen@rbc.com

Chart 2: Canadian wage growth showing signs of life

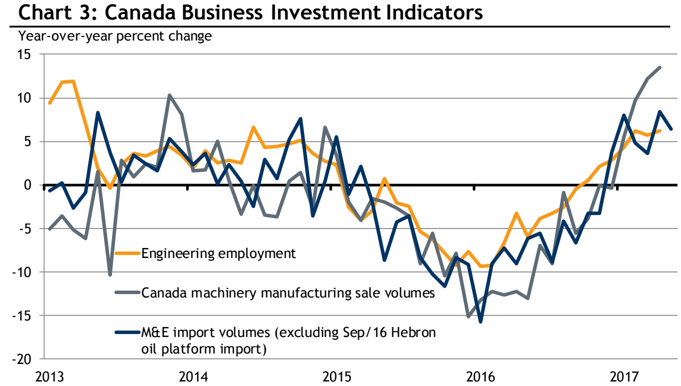


Source: Statistics Canada, RBC Economics Research

- **Wage growth is showing signs of life**

The soft spot in the labour market data has been weak wage growth but recent trends have improved. Growth in average hourly earnings from the closely-watched monthly Labour Force Survey has admittedly remained weak, averaging just 1% year-to-date in 2017, but other measures have shown more strength. Statistics Canada's estimate of average hourly compensation was up 2.5% from a year ago in Q1. That was the strongest since Q1 2015. A 'fixed-weight' measure of wage growth from Statistics Canada's alternative 'SEPH' employment survey that controls for things like shifting industrial mix of job growth and changing hours worked also strengthened to a 2½% year-over-year growth rate in March and April. That is up from sub-2% readings a year ago and tracking above the 1.9% increase in 2016 as a whole. The shrinking unemployment rate coupled with a sharp increase in the 'intensity of labour shortages' in the Bank of Canada's Q2 Business Outlook Survey are reasons to expect wage growth to accelerate further.

Chart 3: Canada Business Investment Indicators



Source: Statistics Canada, RBC Economics Research

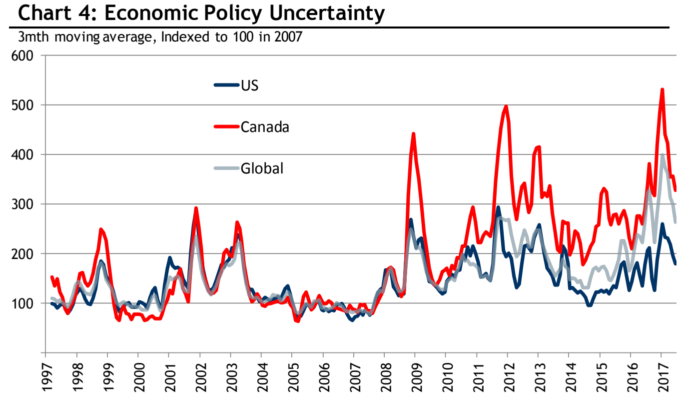
- **Business investment has started to grow again**

Stronger GDP growth and labour market strength is not really new. Perhaps more significant in altering the Bank of Canada's thinking recently has been a broadening in growth. Business investment in particular was stubbornly weak in recent years, including outside of the oil & gas sector. That 'missing piece' of the economic growth pie however, has re-emerged early in 2017. Weaker-than-expected investment intentions in a key annual Statistics Canada survey caused concern early this year but then business investment jumped by its largest amount in almost 5 years in Q1. Machinery and equipment imports, engineering construction employment and machinery sales from Canadian manufacturers — all of which are indicative of investment spending — have continued to strengthen early in Q2 (chart 3). Machinery and equipment investment intentions in the Business Outlook Survey matched their second-highest level on record in Q1 and moderated only slightly from that level in Q2 with survey comments suggesting that a greater number of firms in Q2 were being pushed to expand capacity by rising demand.

- **Uncertainty is still high but the impact is being 'trumped' by rising demand**

The election of President Trump has upset conventional political norms and put previously unthinkable U.S. policy moves — for example, the possible outright dismantling of NAFTA — at least in the realm of the plausible if not yet the probable. As Bank of Canada officials have continued to highlight, businesses that are concerned about the future will invest less. So uncertainty itself can negatively impact the economic outlook even if the feared event does not actually occur. While this is a legitimate concern, there is mounting evidence that uncertainty about the outlook is being offset by the need to expand capacity to take advantage of stronger demand today. See, for example, EDC's [Spring Trade Confidence Index] that showed significantly improved exporter sentiment despite persistent concerns about the global demand backdrop.

Chart 4: Economic Policy Uncertainty



Source: PolicyUncertainty.com, RBC Economics Research

Indeed, growth under uncertainty has been a constant theme throughout the economic recovery. At least one 'news-based' measure suggests that policy uncertainty has generally been higher in Canada than other countries since the 2008/09 recession (Chart 4). It is often forgotten that the recovery in business investment in Canada was nonetheless significantly stronger than in other countries prior to the oil price collapse. Signs of a significant pickup in investment spending this year may be suggesting that Canadian businesses are, once again, getting used to life under uncertainty.

- **Low inflation persists but despite strong demand growth**

The strongest argument for the bank to remain on the sidelines is the low and falling rate of inflation in Canada. Measures of underlying inflation growth trends in Canada were all 1.5% or less in May, significantly below the bank's 2% inflation target. As the Bank of Canada has begun to highlight, however, inflation lags economic growth so weak inflation today is more likely to reflect a lack of demand in the past rather than the present. Other factors may also be at play. For example, competition from internet sales may be temporarily dampening retail price growth. E-commerce retail sales in Canada have risen a whopping 40% year-to-date in 2017 compared to a 6% increase in retail sales overall.

What is more clear is that weakness in consumer demand is not the problem. Consumer expenditures accounted for a record share of GDP in 2016. Auto sales in Canada are on track to total more than 2 million units in 2017. That's an amount that would have been unthinkable just a few years ago. That persistent demand argues that price growth will, eventually, begin to strengthen. Indeed, the pickup in wage growth recently provides tentative evidence that stronger economic growth is starting to have the expected impact on prices.

- **Clearly advantages to an earlier more gradual rate hiking path**

The Bank of Canada has long argued that elevated levels of household debt and imbalances in housing markets represent key domestic vulnerabilities. One of the key risks associated with both of those vulnerabilities is that a faster-than-expected rise in interest rates would sharply increase the cost of servicing high household debt levels. Given that risk, there is clearly an advantage to adopting an earlier and more gradual rate hike path to allow a more gradual adjustment to higher rates in the highly leveraged household sector. To adopt an analogy used recently by Governor Poloz, when a driver sees a red light ahead they (typically) start to slow down gradually before reaching the intersection. The same is true with interest rate policy. Gradual adjustments are better than sharp shocks. To achieve that rates have to begin to rise before the economy is overheating and inflation pressures have emerged.