ECONOMIC VIEWPOINT

Strategic View: High for How Long?

By Royce Mendes, Managing Director and Head of Macro Strategy and Tiago Figueiredo, Associate – Macro Strategy

Highlights

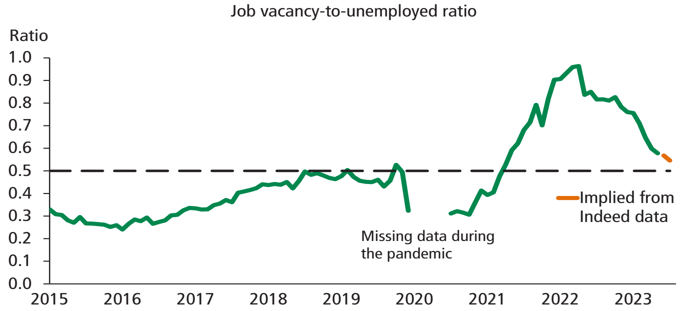
- How long can the Bank of Canada keep its policy rate at 5.00%? Central bankers will likely need to see the unemployment rate around 6.5% AND inflation at or below 3% to begin cutting rates.
- A balanced labour market is a key ingredient for restoring price stability. As a result, they will likely wait until the vacancy-to-unemployed ratio falls to roughly 0.4 before cutting rates. That would be consistent with an unemployment rate of roughly 6.5%.
- Policymakers will also need to see further progress on inflation before trimming rates, but won't be sitting on the sidelines until price growth slows to 2% per annum. So long as our labour market threshold has been met, we believe the Bank of Canada could begin lowering the policy rate even with total inflation still hovering around 3%.

How long can the Bank of Canada keep its policy rate at 5.00%? Assuming the financial system remains on stable footing, the answer obviously lies in the evolution of inflation and the economy. However, instead of just making vague pronouncements, we've tried to distill our response down to a couple of key variables accessible to anyone with an internet connection. For those who don't want to wade through the wonkish details below, the takeaway is that the Bank of Canada will likely need to see the unemployment rate around 6.5% and inflation at or below 3% to begin cutting rates.

The central bank believes that a balanced labour market is a key ingredient for restoring price stability. The job vacancy-to-unemployed ratio, which measures the number of job openings or vacancies relative to the number of unemployed Canadians, is probably the single best measure of supply and demand in the labour market. Moreover, it has a strong relationship with underlying inflation. In late 2021 and early 2022, there was almost one job opening for every unemployed person in Canada. While the ratio of job openings-to-unemployed has begun to fall this year, it's still above the roughly 0.5 vacancies per jobless Canadian seen just before the pandemic (graph 1).

The falling vacancy-to-unemployed ratio has been equally the result of a declining number of job openings and a rise in the number of jobless Canadians. Further normalization is also expected to be the result of both declining job vacancies and

GRAPH 1
Rising Unemployment Along with Falling Job Vacancies Is Easing Labour Market Tightness

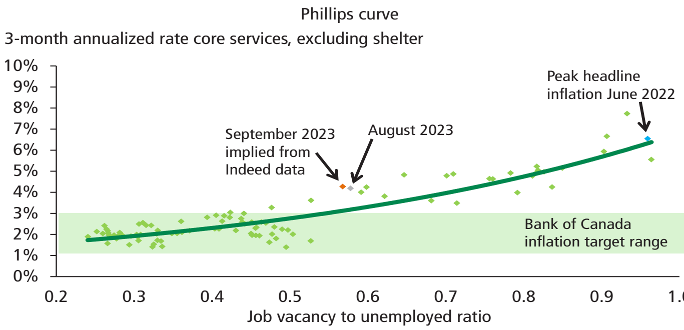


Sources: Statistics Canada, Indeed Hiring Lab and Desjardins Capital Markets rising unemployment. With the economy having already stalled, job openings are likely to continue on a downward trajectory as businesses curtail growth plans. We use Indeed's Hiring Lab data to estimate the number of job openings for September and October, which confirms that the trend lower has remained intact recently. At the same time, the blistering pace of population growth will continue to put upward pressure on unemployment, as newcomers find it more difficult to find jobs.

Assuming vacancies fall and unemployment rises by roughly the same amount, a job vacancy-to-unemployment rate of 0.5 could be seen early next year when our forecasts suggest the unemployment rate will breach 6%. Central bankers will, however, want to err on the side of caution so they don't ease prematurely. As a result, they will likely wait until the vacancy-to-unemployed ratio falls to roughly 0.4 before cutting rates. That would be consistent with an unemployment rate of roughly 6.5% and probably come alongside weak wage pressures. Given the relationship between labour market conditions and core services inflation, such weakness should drive underlying inflation lower (graph 2).

GRAPH 2

Signs of Labour Market Normalization Should Push Underlying Inflationary Pressures Lower

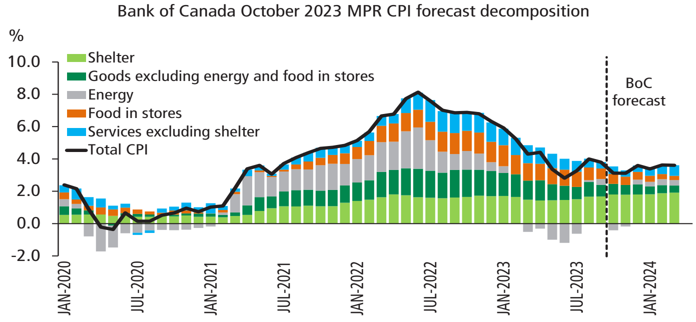


Sources: Statistics Canada, Indeed Hiring Lab and Desjardins Capital Markets

The central bank will also need to see further progress on inflation before trimming rates, but won't be sitting on the sidelines until price growth slows to 2% per annum. The October Monetary Policy Report revealed that more than half of the inflation the central bank expects to see in the coming six months will be driven by shelter costs (graph 3). In total, the central bank mentioned the word "shelter" 38 times in its latest MPR, up sharply from previous iterations (graph 4). Our own forecasts match those of the Bank and further suggest shelter inflation will continue to produce similarly large contributions well into the second half of 2024.

GRAPH 3

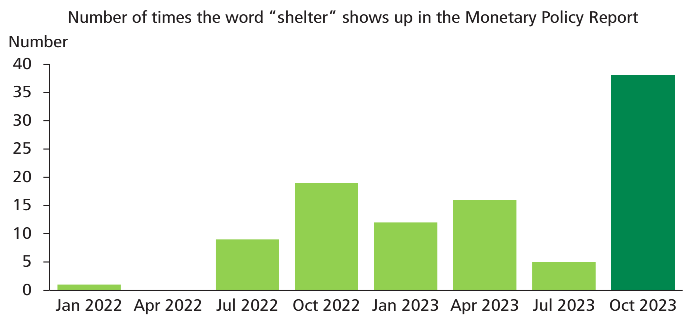
Shelter Is Expected to Have an Outsized Contribution to Headline Inflation in the Coming Quarters



Sources: Bank of Canada and Desjardins Capital Markets

GRAPH 4

The Bank of Canada Has a New Focus on Shelter Inflation

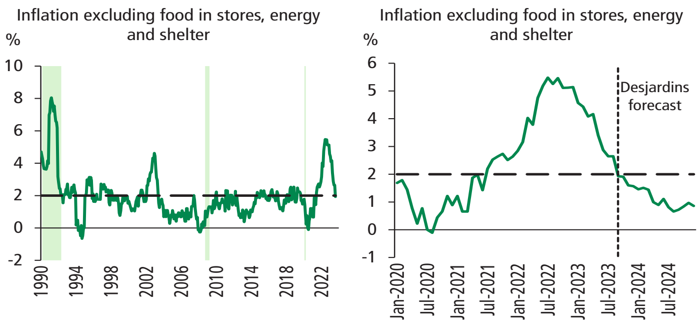


Sources: Bank of Canada and Desjardins Capital Markets

In conceding that it could take a considerable amount of time to increase the supply of housing enough to put downward pressure on shelter price inflation, the Bank of Canada has opened the door to measuring total inflation excluding shelter. Moreover, the fact that central bankers view this as a supply problem, not a demand issue which they can control, is key to understanding why Governor Macklem finally said what we've been forecasting for some time: the central bank will not wait for reported inflation to reach 2% to cut interest rates.

Inflation excluding food from stores, energy and shelter recently fell to 2% and is expected to fall further in the months to come (graph 5 on page 3). On its own, that's not enough to declare 'mission accomplished', but it reveals exactly where excess inflation is still coming from. From that point of view, the Bank of Canada's efforts have actually lowered underlying inflationary pressures in the categories in which monetary policy can effect change. As a result, so long as our labour market threshold has been met, we believe the Bank of Canada could begin lowering the policy rate even with total inflation hovering around 3%. Our current economic forecast has both of these thresholds being breached by the April Bank of Canada rate announcement. Note, our forecast does not see

GRAPH 5
Inflation excluding Food in Stores, Energy and Shelter Should Fall below the 2 Percent Target in the Coming Months



Sources: Statistics Canada and Desjardins Capital Markets

inflation getting stuck at 3%. Instead, it projects price pressures will slow to the 2% target by the beginning of 2025 as the lagged impacts of past rate monetary tightening slows the economy and core non-shelter inflation further.

Keep in mind that a rate cut from 5.00% is more like easing off of the brakes after slamming on them than stepping on the accelerator. That's even more true given that the Bank of Canada will most likely still be operating its quantitative tightening program in the background when rate cuts begin. Between now and the April rate decision, another $33bn worth of Government of Canada bonds will have matured and rolled off of the central bank's balance sheet. All else equal, the stance of monetary policy will have tightened meaningfully by April. In addition to ongoing QT, with inflation expectations likely receding, the real policy rate will be even higher than it is today. So, assuming BOTH of our thresholds are met, the Bank of Canada could begin trimming rates in the second quarter of 2024 to better calibrate policy to the reality that central bankers will have done what they can to conquer inflation. What's left to hit 2% will just be time.