LAURENTIAN BANK

June 7, 2023

Sébastien Lavoie,
Chief Economist
LavoieS@vmbl.ca
514 350-2931

Bank of Canada Decision – Time to Resume the Hiking Cycle

The 4-month pause is over. The BoC lifted its policy rate by 25 basis points to 4.75% this morning. The overnight rate target surpasses the peak of 2007 and reaches its highest level since 2001.

BoC officials previously debated between a pause and a hike at the April meeting. Since then, mounting concerns "*that CPI inflation could get stuck materially above 2%*" tip the scales in favour of an increase. Markets participants should not take this passage lightly: "*Get stuck materially above 2%"* means 3%-4% inflation annually in 2024-25-26, not 2.5%.

The BoC cannot take the risk of letting inflation run away that high, or any longer than it already did in 2021-22. The rebound in sectors sensitive to interest rates so far in 2023, cited in the statement, explains part of the recent overshooting in real GDP and CPI inflation. In our view, the lack of downward adjustment of household spending per capita is partly related to the debt structure: mortgage refinancing at higher rates will happen in 2024-25-26 for many borrowers as the BoC noted in its *Financial Stability Review* released last month, delaying the bite. Furthermore, the absence of the required job market rebalancing continues. The BoC refers to new workers quickly hired. Markets will get the May labour market numbers this Friday with the release of the Labour Force Survey. Both unemployment rate (5.0%) and employment rate (62.4%) figures have stayed unchanged at solid levels so far this year.

A quarter of a point increase does not guarantee CPI inflation will moderate sufficiently over time, particularly since three major things need to happen: a normal behaviour from companies fixing prices; lower consumer inflation expectations; a moderation in several labour market indicators including wage growth currently running at a 4%+ y-o-y clip. Accordingly, investors should not see today's hike as a one-and-done, simple fine-tuning exercise. Resuming the monetary tightening cycle to make sure no one drops the ball on inflation in the future should require at least another 25 basis points at the July 12th meeting. A 5.00% overnight rate target appears imminent. And, if economic momentum does not cool down sufficiently this summer, additional hikes at the September and October meetings cannot not be ruled out either.

Sébastien Lavoie | Chief Economist
514 213-4571| LavoieS@vmbl.ca