Central Banks

Canada’s rate rise is latest shift in global central bank policy

Rate rise boosts the Canadian currency as central bank positions for inflation uptick

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4 HOURS AGO by: Roger Blitz

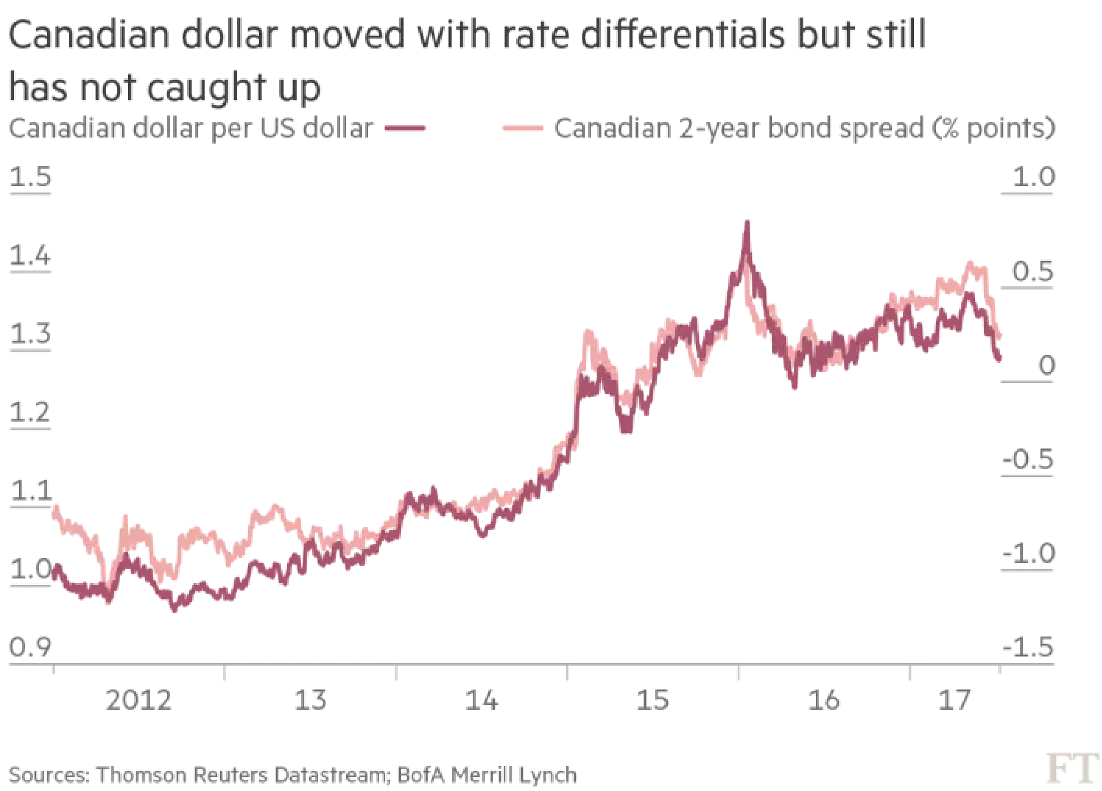
Canada’s first rate rise in nearly seven years puts it in the vanguard of central banks outside the US Federal Reserve shifting monetary policy in response to better global economic growth.

The market had fully priced in the move upwards of 25 basis points to 0.75 per cent, which leaves two obvious questions for investors: what next for Canada, and how soon could other central banks join the retreat from easy monetary policy?

Judging by the reaction of the “loonie”, nickname for the Canadian dollar, the answer to the first question has already been answered by investors.

The loonie rose 1 per cent against the US dollar to C$1.2788, its strongest level since August 2016, a sure sign that investors expect another rate rise soon. Canada's equity market trimmed a gain of 1 per cent after the rates decision and its policy sensitive two-year yield climbed to its highest level since September 2013.

Governor Stephen Poloz's distinctly hawkish accompanying statement, in which he described the economy as "approaching full capacity" and said the 2pc inflation target was on track, encouraged the loonie's strong rally.



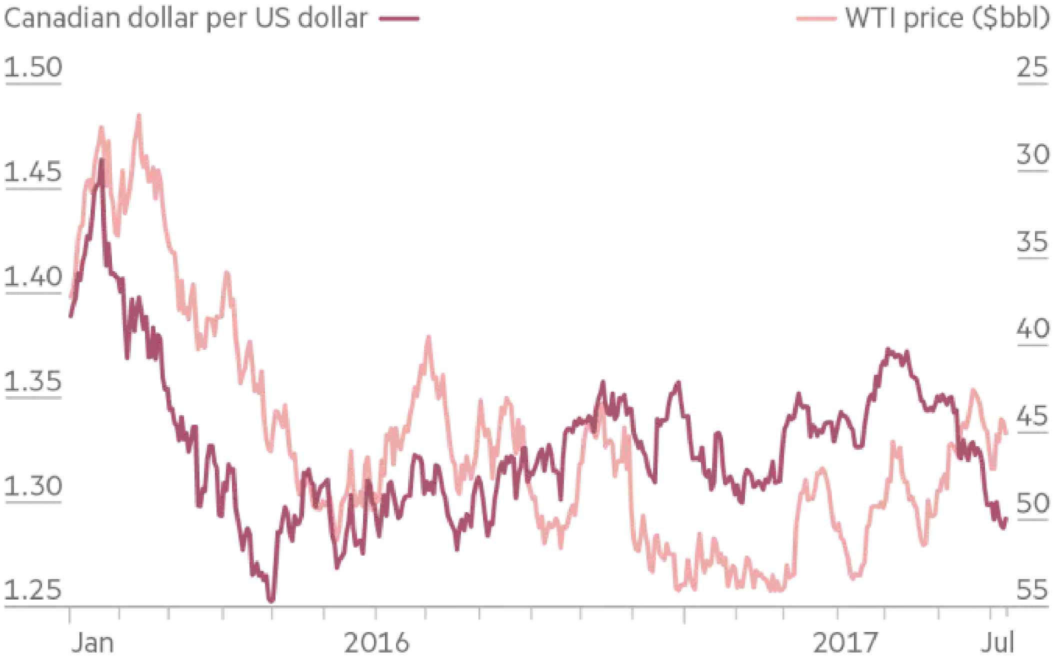
"There is nothing here though to stop the BoC hiking once more in September or October," says Stephen Gallo, Bank of Montreal forex analyst. "And why should the FX and rates markets markedly ratchet down expectations for rate hikes in 2018? The CAD move higher is justified."

The BoC's path looks clearer, and may well influence those central banks other than the Fed that are mulling less monetary stimulus. Behind the BoC comes the European Central Bank, the Bank of England and Norges Bank in considering a shift away from easy monetary policy.

The currencies of Australia, New Zealand, Sweden have all gained against the US dollar thanks to improving economic growth, even if their central banks are cautious about changing policy quite yet.

In contrast, the yen has been weakening against every other G10 currency as the Bank of Japan recommits to buying bonds and keeping the monetary spigot open.

Oil prices have been a mixed feature for the Canadian dollar



Sources: Thomson Reuters Datastream; BofA Merrill Lynch

Goldman Sachs says there is little evidence of central banks’ “desire to follow the latest fashion in easing or tightening per se” or moving in a co-ordinated way.

But Jane Foley at Rabobank says that “game theory presents some reason for central banks to at least consider the actions of their peers in particular to reduce the risk of large swings in FX”.

The BoC’s upwards move is the first by a G10 central bank outside the Fed since the Reserve Bank of New Zealand raised rates three years ago, points out Alan Ruskin at Deutsche Bank.

Its decision is “unlikely to be an isolated affair for upcoming G10 tightenings,” he adds. “The market will view a rate hike in the context of other recent comments from other central banks (notably the ECB and BOE) that a removal of extreme accommodative policies may be warranted."

Each central bank will adopt its own approach, but the speed of the BoC's hawkish switch should be a warning to investors, says Mr Ruskin. " . . . central banks are in a rare moment, where some core assumptions are being questioned and they are more open to change..."

As core assumptions go, none is more important right now than the relationship between inflation, growth and rates. Mr Poloz highlighted this, saying there is "a lively debate, not just in Canada but in many other countries, about the appropriate interest rate setting when economic growth is rapid but inflation is low".

Looking through low levels of inflation is now a key part of Canada's playbook on how to retreat from quantitative easing, one that began to be written last month when Mr Poloz and his deputy primed the market with surprisingly hawkish speeches.

Core inflation is running at 1.3 per cent year-on-year and is trending lower, and the BoC says further rate moves "will be guided by incoming data as they inform the Bank's inflation outlook".

But Mr Poloz points out that since there is a lag of up to two years for monetary policy action to have its full effect on inflation, "reacting only to the latest inflation data would be akin to driving while looking in the rear view mirror".

The message for other policymakers: don't get too hung up on inflation, and focus on the benefits of flexible monetary policy. The BoC wants to position policy to tackle rising consumer prices. It worries about lower rates encouraging risky behaviour in the market, concerned in particular how persistently low rates has contributed to an overheating Canadian property market.

“Stephen Poloz feels complicit in the froth in some housing markets in Canada,” says Mr Gallo.

And the BoC wants to get closer to Fed monetary policy to prevent fluctuations in the Canadian dollar’s value against its US counterpart.

The Fed has been out on its own in normalising rates, with four hikes since December 2015. Canada has now followed. It is up to others to decide to join the party.