BoC’s Macklem warns interest rates will likely fall gradually, and not to pre-pandemic levels

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Bank of Canada governor Tiff Macklem arrives to appear as a witness at a House of Commons Finance Committee in Ottawa on May 2, 2024.

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Bank of Canada governor Tiff Macklem is cautioning that interest rates are unlikely to return to the low levels seen in the decade before the pandemic, and that borrowing costs are likely to decline slowly as inflation inches back toward the central bank’s target over the next year.

Speaking to the House of Commons finance committee on Thursday, Mr. Macklem said he's becoming more confident that inflation is moving in the right direction and that it may soon be appropriate to begin lowering the bank's highly restrictive policy rate. However, he poured cold water on hopes that borrowing costs will decline rapidly.

"Interest rates are certainly not going back to the emergency-low levels we had during COVID. They're unlikely even to go back to the pre-COVID levels," Mr. Macklem said in response to a question from Liberal MP Julie Dzerowicz about whether Canadians needed a "reality check" on the trajectory of monetary policy.

"When you look at our forecast right now, inflation is coming down pretty gradually. So even when we start reducing interest rates, it's likely to be a pretty gradual path."

Financial markets are pricing in a 60-per-cent chance the Bank of Canada starts easing monetary policy at its next meeting in June, according to Refinitiv data. However, interest rate swap markets are only fully pricing in two quarter-point rate cuts before the end of the year.

The trajectory of interest rates matters greatly for the roughly 40 per cent of Canadian mortgage holders who have not yet renewed their mortgages since the central bank started raising rates in the spring of 2022. Most of them will renew over the next two years, and many face significant payment jumps.

One reason for a gradual decline in Canadian interest rates is the strength of the U.S. economy and the hawkish tilt of the U.S. Federal Reserve, which is dealing with more stubborn inflation than in Canada.

U.S. Federal Reserve says interest rates will stay at two-decade high until inflation further cools

If the Bank of Canada cuts interest rates before the Fed, as markets widely expect, that will put downward pressure on the Canadian-U. S. dollar exchange rate. That would stimulate Canadian exports but also push up the price of imports, including many food prices.

Mr. Macklem said that Canadian interest rates don't have to match those in the U.S. or other countries. The Bank of Canada's policy rate of 5 per cent is already below the Fed Funds rate target range of 5.25 to 5.5 per cent.

"But there is a limit to how far they can diverge," Mr. Macklem said, adding that "we're not close to that limit."

National Bank of Canada rate strategists Taylor Schleich and Warren Lovely said in a note to clients on Thursday that Mr. Macklem and his team are unlikely to be overly constrained by the Fed.

"It's entirely reasonable the BoC's policy rate could fall 100 basis points below the Fed's without policy-makers batting an eye," Mr. Schleich and Mr. Lovely wrote, noting that it's been fairly common historically for the Bank of Canada and the Fed to diverge on interest rates. (A basis-point is 1/100th of a percentage point).

"We don't deny that a weaker Canadian dollar boosts import prices, but the pass-through to consumer prices is smaller than widely appreciated," they wrote. "Recent episodes of Canadian dollar weakness haven't coincided with outsized inflation either, outright or vis-a-vis the U.S."

This was echoed by Olivia Cross, North American economist with Capital Economics. She said in a note to clients that exchange rate considerations could act as somewhat of a brake on the Bank of Canada's loosening cycle.

"Nonetheless, while the recent discouraging U.S. inflation data have reduced our confidence that the Bank will be able cut its policy rate to 2.5 per cent next year, we remain confident that the divergence between Canadian and U.S. interest rates will be wider than markets are currently pricing in," she wrote.

Looking further out, Bank of Canada officials believe interest rates are likely to be higher than in the recent past, as a result of structural changes in the global economy that may make inflation more prevalent.

These include changing patterns of saving and spending as the population ages, costs associated with climate change, and splintering global trade, which could put upward pressure on goods prices.

The bank formalized this thinking last month when it raised its “neutral rate” estimate by a quarter percentage point to a range of 2.25 to 3.25 per cent. The neutral rate is where the bank thinks its policy rate will settle in the long run, if monetary policy is neither stimulating nor constraining the economy.

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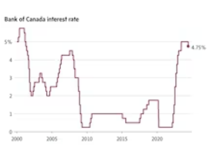

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