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# Bank of Canada hikes again, but NAFTA worries persist

The Canadian economy is strong and inflation pressures are rising, but the outcome of NAFTA talks is key in determining the path for interest rates

Source: Bank of Canada

Following a raft of strong activity data and a pick-up in inflation, the Bank of Canada raised the target for its overnight rate to 1.25%. This was broadly the view amongst economists and in financial markets, which had swung behind the idea of a rate rise following two consecutive bumper Canadian jobs reports and stronger inflation readings.

This was reflected in the accompanying statement, which stated that “labour market slack is being absorbed more quickly than anticipated”. It also highlighted strong data, inflation being close to target and the belief that the “economy is operating roughly at capacity” as reasons to raise interest rates.

The bank is expecting to see a slowdown in 2018, but has had to acknowledge that “growth is expected to remain above potential through the first quarter of 2018”. Nonetheless, there are clearly risks, most notably the potential for Donald Trump to pull the plug on NAFTA. US-Canadian trade flows equate to 32% of Canadian GDP so any disruption would be very bad news.

Uncertainty on this issue is “clouding the economic outlook”, according to the statement, which is likely to weigh on business investment and trade in the bank's view.

Consequently, the BoC still sees the need for “some continued monetary policy accommodation” and warns that the Governing Council will “remain cautious in considering future policy adjustments”. Despite this, the “economic outlook is expected to warrant higher interest rates over time”.

We certainly agree and see further upside to Canadian growth given the improving global backdrop and rising commodity demand. We are also encouraged by Trump’s recent comments, hinting at a growing willingness to work with Mexico and Canada on a NAFTA compromise. As such, we are predicting two more 25bp hikes in the second half of 2018.

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