



Policy Rate: 2 More Hikes After July 2022 to Reach Neutral Level

Description

Most economists and bankers say the chances of a 75-basis-point increase in interest rates next month are 80%. They also believe that the Bank of Canada (BoC) will follow the footsteps of the U.S. Federal Reserve when it raised the policy rate by 0.75% last week.

According to former BoC governor David Dodge, the policy rate must go up quickly to neutral level. He's less concerned about the size or percentage increases for as long as rates return to neutral. He said, "I think it's been quite clear that central banks need to get up to neutral in North America quickly to make up for lost time in 2021."

Dodge added, "Whether they're going by 50 basis points, 75 basis points, or even making a full-point move really isn't so much the issue." Once interest rates in North America return to neutral, the Feds can then reassess the next direction of rates. However, it depends on global economic conditions.

BoC's neutral level

A monetary policy at neutral level means the interest rate is no longer accommodative nor restrictive. If the Bank of Canada estimates the high neutral rate to be 3%, three more rate hikes of 50 basis points are inevitable. Assuming the increase on July 13, 2022, is forceful or 0.75%, the next two increases must be 0.5% and 0.25%, or vice versa. The current policy rate after three rate hikes in 2022 stands at 1.5%.

Dodge said, "No one knows how events in the world are going to play out. This is a very, [very uncertain time](#). What is clear is we need to get policy up to being no longer accommodative, or being very mildly restrictionary. You need to get there."

BoC Deputy governor Toni Gravelle said the sharp rebound in global demand for goods, along with pandemic-related restrictions and some weather-related events, created the perfect storm. He added, "The global supply of goods did not meet rapid growth in demand, causing goods prices to rise in Canada and around the world."

Investment for keeps

After the BoC's rate-hike announcement on June 1, 2022, Canada's largest bank increased its prime rate by 50 basis points to 3.7%. However, **Royal Bank of Canada** ([TSX:RY](#))([NYSE:RY](#)) rewarded investors with a 7% dividend hike. In Q2 fiscal 2022, the net income of the \$174.6 billion bank increased 6% year over year to \$4.25 billion.

If you own the RBC shares, hold on to them. RBC should remain formidable amid the worries over tightening monetary policies, inflation, and the ongoing war. According to management, the reduced uncertainty related to the pandemic improved the bank's credit quality.

The big bank stock trades at \$124.53 per share and pays an attractive 4.11% dividend.

Economy can handle higher rates

Some market analysts the rate-hike campaign of the central bank started late or "behind the eight ball," as inflation rose above the control range. However, Governor Tiff Macklem considers high household debt and elevated housing prices as bigger vulnerabilities. He said, "We think the economy needs higher interest rates, and it can certainly handle higher interest rates."

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