Taking what is offered
By Warren Lovely & Taylor Schleich

Full disclosure: Notwithstanding the apparent bias to OIS pricing, Wednesday’s interest rate decision by the Bank of Canada may be no slam dunk. Not that all earlier rate decisions have been straight-forward, 2022 delivering a couple of notable BoC surprises.

One presumes Governing Council will be debating whether it’s time to scale back the pace of tightening, for a number of recent economic signposts have surely been unnerving. Earlier rate hikes are clearly working and the economic mood has soured meaningfully.

Yet, we’ve seen and heard enough of late to anticipate another oversized tightening move. Expect the Bank to hike the overnight target rate 75 basis points to 4% next week. That would make 375 basis points of cumulative tightening via six consecutive decisions, all but the first move of the ‘greater-than-25’ variety. Wednesday’s hike may not be the last and the BoC will likely be reticent to wave the ‘all clear’ via forward guidance, at least until inflation is more controlled.

Dovish signals may be self-defeating for the moment. But by pushing rates into decisively restrictive territory more quickly, it’s less obvious (to us) that rates will need to move up much further. No fine-tuning on Wednesday then, but future decisions (starting December 7th) look to embed a greater degree of data dependency.

Much has transpired since the BoC hiked by 75 basis points on September 7th. The global outlook has unquestionably eroded. The IMF flagged a “broad-based and sharper-than-expected slowdown” in its fresh World Economic Outlook. BoC surveys highlight mounting pessimism. The majority of businesses and consumers are bracing for recession. Anxiety could see these agents buying less and/or slowing the pace of investment/hiring. In this way, recession fears may be self-fulfilling. Housing markets are under intense strain, as record declines in the Teranet-National Bank House Price Index make clear (link). Financial conditions have tightened appreciably.

Our fresh Monthly Economic Monitor (link) may not embed an outright recession call but nonetheless projects tepid real GDP growth. To us, Canada can hope for no more than 0.7% growth next year, the U.S. at virtual stall speed (0.2%). Consistent with a consensus forecast that’s fallen out of bed, the Bank’s 2023 GDP call will be seriously degraded via the Monetary Policy Report accompanying the rate decision. Note: The BoC projected 1.8% growth for 2023 in July, which was already a major downgrade vs. the 3.2% rate assumed in April.

So on the demand side there’s considerable (and still-accumulating) evidence that the tightening delivered through September has assured the sub-potential growth needed to open up economic slack. Looked at in isolation that might argue for moderating the pace of rate hikes (i.e., opting for ‘just’ 50 bps on Wednesday).

Despite ominous growth signals, inflation remains problematic. While we’ve had two CPI reports showing improvement since the Bank’s last decision, there’s still a lingering whiff of pervasive pressure. As it stands, capacity pressures and labour shortages remain acute. Short-term inflation expectations have eased somewhat but remain elevated (4.3% on a 2-year basis as per the BOS). As Governor Macklem warned, “the clear implication [of elevated inflation expectations] is that further interest rate increases are warranted”.

Believe it or not, you can unearth some evidence that inflation, if not quite under control, is less poorly behaved. Headline CPI inflation averaged 7.2% in Q3. Elevated yes, but less egregious than the 8% the BoC projected in July. The Bank’s core measures now range from 4.7-6%, compared with 5–5.5% at the time of the last decision. Of note, the highest core reading comes from a measure—CPI Common—the BoC now concedes is flawed. We’ve flagged problems with CPI Common for some time, including in a recent Special Report (link).

We’re more than happy to focus on Trim and Median, where seasonally adjusted data suggest momentum is easing. Our detailed analysis of September’s CPI report is available on our website (link).

So what’s to justify a 75-basis point hike, beyond still-too-high inflation and an exceedingly tight labour market? There’s the argument, freshly advanced by the IMF, that risks of under-tightening (in terms of credibility and a de-anchoring of inflation expectations) are greater than moving aggressively. Macklem endorsed this view. That’s no surprise since the IMF’s advice is really just a spin on the Bank’s pre-existing ‘front-loaded’ hiking strategy—an approach that certain other central banks (vitally the Fed) have emulated.

That brings us to the Canadian dollar. To listen to the Governor, there’s concern that a cheap(er) loonie could offset some inflation progress coming from recovering supply chains. If the Bank is legitimately worried about currency driven inflation, the relative monetary policy stance is worth bearing in mind. We’re less than two weeks removed from the next FOMC decision on November 2nd. To us, Powell & Company are unlikely to let up, a fourth straight 75-basis point hike (to 4% for fed funds upper) teed up south of the border.

We’re not so narrow-minded as to argue that policy needs to be set purely in response to what others are doing. But as we’ve seen in a few corners of the globe, failing too far behind the Fed risks unsettling your home currency. In the context of Wednesday’s BoC decision, failing to deliver a 75-basis point hike that is all-but-fully priced could drive an already weak Canadian dollar to even weaker levels, perhaps complicating inflation containment efforts down the road.

Bottom line: Do we see evidence that rate hikes are already working?
Absolutely! The Bank’s fresh forecast will usher in another material downgrade to GDP growth and will likewise confirm that the central bank’s worst inflation fears have failed to materialize. But that may not be enough to stop the BoC from driving the overnight target to 4% via another swift jolt. Such aggressiveness would back up the Bank’s recently tough talk on how vital it is to tame domestic inflation (and inflation expectations) quickly. It just might buy the Canadian dollar a bit of breathing room too, although any serious rally for the loonie must surely avoid evidence that the Fed is prepared to pivot.

In the end, we look for the Bank of Canada to take what is being offered: A 75 basis point hike that is. The maintenance of a tightening bias would signal that the Bank isn’t yet prepared to let down its guard. Come December 7th, policy rate fine-tuning could begin in earnest. While there may be a case for a final rate hike to close out an exceptional 2022, Wednesday should amount to the last truly ‘jumbo’ tightening of the cycle, as slumping growth is bound to intersect with clear(er) inflation relief in the new year.

Note: In addition to a 75-basis point interest rate hike, the BoC will confirm a continuation of quantitative tightening. The next scheduled GoC bond run off takes place on November 1st (C$17.6 billion). An additional C$98.5 billion is scheduled to passively run off (i.e, retire) in calendar 2023.
The Bank of Canada today increased its target for the overnight rate to 3¼%, with the Bank Rate at 3½% and the deposit rate at 3¼%. The Bank is also continuing its policy of quantitative tightening.

The global and Canadian economies are evolving broadly in line with the Bank’s July projection. The effects of COVID-19 outbreaks, ongoing supply disruptions, and the war in Ukraine continue to dampen growth and boost prices. Global inflation remains high and measures of core inflation are moving up in most countries. In response, central banks around the world continue to tighten monetary policy. Economic activity in the United States has moderated, although the US labour market remains tight. China is facing ongoing challenges from COVID shutdowns. Commodity prices have been volatile: oil, wheat and lumber prices have moderated while natural gas prices have risen.

In Canada, CPI inflation eased in July to 7.6% from 8.1% because of a drop in gasoline prices. However, inflation excluding gasoline increased and data indicate a further broadening of price pressures, particularly in services. The Bank’s core measures of inflation continued to move up, ranging from 5% to 5.5% in July. Surveys suggest that short-term inflation expectations remain high. The longer this continues, the greater the risk that elevated inflation becomes entrenched.

The Canadian economy continues to operate in excess demand and labour markets remain tight. Canada’s GDP grew by 3.3% in the second quarter. While this was somewhat weaker than the Bank had projected, indicators of domestic demand were very strong – consumption grew by about 9½% and business investment was up by close to 12%. With higher mortgage rates, the housing market is pulling back as anticipated, following unsustainable growth during the pandemic. The Bank continues to expect the economy to moderate in the second half of this year, as global demand weakens and tighter monetary policy here in Canada begins to bring demand more in line with supply.

Given the outlook for inflation, the Governing Council still judges that the policy interest rate will need to rise further. Quantitative tightening is complementing increases in the policy rate. As the effects of tighter monetary policy work through the economy, we will be assessing how much higher interest rates need to go to return inflation to target. The Governing Council remains resolute in its commitment to price stability and will continue to take action as required to achieve the 2% inflation target.

**Information note**

The next scheduled date for announcing the overnight rate target is October 26, 2022. The Bank will publish its next full outlook for the economy and inflation, including risks to the projection, in the MPR at the same time.

**Table 2: Contributions to average annual real GDP growth**

<table>
<thead>
<tr>
<th>Percentage points</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consumption</td>
<td>2.8</td>
<td>2.8</td>
<td>1.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Housing</td>
<td>1.3</td>
<td>0.7</td>
<td>0.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Government</td>
<td>1.5</td>
<td>0.4</td>
<td>0.5</td>
<td>0.3</td>
</tr>
<tr>
<td>Business fixed investment</td>
<td>0.2</td>
<td>0.7</td>
<td>0.6</td>
<td>0.0</td>
</tr>
<tr>
<td>Subtotal: final domestic demand</td>
<td>5.8</td>
<td>3.2</td>
<td>1.1</td>
<td>2.6</td>
</tr>
<tr>
<td>Exports</td>
<td>0.4</td>
<td>0.9</td>
<td>1.3</td>
<td>0.3</td>
</tr>
<tr>
<td>Imports</td>
<td>2.3</td>
<td>1.6</td>
<td>0.7</td>
<td>0.0</td>
</tr>
<tr>
<td>Subtotal: net exports</td>
<td>-1.9</td>
<td>0.2</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Inventories</td>
<td>0.7</td>
<td>1.9</td>
<td>0.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>GDP</td>
<td>4.5</td>
<td>3.6</td>
<td>1.8</td>
<td>2.4</td>
</tr>
</tbody>
</table>


* Numbers in parentheses are from the projection in the previous Report.

**Table 3: Summary of the quarterly projection for Canada**

<table>
<thead>
<tr>
<th>Percentage points</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
<th>2024</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI inflation</td>
<td>4.7</td>
<td>5.8</td>
<td>7.6</td>
<td>8.0</td>
</tr>
<tr>
<td>Real GDP</td>
<td>3.2</td>
<td>2.9</td>
<td>4.7</td>
<td>3.9</td>
</tr>
<tr>
<td>Real GDP quarter over-quarter percentage change at annual rates</td>
<td>6.6</td>
<td>3.1</td>
<td>4.0</td>
<td>2.0</td>
</tr>
</tbody>
</table>

* Details on the key inputs to the base case projection are provided in Box 2. Numbers in parentheses are from the projection in the previous Report.  
† Over the projection horizon, 2022Q4 and 2023Q4 are the only quarters for which some information about real GDP growth was available at the time the projection was conducted. For longer horizons, fourth-quarter-over-fourth-quarter percentage changes are presented. They show the Bank’s projected growth rates of CPI and real GDP within a given year. As such, they can differ from the growth rates of annual averages shown in Table 2. Sources: Statistics Canada and Bank of Canada calculations and projections.
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