“Getting closer, but not there yet”
By Warren Lovely & Kyle Dahms

Rate Statement

In something of a surprise move, the Bank of Canada hiked the overnight target rate by 50 bps to 3.75%, whereas the market had been more-or-less discounting a larger 75 bp move. This represents the sixth consecutive hike in the Bank’s policy interest rate since March, all but the very first move (back in March) being of the ‘larger-than-25 bp’ variety. Cumulative tightening now amounts to 350 bps, leaving Canada’s monetary policy stance in distinctly restrictive territory.

With the Bank Rate now set at 4.00% and the deposit rate at 3.75%, the overnight band remains 25 bps wide. Complementing the latest policy rate hike, the Bank continues its Quantitative Tightening (QT) program, which involves passively running off its GoC bond holdings. Near term, ~C$18 bln (par value) will drop off the balance sheet next week (November 1st), while a further ~C$89 bln of GoC bonds are set to run off in calendar 2023. As always, the precise details of the Bank’s bond holdings are available here.

Importantly, the Bank’s ‘forward guidance’ indicates that further policy rate tightening is expected. In this regard, the Bank will be influenced by “how tighter monetary policy is working to slow demand, how supply challenges are resolving, and how inflation and inflation expectations are responding.” The statement reiterated the Governing Council’s strong commitment to achieving price stability. “Resolute” is the preferred nomenclature.

The rate statement acknowledges that the growth picture has deteriorated, with Canada real GDP growth expected to downshift markedly (see details below). Indeed, a near-term “stall” is now expected, characterized by a few quarters of limited or negative growth starting in 2022 Q4 and extending through the first half of 2023. Interest-sensitive demand is reacting to higher rates; housing activity has “retreated sharply”, with household/business spending “softening”. Softer international demand is starting to crimp exports. Still, the economy remains in excess demand and labour markets remain tight, with the Bank’s latest Business Outlook Survey flagging ongoing and widespread worker shortages. The Canadian dollar, which was not explicitly mentioned in September’s BoC rate announcement, gets indirect attention here. The statement noted that USD strength “is adding to inflationary pressures in many countries”.

Canadian inflation has receded from its earlier peak and came in below the Bank’s forecast in Q3, but nonetheless remains high with price pressures broadly based. Core inflation measures have yet to show “meaningful evidence” that underlying price pressures are easing. A noted worry, near-term inflation expectations remain “high”. Inflation is, however, expected to moderate, globally and in Canada. CPI inflation is expected to ease throughout 2023, returning to the Bank’s 2% target by the end of 2024 (further details below).

Monetary Policy Report

October’s Monetary Policy Report ushers in another material downgrade to global growth. For Canada, the Bank has fine-tuned its growth call for 2022 (from 3.5% to 3.3%), with a much more significant downward adjustment made to 2023 growth (from 1.8% to 0.9%). There’s an expectation that growth will rebound to 2.0% in 2024. On a quarterly basis, the Bank expects a slowdown in the second half of 2022, with Q3 annualized growth registering at 1.5% (vs. 2.0%) and the fourth quarter at 0.5%. That slowdown will continue into 2023, with the BoC downgrading its expectations for consumption (0.6% now vs 1.0% previously) and inventories (~0.8% now vs. 0.1% previously).

On a full-year basis, CPI inflation is thought to average 4.1% in 2023 (vs. 4.6% previously), with inflation moving closer to the Bank’s 2% target in 2024 (2.2%). The quarterly profile for inflation is one of moderation with the third quarter at 7.2% (vs. 8.0% previously) and the last quarter of 2022 at 7.1%. The Bank expects inflation to be under 3.0% in the fourth quarter of 2023.

The output gap is now estimated between 0.25% and 1.25% in the third quarter of 2022. As previously outlined, the estimated range for the nominal neutral policy interest rate is 2–3%.
Press Conference

Governor Macklem and Senior Deputy Governor Rogers covered a range of topics/questions in the press conference. Macklem stressed that the Bank is balancing several considerations, with inflation (and near-term inflation expectations) still high but a slowdown (particularly in interest-sensitive sectors) increasingly evident. The Governor conceded that the path to a soft landing has narrowed (again) but emphasized that a growth “stall”—starting in the final quarter of 2022—will allow supply to catch up to demand. He was optimistic that inflation will be corralled and that growth will be able to pick back up in 2024.

In defending what has been a very aggressive monetary policy reaction this year, the Governor stated (a few times) that there are “no easy outs”, since inflation won’t simply go away on its own. He was sympathetic to low(er) income households that are experiencing broad-based inflation. His remarks emphasized the dual risks of policy tightening at this stage: go too fast/too far and you’ll slow the economy too much; go too slow and inflation expectations risk de-anchoring. The implication is that future policy decisions are likely to be more nuanced, with the size of future policy rate increases looking increasingly data dependent.

By “front-loading” hikes, the Bank hopes to avoid a more pronounced slowdown later. And with today’s hike—which the Governor dubbed as “a big step” even if it wasn’t the 75 bps many had expected—the Bank is closer to the end of the line in terms of tightening, but not quite there. In terms of credibility and political pressure, the Governor remarked that central bank independence is more important when decisions are difficult. We tend to agree. The Governor was also adamant that the central bank has an appropriate policy mandate, one that is well-aligned with the needs of Canadians.

On inflation, the Governor emphasized that near-term expectations are still high. There are, however, some encouraging signs, as the 3-month rate of change in core measures has eased and businesses suggest that they will be slowing the rate of increase in output prices. The Bank is not relying solely on its traditional models, owing to the unique/extreme nature of today’s economic backdrop (e.g., pandemic, war). He expounded on the differences between inflation in the 1970s and now, a key distinction being today’s clear monetary policy framework which has helped to keep longer-term inflation expectations well anchored.

Bottom Line:

While there was some debate amongst economists over the size of today’s hike (i.e., 50 vs. 75 bps), traders had all-but-fully embraced/discounted the larger 75 bp move. The Bank decided to take the road of caution, opting for the smaller of the two, triggering a significant rally in Canada’s bond market. While the 50 bp move may not jive with recently hawkish rhetoric, today’s rate statement (and associated commentary) make clear that the Governing Council is now willing to weigh the risks of over- vs. under-tightening. Despite the smaller move (relative to consensus expectations and market pricing), the Bank remains reluctant to fully let down its guard via forward guidance, at least until more concrete progress has been secured on inflation. So while the pace of hiking has clearly moderated (from 100 bps in July, to 75 bps in September, to 50 bps today), the Bank still feels that additional tightening will be needed.

Unquestionably, we have covered a lot of ground when it comes to monetary policy normalization in Canada. It’s increasingly clear that rapid-fire/aggressive rate hikes are working to slow economic growth, not just in Canada and the U.S., but in other key parts of the global economy. While a recession may still be avoided in Canada, GDP growth will be stepping down appreciably, the Bank conceding that a near-term “stall” is likely. With growth set to fall far below potential, financial conditions already tight and consumer/business sentiment weakening, there are risks to pushing the policy rate much further into restrictive territory. Vitaly, we some see evidence that inflation momentum is easing in Canada, even if the Bank is understandably reticent to wave the ‘all-clear’ given still-elevated year-over-year readings for the headline and core baskets.

If, as we expect, Canadian inflation continues to recede rapidly, the Bank may find itself with little more to do on the policy rate, beyond what we believe could be a final rate hike in December. The Canadian dollar remains something of a monetary policy wildcard here, to the extent currency cheapness is deemed a risk to imported inflation from abroad. The Bank may not be setting policy based solely on what the Fed is prepared to do, but the relative policy rate stance is nonetheless important for bond and currency markets. While the Fed is not yet done hiking—a 75 bp hike expected on November 2nd—we likewise see the makings of a less aggressive posture around the turn of the year, an eventual Fed policy pivot likely to lend some support to the loonie in 2023 (and thus gradually easing currency related anxiety at the Bank).

It’s clear that much continues to depend on the evolution of inflation. While this may not be the last hike, it’s hopefully the final ‘large’ tightening the economy is subjected to. We believe it’s time for the Bank to adopt a more data dependent stance, the time for policy rate fine-tuning now upon us. No more big steps then, and perhaps only one final small step up to end a truly extraordinary year of tightening.
### BoC: Summary of Economic Projections

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<th>Latest</th>
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<td><strong>Range for potential output (%)</strong></td>
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NBF Economics and Strategy
Bank of Canada increases policy interest rate by 50 basis points, continues quantitative tightening

The Bank of Canada today increased its target for the overnight rate to 3.4%, with the Bank Rate at 4% and the deposit rate at 3.4%. The Bank is also continuing its policy of quantitative tightening.

Inflation around the world remains high and broadly based. This reflects the strength of the global recovery from the pandemic, a series of global supply disruptions, and elevated commodity prices, particularly for energy, which have been pushed up by Russia’s attack on Ukraine. The strength of the US dollar is adding to inflationary pressures in many countries. Tighter monetary policies aimed at controlling inflation are weighing on economic activity around the world. As economies slow and supply disruptions ease, global inflation is expected to come down.

In the United States, labour markets remain very tight even as restrictive financial conditions are slowing economic activity. The Bank projects no growth in the US economy through most of next year. In the euro area, the economy is forecast to contract in the quarters ahead, largely due to acute energy shortages. China’s economy appears to have picked up after the recent round of pandemic lockdowns, although ongoing challenges related to its property market will continue to weigh on growth. Overall, the Bank projects that global growth will slow from 3% in 2022 to about 1½% in 2023, and then pick back up to roughly 2½% in 2024. This is a slower pace of growth than was projected in the Bank’s July Monetary Policy Report (MPR).

In Canada, the economy continues to operate in excess demand and labour markets remain tight. The demand for goods and services is still running ahead of the economy’s ability to supply them, putting upward pressure on domestic inflation. Businesses continue to report widespread labour shortages and, with the full reopening of the economy, strong demand has led to a sharp rise in the price of services. The effects of recent policy rate increases by the Bank are becoming evident in interest-sensitive areas of the economy: housing activity has retreated sharply, and spending by households and businesses is softening. Also, the slowdown in international demand is beginning to weigh on exports. Economic growth is expected to stall through the end of this year and the first half of next year as the effects of higher interest rates spread through the economy. The Bank projects GDP growth will slow from 3½% this year to just under 1% next year and 2% in 2024.

In the last three months, CPI inflation has declined from 8.1% to 6.9%, primarily due to a fall in gasoline prices. However, price pressures remain broadly based, with two-thirds of CPI components increasing more than 5% over the past year. The Bank’s preferred measures of core inflation are not yet showing meaningful evidence that underlying price pressures are easing. Near-term inflation expectations remain high, increasing the risk that elevated inflation becomes entrenched.

The Bank expects CPI inflation to ease as higher interest rates help rebalance demand and supply, price pressures from global supply disruptions fade, and the past effects of higher commodity prices dissipate. CPI inflation is projected to move down to about 3% by the end of 2023, and then return to the 2% target by the end of 2024.

Given elevated inflation and inflation expectations, as well as ongoing demand pressures in the economy, the Governing Council expects that the policy interest rate will need to rise further. Future rate increases will be influenced by our assessments of how tighter monetary policy is working to slow demand, how supply challenges are resolving, and how inflation and inflation expectations are responding. Quantitative tightening is complementing increases in the policy rate. We are resolute in our commitment to restore price stability for Canadians 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 December 7, 2022. The Bank will publish its next full outlook for the economy and inflation, including risks to the projection, in the MPR on January 25, 2023.
Economics and Strategy

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