July 11, 2018

The BoC leaves the door open for further policy normalization

The Bank of Canada raised the overnight rate by 25 basis points to 1.50% today. Explaining its decision, the BoC said the economy is operating close to full capacity and it expects GDP to expand faster than potential. CPI inflation is expected to rise to about 2.5% "before settling back to 2% by the second half of 2019". Moreover, the impacts of U.S. tariffs on steel and aluminum were "expected to be modest". That said, the BoC cautioned about impact of uncertainties related to trade on investment and exports which are "now judged to be larger (than in April's estimates), given mounting trade tensions."

Presenting its latest Monetary Policy Report (MPR), the BoC left its 2018 Canadian GDP growth forecasts unchanged at 2.0% for 2018, but raised 2019 to 2.2% (from 2.1%) and 2020 to 1.9% (From 1.8%). While 2018 growth was left unchanged, the central bank tweaked its quarterly forecasts slightly, pushing up Q2 to 2.8% annualized and trimming Q3 to 1.5%. The composition of 2018 growth was also adjusted with downgrades to consumption and trade being exactly offset by upgrades to government spending, housing and business investment (partly reflecting higher oil prices). Real gross domestic income is expected to rise 2.6% this year and by 2.3% in 2019, both higher compared to last April's MPR.

Potential GDP growth is still estimated to be 1.5-2.1% for this year and 1.4-2.2% for 2019. The neutral nominal policy rate (R-star) has been left unchanged at 2.5-3.5%. The BoC says the output gap in 2018Q2 was between -0.5% and +0.5%. That compares to an estimate of -0.75% and +0.25% in Q1. Forecasts for world growth were left unchanged at 3.8% for this year, but downgraded slightly to 3.5% for 2019. The BoC expects the U.S. economy to grow 3.1% this year, i.e. revised up from 2.7%.

Press Conference:

When asked why the BoC opted to raise rates in such uncertain times, Governor Poloz acknowledged that the downside risks associated with trade negotiation and tariff threats are serious but said it is also possible that a lot of that could evaporate if NAFTA discussions were to be settled this fall. So, monetary policy has to be based on what is known rather than on the basis of hypothetical scenarios. Moreover, in light of incoming data, the Bank`s confidence in its projections have increased since May. Although the Bank`s models project that the trade measures that have been put in place up to now will subtract about 2/3 per cent from the level of GDP by the end of 2020, the economy will nonetheless grow above potential over the projection horizon. In that context and given where the Canadian economy stands currently, the Bank judges that it was appropriate to raise the overnight rate this time and believes that higher interest rates will be warranted to keep inflation near target. This said, Governor Poloz reiterated that the decision process is data dependent and currently both the pace and end-point of monetary policy normalization is uncertain — the neutral rate is currently estimated to be in 2.5-3.5% range assuming inflation is at 2%.

Bottom line:

The central bank's decision to raise rates was largely expected by markets. The economy is at capacity, inflation pressures are on the rise, and real rates remain negative, which all warrant further tightening of monetary policy. In that regard, an October rate hike is possible if the BoC's forecasts for growth pan out. That said, the central bank made clear it is data dependent and hence nothing is cast in stone. Note that the BoC cautioned about rising trade protectionism which have arguably raised downside risks to the economy. The U.S., which last month imposed tariffs on imports of steel and aluminum, is now threatening additional trade barriers. Tariffs on autos for example, which are now being considered by the Trump administration — public hearings held by the U.S. Department of Commerce take place next week —, would have unambiguously devastating economic impacts if enacted.

Krishen Rangasamy/Paul-André Pinsonnault

Here is the press release (sections highlighted by us):

July 11, 2018

The Bank of Canada today increased its target for the overnight rate to 1 ½ per cent. The Bank Rate is correspondingly 1 ¾ per cent and the deposit rate is 1 ¼ per cent.

The Bank expects the global economy to grow by about 3 ¾ per cent in 2018 and 3 ½ per cent in 2019, in line with the April Monetary Policy Report (MPR). The US economy is proving stronger than expected, reinforcing market expectations of higher policy rates and pushing up the US dollar. This is contributing to financial stresses in some emerging market economies. Meanwhile, oil prices have risen. Yet, the Canadian dollar is lower, reflecting broad-based US dollar strength and concerns about trade actions. The possibility of more trade protectionism is the most important threat to global prospects.

Canada's economy continues to operate close to its capacity and the composition of growth is shifting. Temporary factors are causing volatility in quarterly growth rates: the Bank projects a pick-up to 2.8 per cent in the second quarter and a moderation to 1.5 per cent in the third. Household spending is being dampened by higher interest rates and tighter mortgage lending guidelines. Recent data suggest housing markets are beginning to stabilize following a weak start to 2018. Meanwhile, exports are being buoyed by strong global demand and higher commodity prices. Business investment is growing in response to solid demand growth and capacity pressures, although trade tensions are weighing on investment in some sectors. Overall, the Bank still expects average growth of close to 2 per cent over 2018-2020.

CPI and the Bank's core measures of inflation remain near 2 per cent, consistent with an economy operating close to capacity. CPI inflation is expected to edge up further to about 2.5 per cent before settling back to 2 per cent by the second half of 2019. The Bank estimates that underlying wage growth is running at about 2.3 per cent, slower than would be expected in a labour market with no slack.

As in April, the projection incorporates an estimate of the impact of trade uncertainty on Canadian investment and exports. This effect is now judged to be larger, given mounting trade tensions.

The July projection also incorporates the estimated impact of tariffs on steel and aluminum recently imposed by the United States, as well as the countermeasures enacted by Canada. Although there will be difficult adjustments for some industries and their workers, the effect of these measures on Canadian growth and inflation is expected to be modest.

Governing Council expects that higher interest rates will be warranted to keep inflation near target and will continue to take a gradual approach, guided by incoming data. In particular, the Bank is monitoring the economy's adjustment to higher interest rates and the evolution of capacity and wage pressures, as well as the response of companies and consumers to trade actions.

Information note

The next scheduled date for announcing the overnight rate target is September 5, 2018. The next full update of the Bank's outlook for the economy and inflation, including risks to the projection, will be published in the MPR on October 24, 2018.

BoC Policy Monitor

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