NATIONAL BANK OF CANADA
FINANCIAL MARKETS

BoC Policy Monitor

Economics and Strategy

April 18, 2018

BoC says higher rates are coming, although timing uncertain

As widely expected, the Bank of Canada left the overnight rate unchanged at 1.25% today. The central bank acknowledged rising core inflation, saying this is "consistent with an economy operating with little slack". The central bank sees total inflation averaging 2.3% this year (three ticks higher than previous estimation), but coming back down to 2.1% in 2019 and 2020. According to the BoC, wage growth, while rising, remains slightly below levels that are consistent with a labour market with no slack. With above-potential GDP growth projected for the next three years, the BoC made clear that higher interest rates will be warranted over time, although "some monetary policy accommodation will still be needed to keep inflation on target".

Presenting its latest Monetary Policy Report (MPR), the BoC downgraded its 2018 Canadian GDP growth forecasts to 2.0% for 2018 (from 2.2%) due to the weaker-than-expected start to the year — the BoC now expects Q1 growth of just 1.3%, about half its earlier estimate —, but raised 2019 to 2.1% (from 1.6%). The 2018 downgrade was due to lower contributions from consumption, housing and trade, the latter now expected to be a net drag on growth. Those more than offset upgrades to government's contribution to growth, the latter reflecting provincial fiscal stimulus which has been included in the forecasts. Real gross domestic income is expected to rise 2.5% this year and by 1.9% in 2019, both higher compared to last January's MPR. On net, the BoC says this is a "stronger profile for GDP".

Potential GDP growth has been raised to 1.5-2.1% for this year and to 1.4-2.2% for 2019, both ranges about 0.4% higher than previously estimated. The central bank says this "suggest the Canadian economy has made some progress in building capacity". But the neutral nominal policy rate (R-star) has been left unchanged at 2.5-3.5%.

The BoC says the output gap in 2018Q1 was between -0.75% and +0.25%. That compares to an estimate of -0.25% and +0.75% in Q4 last year.

The BoC expects GDP growth to bounce back after Q1 as "some of the weakness in housing and exports is expected to be unwound". However, challenges remain: "exports and investment are being held back by ongoing competitiveness challenges and uncertainty about trade policies."

The MPR also showed upgrades for world growth to 3.8% this year, with higher forecasts for the U.S., the Eurozone, Japan, China, and oil importing emerging economies. The BoC expects the U.S. economy to grow 2.7% both this year and next, "boosted by new government spending plans".

Press conference:

Saying that the message from the MPR was confusing, a reporter asked Governor Poloz for clarifications. For the Governor, the question facing the Bank is not if the overnight rate will going up, but rather by how much and at what pace. According to him, the economy is now close to operating at potential, and inflation is also close to target. However, there are still forces that act as headwinds (NAFTA uncertainties, export bottlenecks, housing for example), which means that if monetary policy was not accommodative the economy would not be growing at potential on its own. Since those headwinds will each fade at a different pace, it is difficult to gauge what will be the necessary pace of monetary policy tightening. The Bank will adjust its stance over time should data give it confidence the economy is evolving as projected.

Asked if a positive conclusion to NAFTA renegotiations would be the green light for rate hikes in Canada, Governor Poloz made clear this was not a given. While that would be a positive development regarding business investment decisions, the Bank will first have to see a pick-up in actual investment activity up before acting.

As far as housing activity is concerned, the Bank still says it is too early to judge the impact of macro prudential measures, such as B20. While resales have come down, Governor Poloz pointed out that housing starts remained strong.

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Bottom line:

The no-change decision from the Bank of Canada and the 2018 growth downgrade were both expected. The consideration of recently announced provincial fiscal stimulus — the expected contribution of government to 2018 growth was indeed increased — was not enough to offset the weaker-than-expected start to the year, resulting in a net downgrade of the BoC's 2018 growth forecast. But, like us, the central bank expects a growth rebound in subsequent quarters. The BoC even raised 2019 significantly (in fact growth for the next three years are slated to be above potential) and says that on net, this is a "stronger profile for GDP". That is why the Governing Council says that higher interest rates will be warranted over time. The caveat of course, is that downside risks, including trade policy, remain contained.

The press conference provided an opportunity for Governor Poloz to lower expectations of a spring rate hike. Of note, was the Governor's statement that a positive conclusion of NAFTA renegotiations will not automatically trigger rate hikes.

Based on today's message, a May rate hike looks unlikely at this point. That said, should the "data-dependent" Bank of Canada see upside economic surprises before the meeting of May 30th, e.g. monthly GDP, wage, employment and inflation, a change of stance remains possible. Recall that while the economy is currently at capacity, the overnight rate remains 175 basis points below the estimated neutral rate of 3%.

Krishen Rangasamy/Paul-André Pinsonnault

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

April 18, 2018

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

Inflation in Canada is close to 2 per cent as temporary factors that have been weighing on inflation have largely dissipated, as expected. **Consistent with an economy operating with little slack, core measures of inflation have continued to edge up and are all now close to 2 per cent**. The transitory impact of higher gasoline prices and recent minimum wage increases will likely cause inflation in 2018 to be modestly higher than the Bank expected in its January Monetary Policy Report (MPR), returning to the 2 per cent target for the rest of the projection horizon.

The global economy is on a modestly stronger track than forecast in January, with upward revisions to growth and potential output in a number of major advanced economies. The outlook for the U.S. economy has been further boosted by new government spending plans. However, escalating geopolitical and trade conflicts risk undermining the global expansion.

In Canada, GDP growth in the first quarter was weaker than the Bank had expected, but should rebound in the second quarter, resulting in 2 per cent average growth in the first half of 2018. **The economy is projected to operate slightly above its potential over the next three years**, with real GDP growth of about 2 per cent in both 2018 and 2019, and 1.8 per cent in 2020. This **stronger profile for GDP** incorporates new provincial and federal fiscal measures announced since January. It also reflects upward revisions to estimates of potential output growth, which suggest **the Canadian economy has made some progress in building capacity**.

Slower economic growth in the first quarter primarily reflects weakness in two areas. Housing markets responded to new mortgage guidelines and other policy measures by pulling forward transactions to late 2017. Exports also faltered, partly owing to transportation bottlenecks. Some of the weakness in housing and exports is expected to be unwound as 2018 progresses.

The Bank anticipates that Canadian exports will strengthen as foreign demand increases, but not sufficiently to recover the ground lost during recent quarters. Export growth is being increasingly limited by capacity constraints in some sectors. Continued gains in business investment should build additional capacity in those sectors and in the economy more generally. However, **both exports and investment are being held back by ongoing competitiveness challenges and uncertainty about trade policies**.

Growth in consumption remains robust, supported by strong labour income growth. Wages have continued to pick up as expected, even after factoring out recent minimum wage increases in Ontario and Alberta. The Bank will continue to assess labour market data for signs of remaining slack.

Some **progress has been made on the key issues** being watched closely by Governing Council, particularly the dynamics of inflation and wage growth. This progress reinforces Governing Council's view that **higher interest rates will be warranted over time, although some monetary policy accommodation will still be needed to keep inflation on target**. The Bank will also continue to monitor the economy's sensitivity to interest rate movements and the evolution of economic capacity. In this context, **Governing Council will remain cautious with respect to future policy adjustments, guided by incoming data**.

Information note: The next scheduled date for announcing the overnight rate target is May 30, 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 July 11, 2018.

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