Desperate times call for drastic action

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Rate Statement

After consecutive 50 basis point rate hikes in April and June, the Bank of Canada increased their pace of tightening, lifting the overnight target by a full percentage point to 2.50%. 75 basis point had been the widely-held expectation by markets and economists alike but the Governing Council judged it was appropriate to ‘front-load the path to higher rates’. Today’s move brings the policy rate into middle of the Bank of Canada’s estimated 2–3% neutral range but the trajectory from here is still highly uncertain. As for guidance, it’s notable that the Bank no longer says it might have to act more forcefully, or act forcefully at all. Instead, the Bank reiterated that “interest rates will need to rise further” with the pace of hikes being dictated by the Bank’s assessment of the economy and inflation. The statement does now say that the GC “is resolute in its commitment to price stability and will continue to take action as required to achieve the 2% inflation target” but that does little to signal the magnitude of a September hike.

When it comes to the BoC’s balance sheet, there’s nothing new to report here. With the April decision ushering in the start of quantitative tightening, balance sheet run-off is now on autopilot, dictated by the Bank’s bond holdings.

Elsewhere in the rate statement, the Bank highlighted another upside surprise to inflation. As discussed in greater detail below, Canadian inflation “is higher and more persistent” than previously thought. Qualitative language on price pressures remains consistent with a central bank who is desperate to grapple inflation and, as importantly, inflation expectations back under control. The statement said that “domestic price pressures from excess demand are becoming more prominent”. Meanwhile, it acknowledged rising expectations in the recent Business Outlook Survey, which raises the risk that “elevated inflation becomes entrenched in price- and wage-setting”. As for the economy, the statement highlighted “further excess demand” has built up. While housing activity “pulls back following unsustainable strength”, consumption remains “robust”, business investment “is solid” and exports “are being boosted by elevated commodity prices”. And on the labour market, the Bank acknowledged continued tightening which is leading to increasing wage pressures.

Monetary Policy Report

The central bank also released the latest edition of its Monetary Policy Report (MPR) which included a downward revision to the global growth forecast for this year (from 3.5% to 3.3%), made to reflect the impacts of the war in Ukraine, lockdowns in China and the tightening of monetary policy by many central banks which was causing financial conditions to tighten. The BoC then anticipated the global economy to expand 2.0% in 2023, significantly less than the 2.5% penciled in the April MPR.

Turning to Canada, the BoC acknowledged a strong rebound in hard-to-distance service sectors consistent with the removal of most public health restrictions. With other sectors already more than fully recovered, the BoC even said that the Canadian economy was now “clearly” in excess demand. It nonetheless signaled that growth was showing signs of slowing. High prices for energy and food were indeed forcing households to allocate more of their disposable income towards these items, leaving them with less money to spend on other goods and service. Looking ahead, the Bank also expected consumption to be negatively impacted by higher interest rates, which were likely to increase the cost to finance big-ticket purchases and translate into “significantly larger” mortgage payments for some households. As for foreign demand, the BoC expected it to weaken, thereby leading to slower growth in exports and business investment in Canada.

After a strong showing in 2022 (+3.5%, still lower than the +4.2% penciled in the previous edition of the MPR), economic growth was thus anticipated to slow to 1.8% next year (down from 3.2% prior). Further down the horizon, the BoC expected GDP to expand 2.4% in 2024. Overall, these revisions left the level of real GDP at the end of 2023 1.75% below the April estimate. As for the output gap, the bank estimated it at around +0.5%/+1.5% in the second quarter, up from -0.25%/+0.75% in the first quarter.

As expected, policymakers significantly increased their CPI inflation projection for this year (from 5.3% to 7.2%) and next (from 2.8% to 4.6%). Global factors such as food and oil prices, as well as elevated transport costs, remained the main driver of inflation but the BoC noted that domestic demand pressures had become more prominent. Specifically, the strength of the labour market—which the central bank described as “tight along all dimensions”—was now pushing up wages. The BoC also noted that consumer and business inflation expectations had moved higher recently, something which suggested “greater uncertainty about the future path of inflation” and “increased[ed] risk that inflation expectations [would] become de-anchored.” Reflecting these concerns, the BoC expected CPI inflation to average around 8% in the middle quarters of 2022. It then anticipated it to ease to roughly 3% by the end of 2023 and return to target by the end of 2024 thanks to an easing of global supply chain problems and a decline in energy prices. Higher interest rates were also expected to soften demand, reducing domestic inflationary pressure.
Press Conference

It was a bit of a mixed bag in the press conference. Certainly, Macklem indicated that they still think we’re on track for a soft landing but did concede that “the path to this soft landing has narrowed” because of persistent inflation. Taking a page out of Fed Chair Powell’s book, Macklem also stated that they believe still-elevated job vacancies mean that unemployment needn’t rise materially as the BoC continues to raise rates. On housing, the tone struck by the BoC was similar to what we read in the Financial System Review. They’re aware that higher rates will add to household difficulties, but they note that higher variable mortgage rates will only immediately impact a small share of Canadian households. As it relates the today’s hike, Macklem defended the decision by noting that “front-loaded tightening cycles tend to be followed by softer landings.” In Macklem’s view, “this argues for getting our policy rate quickly to the top end or slightly above the neutral range.”

Bottom Line:

Well, that was unexpected. While we’d been looking for the Bank to ratchet up their tightening pace to 75 basis point today, we certainly didn’t foresee a 100 basis point move. Clearly, this is a central bank desperate to wrangle inflation (and expectations) back under control, which is proving difficult given Canada’s still solid near-term economic outlook and tight labour market. While rates are sure to climb further, the near-term policy outlook, even for September is highly uncertain. On one hand, the Bank is highlighting the benefit of ‘front-loading’ rate hikes (an aside: with how far behind the curve the BoC is, can we really characterize this as front-loading?). With Macklem noting that this argues for the policy rate getting to the ‘top end or slightly above the neutral range quickly’, why not just rip the band-aid off and hike 75 or 100 bps again in September? On the other hand, the Bank has no longer made any kind of commitment to act ‘forcefully’. This would suggest a slower, more cautious move in September (perhaps 50 bps to bring us to the top of the neutral range).

Over the medium term, there’s plenty of uncertainty too. Macklem’s comments suggest the high watermark for the overnight rate might be in the low-to-mid 3% range. However, economic and inflation forecasts in the Bank’s MPR are not consistent with that, in our view. To us, nearly-2% real GDP growth in 2023 does little reduce excess demand. Meanwhile, an inflation projection of 4.6% in 2023 (3.2% Q4/Q4) doesn’t suggest that the Bank will have room to stop hiking at a barely restrictive level. As Macklem said in his opening statement, “The way to protect people from high inflation is to eliminate it. That’s our job, and we are determined to do it”.

From our perspective, we’re looking for a far more tepid inflation outlook next year and we’re also expecting slower growth than the Bank is projecting. Our economic/inflation outlook is far more consistent with the Bank tapping out in the low-to-mid 3% range than the outlook laid out in the MPR. As a result, our terminal rate expectation won’t be meaningfully altered by today’s decision (our Fixed Income Monitor to be released later this week will outline our full suite of forecasts) but we’d stress that uncertainty on the ultimate destination for policy has only grown today.
Bank of Canada increases policy interest rate by 100 basis points, continues quantitative tightening

The Bank of Canada today increased its target for the overnight rate to 2½%, with the Bank Rate at 2¾% and the deposit rate at 2½%. The Bank is also continuing its policy of quantitative tightening (QT).

Inflation in Canada is higher and more persistent than the Bank expected in its April Monetary Policy Report (MPR), and will likely remain around 8% in the next few months. While global factors such as the war in Ukraine and ongoing supply disruptions have been the biggest drivers, domestic price pressures from excess demand are becoming more prominent. More than half of the components that make up the CPI are now rising by more than 5%. With this broadening of price pressures, the Bank’s core measures of inflation have moved up to between 3.9% and 5.4%. Also, surveys indicate more consumers and businesses are expecting inflation to be higher for longer, raising the risk that elevated inflation becomes entrenched in price- and wage-setting. If that occurs, the economic cost of restoring price stability will be higher.

Global inflation is higher, reflecting the impact of the Russian invasion of Ukraine, ongoing supply constraints, and strong demand. Many central banks are tightening monetary policy to combat inflation, and the resulting tighter financial conditions are moderating economic growth. In the United States, high inflation and rising interest rates are contributing to a slowdown in domestic demand. China’s economy is being held back by waves of restrictive measures to contain COVID-19 outbreaks. Oil prices remain high and volatile. The Bank now expects global economic growth to slow to about 3½% this year and 2% in 2023 before strengthening to 3% in 2024.

Further excess demand has built up in the Canadian economy. Labour markets are tight with a record low unemployment rate, widespread labour shortages, and increasing wage pressures. With strong demand, businesses are passing on higher input and labour costs by raising prices. Consumption is robust, led by a rebound in spending on hard-to-distance services. Business investment is solid and exports are being boosted by elevated commodity prices. The Bank estimates that GDP grew by about 4% in the second quarter. Growth is expected to slow to about 2% in the third quarter as consumption growth moderates and housing market activity pulls back following unsustainable strength during the pandemic.

The Bank expects Canada’s economy to grow by 3⅞% in 2022, 1⅝% in 2023, and 2⅔% in 2024. Economic activity will slow as global growth moderates and tighter monetary policy works its way through the economy. This, combined with the resolution of supply disruptions, will bring demand and supply back into balance and alleviate inflationary pressures. Global energy prices are also projected to decline. The July outlook has inflation starting to come back down later this year, easing to about 3% by the end of next year and returning to the 2% target by the end of 2024.

With the economy clearly in excess demand, inflation high and broadening, and more businesses and consumers expecting high inflation to persist for longer, the Governing Council decided to front-load the path to higher interest rates by raising the policy rate by 100 basis points today. The Governing Council continues to judge that interest rates will need to rise further, and the pace of increases will be guided by the Bank’s ongoing assessment of the economy and inflation. Quantitative tightening continues and is complementing increases in the policy interest rate. The Governing Council is 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 September 7, 2022. The Bank will publish its next full outlook for the economy and inflation, including risks to the projection, in the MPR on October 26, 2022.
General

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