January 17, 2018

BoC reacts to strong data but remains preoccupied by NAFTA

As we had expected, the Bank of Canada increased the overnight rate to 1.25% today. The central bank acknowledged the string of strong data and says the economy is "operating roughly at capacity". The BoC upgraded its Canadian GDP growth forecasts slightly to 2.2% for 2018 (from 2.1%) and to 1.6% for 2019 (from 1.5%). The 2018 upgrade was due to slightly better contributions from consumption and housing. Real gross domestic income is expected to rise 2.4% this year and by 1.7% in 2019 (both up one tick from last October's MPR). Potential GDP growth is "assumed to average 1.6% over 2018-2019". The BoC expects consumption and residential investment to contribute less to growth going forward (in light of rising interest rates and new mortgage rules) and business investment and exports (thanks to increased U.S. demand stemming from tax cuts) to contribute more to growth. But the main source of concern to the BoC is trade: "as uncertainty about the future of NAFTA is weighing increasingly on the outlook, the Bank has incorporated into its projection additional negative judgement on business investment and trade."

The central bank sees inflation remaining close to 2% over the forecast horizon although uncertainties remain with regards to the impact of rising potential GDP via increased investment, firm creation and labour participation. Wage growth is also uncertain given that it is "rising by less than would be typical in the absence of labour market slack."

The BoC said that while higher interest rates are expected to be warranted, "continued monetary policy accommodation will likely be needed to keep the economy operating close to potential". The BoC again mentioned it will be cautious in making future adjustments to the policy rate given the economy's sensitivity to interest rates amidst high household indebtedness.

In its updated Monetary Policy Report, the BoC raised its forecast for world growth to 3.6% for this year with significant upgrades for the U.S., the Eurozone and Japan. The BoC expects the U.S. economy to grow 2.6% this year and 2.3% in 2019.

Press conference:

Not surprisingly, a large part of the press conference dealt with uncertainties related to NAFTA. Governor Poloz suggested it is challenging to quantify the impacts of a failure of NAFTA negotiations given that several scenarios can be built and different economic models will give different answers. However, business contacts are telling the BoC that the current uncertainty is already affecting investment decisions. Some firms are reportedly choosing to postpone investment, while others are investing south of the border. In either case, this is a negative for the current economic outlook and the reason why the Bank decided to incorporate into its projections additional negative judgement on business investment and trade. Given the erosion of competitiveness on international markets during the last recession and headwinds brought by current trade negotiations, the Bank believes it will likely need to maintain some degree of monetary policy accommodation.

Bottom line:

A dovish interest rate hike from the Bank of Canada was always in the cards. The central bank, which previously said its actions are data-dependent, was forced to adjust its stance amidst strong data. But it tried to pare back expectations of additional rate hikes via cautionary language including concerns about NAFTA-related risks and uncertainty about inflation. The dovish spin was reinforced by the BoC saying that even though the output gap is closed, it still thinks "continued monetary policy accommodation will likely be needed to keep the economy operating close to potential". Based on that statement, we expect a pause until late May, which will give the BoC some time to assess the impacts on the economy of slightly tighter policy, B20 regulations and NAFTA-related developments. But given our own outlook i.e. 2.5% for Canadian GDP growth in 2018, we continue to call for three additional rate hikes this year. We anticipate a stronger economy this year than what the central bank is calling, in part because of provincial fiscal stimulus (expected to be announced during budget season), the latter not fully accounted for in the BoC's projections.

Krishen Rangasamy/Paul-André Pinsonnault

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

January 17, 2018

The Bank of Canada today increased its target for the overnight rate to 1 1/4 per cent. The Bank Rate is correspondingly 1 1/2 per cent and the deposit rate is 1 per cent. Recent data have been strong, inflation is close to target, and the economy is operating roughly at capacity. However, uncertainty surrounding the future of the North American Free Trade Agreement (NAFTA) is clouding the economic outlook.

The global economy continues to strengthen, with growth expected to average 3 1/2 per cent over the projection horizon. Growth in advanced economies is projected to be stronger than in the Bank's October Monetary Policy Report (MPR). In particular, there are signs of increasing momentum in the US economy, which will be boosted further by recent tax changes. Global commodity prices are higher, although the benefits to Canada are being diluted by wider spreads between benchmark world and Canadian oil prices.

In Canada, real GDP growth is expected to slow to 2.2 per cent in 2018 and 1.6 per cent in 2019, following an estimated 3.0 per cent in 2017. Growth is expected to remain above potential through the first quarter of 2018 and then slow to a rate close to potential for the rest of the projection horizon.

Consumption and residential investment have been stronger than anticipated, reflecting strong employment growth. Business investment has been increasing at a solid pace, and investment intentions remain positive. Exports have been weaker than expected although, apart from cross-border shifts in automotive production, there have been positive signs in most other categories.

Looking forward, consumption and residential investment are expected to contribute less to growth, given higher interest rates and new mortgage guidelines, while business investment and exports are expected to contribute more. The Bank's outlook takes into account a small benefit to Canada's economy from stronger US demand arising from recent tax changes. However, as uncertainty about the future of NAFTA is weighing increasingly on the outlook, the Bank has incorporated into its projection additional negative judgement on business investment and trade.

The Bank continues to monitor the extent to which strong demand is boosting potential, creating room for more non-inflationary expansion. In this respect, capital investment, firm creation, labour force participation, and hours worked are all showing promising signs. Recent data show that labour market slack is being absorbed more quickly than anticipated. Wages have picked up but are rising by less than would be typical in the absence of labour market slack.

In this context, inflation is close to 2 per cent and core measures of inflation have edged up, consistent with diminishing slack in the economy. The Bank expects CPI inflation to fluctuate in the months ahead as various temporary factors (including gasoline and electricity prices) unwind. Looking through these temporary factors, inflation is expected to remain close to 2 per cent over the projection horizon.

While the economic outlook is expected to warrant higher interest rates over time, some continued monetary policy accommodation will likely be needed to keep the economy operating close to potential and inflation on target. Governing Council will remain cautious in considering future policy adjustments, guided by incoming data in assessing the economy's sensitivity to interest rates, the evolution of economic capacity, and the dynamics of both wage growth and inflation.

Information note

The next scheduled date for announcing the overnight rate target is March 7, 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 April 18, 2018.

BoC Policy Monitor

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