NATIONAL BANK OF CANADA
FINANCIAL MARKETS

BoC Policy Monitor

Economics and Strategy

July 12, 2017

Bank of Canada hikes policy rate for the first time in 7 years

Stephen Poloz delivered today his first ever interest rate hike as Governor of the Bank of Canada. The central bank raised the overnight rate to 0.75%, a first rate increase in almost 7 years, a move that was widely expected by markets. The decision to tighten monetary policy was supported by the BoC's confidence that above-potential growth will absorb excess capacity in the economy. The central bank raised its real GDP growth forecast for both this year to 2.8% (from 2.6%) and next year (up one tick to 2%). The reason for the 2017 upgrade was not only the stunning Q1 (when growth surged to 3.7% annualized), but also a solid follow-up with Q2 and Q3 pegged at 3.0% and 2.0% respectively. While it acknowledged that inflation remains low, the central bank blamed temporary factors and "the lag between monetary policy actions and future inflation".

In its updated Monetary Policy Report, the BoC raised its forecast for world growth by one tick to 3.4% this year (from 3.3%). Part of the increased optimism about the global outlook was due to the U.S. whose 2017 growth was revised up one tick to 2.2% and the euro area whose growth was raised three ticks to 1.9%. China's growth was raised one tick to 6.6%, while oil-importing emerging economies were raised three ticks to 4%. Next year's global growth was estimated at 3.4% as well, with a moderation in the U.S. and the Eurozone offset by higher growth in the rest of the world.

For Canada, the upgrade to 2017 growth was largely due to consumption and inventories, while investment is now seen to be slightly less of a drag on growth than previously thought. Those upgrades more than offset downgrades to contributions from government and trade, the latter now expected to be a drag on growth due to larger imports (which explains the upgrade to inventories). The contribution of housing was left unchanged for both this year and next, although those point to diminished contribution from that sector over time: "Macroprudential and housing policy measures, as well as higher longer-term borrowing costs resulting from the projected gradual rise in global long-term yields, are all expected to weigh on housing expenditures". Real gross domestic income is expected to rise 4% this year, versus 3.6% in last April's estimate.

The estimate of Canada's potential GDP growth was left unchanged at 1.0-1.6% for this year. The BoC estimates the output gap at the end of 2017Q2 was about 0.5%. Thanks to the growth upgrades, the central bank now expects slack to be eliminated by the end of this year, two quarters earlier than what it had expected in the last MPR. The BoC's estimate of the neutral policy rate was left unchanged at 2.50-3.50%. The central bank's inflation forecasts were lowered slightly for this year but the BoC still expects inflation to be close to 2% by next year.

Press conference:

Asked if today`s rate hike should be seen as a first step in removing the "insurance policy" taken in 2015 or the beginning of a series of upcoming rate hikes, Governor Poloz pointed out that since 2014 the economy has evolved and may behave quite differently than prior to the oil shock. So, one should not take the policy rate of 2014 as a reference point. The economy may be more sensitive to higher interest rates than in the past given the accumulation of household debt for example. However, the Governing Council is confident that the economy can absorb today`s rate hike. While monetary policy is not on a pre-set course, rates should be expected to be higher over time. The policy stance will be adjusted according to the evolution of the economic outlook.

Bottom line:

The central bank's decision to raise the overnight rate by 25 basis points was expected by markets. The decision to tighten monetary policy was backed by a more optimistic take on the economy as evidenced by an upgrade to Canada's 2017 real GDP growth forecast to 2.8% — the central bank expects a solid follow-up to the strong first half. Does that mean the BoC will raise rates again at its next meeting? It's unclear, given the inflation outlook. While it seems confident inflation will return to 2% in 2018, the BoC acknowledged some risks to that forecast. The slowdown in inflation of some advanced economies (including Canada) may be due to "common factors" such as downward trend in inflation expectations, which would call for a cautious approach in policy normalization. At this point, we still think there is another rate hike slated for this year.

Krishen Rangasamy/Paul-André Pinsonnault

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

July 12, 2017

The Bank of Canada is raising its target for **the overnight rate to 3/4 per cent**. The Bank Rate is correspondingly 1 per cent and the deposit rate is 1/2 per cent. **Recent data have bolstered the Bank's confidence in its outlook for above-potential growth** and the absorption of excess capacity in the economy. **The Bank acknowledges recent softness in inflation but judges this to be temporary**. **Recognizing the lag between monetary policy actions and future inflation, Governing Council considers it appropriate to raise its overnight rate target at this time.**

The global economy continues to strengthen and growth is broadening across countries and regions. The US economy was tepid in the first quarter of 2017 but is now growing at a solid pace, underpinned by a robust labour market and stronger investment. Above-potential growth is becoming more widespread in the euro area. However, elevated geopolitical uncertainty still clouds the global outlook, particularly for trade and investment. Meanwhile, world oil prices have softened as markets work toward a new supply/demand balance.

Canada's economy has been robust, fuelled by household spending. As a result, a significant amount of economic slack has been absorbed. The very strong growth of the first quarter is expected to moderate over the balance of the year, but remain above potential. **Growth is broadening across industries and regions and therefore becoming more sustainable**. As the adjustment to lower oil prices is largely complete, both the goods and services sectors are expanding. Household spending will likely remain solid in the months ahead, supported by rising employment and wages, but its pace is expected to slow over the projection horizon. At the same time, exports should make an increasing contribution to GDP growth. Business investment should also add to growth, a view supported by the most recent Business Outlook Survey.

The Bank estimates real GDP growth will moderate further over the projection horizon, from 2.8 per cent in 2017 to 2.0 per cent in 2018 and 1.6 per cent in 2019. **The output gap is now projected to close around the end of 2017**, **earlier than the Bank anticipated in its April Monetary Policy Report (MPR).**

CPI inflation has eased in recent months and the Bank's three measures of core inflation all remain below 2 per cent. The factors behind soft inflation appear to be mostly temporary, including heightened food price competition, electricity rebates in Ontario, and changes in automobile pricing. As the effects of these relative price movements fade and excess capacity is absorbed, **the Bank expects inflation to return to close to 2 per cent by the middle of 2018**. The Bank will continue to analyze short-term inflation fluctuations to determine the extent to which it remains appropriate to look through them.

Governing Council judges that the current outlook warrants today's withdrawal of some of the monetary policy stimulus in the economy. Future adjustments to the target for the overnight rate will be guided by incoming data as they inform the Bank's inflation outlook, keeping in mind continued uncertainty and financial system vulnerabilities.

Information note

The next scheduled date for announcing the overnight rate target is September 6, 2017. 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 25, 2017.

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