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July 13, 2022

Bank of Canada: into the neutral zone

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After being overtaken by the Fed in June, the Bank of Canada reclaimed its top gun status, with the highest policy rate among G7 countries and the biggest step in this tightening cycle, as it seeks to calm inflation fears. Exceeding most expectations, the overnight rate was raised by 100 basis points to 2.5% in what is the biggest increase by the Bank of Canada since 1998 and the highest level since 2008. The policy rate now sits in the middle of the estimated neutral rate range of 2-3%. In addition, the Bank will continue with quantitative tightening.

Markets anticipate that rates will need to go well above the top of the neutral range, and while we think that they may now go to 3.25%, the qualification of this larger step as "front-loading" means they may not go beyond that. The economy has not seen a policy rate this high since the fall of 2008. A lot has happened in the intervening years - a Great Financial Crisis, the oil price shock of 2014, a pandemic and a war in Europe – so it is impossible to be confident about how households and firms will react. That's partly why we believe that the Bank will be more cautious in going beyond their estimated neutral range of 2-3% as they try to assess the economy's reaction.

- The statement cites clear excess demand in the economy and inflation expectations as drivers of high inflation and reasons for front-loading interest rate increases. In fact, both the statement and the MPR have put the spotlight on inflation expectations. For the first time, the Bank cites rising inflation expectations as one of the reasons for raising rates, as it acknowledges that the risks of de-anchoring have increased. It further attributes some of the ongoing price pressures to higher inflation expectations and has tied its projection of inflation to the outlook for expectations.
- The Bank added a box on the risk of a wage-price spiral. The box implies that they would have to tighten monetary policy a lot more in the event that a wage-price spiral emerged. Front-loading the tightening helps to reduce the likelihood that they will have to be more aggressive later. This is a risk we flagged in a recent report.
- The inflation forecast was revised up significantly, with the Bank now expecting CPI inflation to stay around 8% for the next few months. They attribute this surprise to higher commodity prices, but also more excess demand and rising inflation expectations. The Bank forecasts that inflation will end the year at 7.5% (from 4.5% previously) before easing slower than forecasted in April to 3.2% by end 2023 (previously 2.4%), still above the target range. Inflation is projected to return to target by end 2024. The deceleration in inflation is expected to come from a decline in commodity prices and an easing of global supply disruptions, but also from a reduction in shelter inflation as interest rate hikes cool the housing market.
- Meanwhile, the economic growth forecast was revised down due to lower supply, as supply chain disruption are assumed to weigh more and for longer on activity than expected in April, lower household spending in the face of higher inflation and higher interest rates, and slower global growth. As a result, the MPR GDP growth forecast was downgraded to 3.5% for 2022 (previously 4.2%) and 1.8% for 2023 (prev. 3.2%).
- Excess demand is still partly due to supply constraints, which, despite the downgrade, leaves some room for decent economic and productivity growth as disruptions are eased.

Implications & actions

Re: Economic forecast — The Bank's growth outlook is now much closer to our forecast, partly due to the reaction of the slowdown of the economy in response to high inflation and interest rates hikes. The Bank seems determined to get to the finish line as quickly as possible. They are likely considering a move of 75 bps in September, and it will take some downside data surprises to hold them to 50. Going above 3 percent this year might open the door to a small rate cut next year if as we expect inflation will dissipate a bit faster than what the Bank foresees.

Re: Markets — Bond yields had already climbed on the US inflation numbers and continued to march a little higher after the announcement. The Canadian dollar appreciated slightly. Overall, markets had a relatively muted reaction despite the surprise, which suggests that participants buy the qualification of "front-loading" rather than view that the larger hike suggest a much higher finish line.