

Economics

ECONOMIC FLASH!

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Bank of Canada Says We're Not There Yet

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For those asking “are we there yet?”, the Bank of Canada answered “not yet,” signaling that today’s outsized hike still leaves rates shy of where it believes they will need to be to quell inflation. The 75 bp hike to an overnight rate of 3.25% was widely expected, but we took note that the final paragraph opted to retain the view that “interest rates will need to rise further.” We’ll therefore be lifting our target for the end of this tightening cycle, with another 25-50 bps on tap for October.

Even in October, the Bank is likely to want to leave the door open for a further move until it gets more definitive evidence of a deceleration in growth and inflationary pressures. We see that as likely to be in evidence over the next two quarters, probably not fast enough to forestall at least a small further hike in October, but in time to have the Bank of Canada stand pat in December. A front-end loaded strategy for rate hikes is designed to take rates up quickly, but also behooves the central bank to pause at some point to see how the economy is coping, given that there is a lag in seeing that response in growth, and an even longer lag for its impacts on inflation.

In justifying another large bump, the statement red-flagged the more positive signposts for growth and more worrisome aspects of inflation, while downplaying some of the softer indicators. It noted the high recent core CPI reading as a reason to give less weight to the gasoline-related drop in headline prices. It expressed concern about high short-term inflation expectations, while opting not to mention the reasonably well-anchored expectations further out. While conceding Q2 real GDP growth missed their forecast, they emphasized the strength of domestic demand.

There were only two small nods towards a hint that rate hikes might come to an end anytime soon. They expect growth to slow ahead, and cited the moderation in resource prices other than natural gas. A member of the Governing Council has a chance to add some colour to today’s short statement in remarks tomorrow, but this is one case where they might opt to hold off on anything material until the MPR in October, given some of the conflicting cross currents in recent data, and the need to have a fully updated forecast before weighing in too strongly about what lies ahead.

Implications & actions

Re: Economic forecast — The BoC appears ready to sacrifice more growth than we expected to get inflation falling on a faster trajectory, and we’ll be bumping down our GDP projections for Canada in an updated forecast to be released next week. While the Bank could opt for as little as an extra quarter point, had they been convinced that 3.5% was the ceiling, they could have done that move today, so we’ll have to give some thought to whether they’re thinking of a 3.75% rate. That would be a half point above what we had built into our prior GDP call, and therefore somewhat material to the outlook.

Re: Markets — Yields had been falling going into the announcement but ticked up a bit on the news, and the Canadian dollar was a bit stronger. The fact that the Fed is also talking fairly tough these days, and might also be leaning to hike a bit more than we had projected, dulls the benefits to the loonie of a more hawkish Bank of Canada. We still judge it as unlikely that the peak overnight rate in Canada will end up exceeding that of the US.

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