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## Bank of Canada: Dr. Macklem tries to avoid an overdose

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The medicine we have to take to get inflation under control has some painful side effects, so it's important to get the dosage right. Dr. Macklem is trying to do just that in his role as Bank of Canada Governor, and today's decision to leave interest rates on hold reflects the fact that Canada's economy is already seeing some of those side effects, rather than a judgement that our inflation maladies have been cured. While the Bank is clearly unhappy with the very limited progress seen of late on core inflation measures, and has raised it's near term forecast for inflation somewhat, its willing to let the medicine we've already taken work its way through a sluggish economy into a deceleration in price pressures. But it still has retained its warning that higher interest rates would be in the offing if the inflation data persist in disappointing their projections.

- There were few surprises for financial markets in either the rate decision today or what it had to say in the accompanying statement and policy report. The disappointments in second and third quarter growth necessitated a downward revision to 2023 GDP projection (to 1.2% from 1.8% previously) but the lack of momentum also shifted the 2024 forecast into a lower gear (to 0.9% from 1.2%). These aren't yet painting a picture of an outright recession, but are slow enough to continue to open up economic slack and drive the unemployment rate somewhat higher.
- On the inflation front, a higher assumption for energy prices and the stickiness of core inflation bumped up the near term CPI outlook, which decelerates to 2.5% by Q4 of 2024 (versus 2.2% previously), but then gets to the prior target of 2.1% by the end of 2025. The text of the MPR is a bit more balanced on the inflation story rather than uniformly hawkish, as was more the case when they were hiking. And the Bank echoed what we said in Friday's Week Ahead, in noting in the MPR that the slowing in demand comes first, and the decline in inflation shows up later, after the softness in demand has opened up sufficient economic slack.
- By one measure, we're already starting to see that slack, if you buy into the Bank's judgement that the output gap is now slightly negative as of the end of Q3 (in a range of -0.75% to +0.25%). But the output gap, based on comparing actual GDP to a measure of the economy's non-inflationary potential output, has been an unreliable steering mechanism ever since the pandemic caused havoc with productivity measures. Instead, we see the Bank as more reliant on measures of labour market slack. The Bank notes that as of Q3, the labour market, while easing somewhat, was still "tight" overall, and generating upward pressures on wages.
- Here too, the central bank needs to be patient, as high job vacancies have meant that many of those losing their jobs have thus far been able to find another position quickly. The slowing economy is seeing those vacancies rapidly being filled up, which should soon see weak hiring translate into a further climb in the jobless rate and softer wage inflation next year. The Bank is concerned about "corporate pricing behaviour", but from our perspective, a cooling in labour income growth and the squeeze on spending power from higher mortgage rates will, over time, see companies that try to push through larger or more frequent price increases finding their sales drying up enough to force a return to more modest price hikes. There's nothing like a pile-up of inventories to prompt a flurry on "on sale" stickers.
- That's still, however, a forecast. In the here and now, with core inflation well above 2%, the Bank is still months away from dropping its warning that rates could have to climb again, let alone even whisper about an eventual easing. The warning could disappear if we get another significant leg down in core inflation, while any mention of rate cuts would have to be in the context of labour markets no longer looking tight and a path to 2% inflation being self-evident.

**Re: Economic forecast** — We'll stick to our view that the Bank of Canada has already delivered enough rate hikes to keep growth under wraps, and bring inflation down on a somewhat faster trajectory than its latest forecasts. That good news on the inflation front, and not so good news for growth, should be sufficient to bring a policy ease towards mid-2024, with overnight rates getting to 3.5% by the end of that year. While that seems a long way from where we are now, its still twice the peak interest rate of the prior cycle, and above the level that the Bank of Canada judges as neutral for economic growth.

**Re: Markets** — This was largely a "no surprise" policy announcement for markets, and there wasn't anything in the MPR that should have shocked forecasters, with the economic slowdown well baked into consensus forecasts at this point.

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