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Bank of Canada sees less room to run

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The Bank of Canada sees less elbow room for non-inflationary growth, and that has the central bank slightly advancing the timetable for a climb in interest rates even as it slashed its GDP forecasts. It's now moved to only reinvesting maturing Government of Canada bonds rather than adding to its portfolio in its QE program, and hinted that rate hikes could begin the middle two quarters of 2022, when it has the output gap closing, as opposed to its prior timetable that centred on the second half of 2022. Covid-19 remains the villain in the story, having suppressed activity and elevated inflation at the same time, and the Bank is concerned that global supply chain disruptions and less capital spending growth will cut into the economy's non-inflationary capacity to produce goods and services on a more sustained basis. But at the same time, the Bank is more optimistic about 2021-22 economic growth than our latest projection, which also makes it a bit more hawkish on when rate hikes will be appropriate.

- A major disappointment in Q2 growth did not lead the Bank to adjust the starting point for the output gap as much as we expected. That seemed to include a backdated reduction in potential growth, but also reflects a forecasted 5.5% annualized GDP gain in Q3 (well above our current call). Even with that, GDP growth this year was revised down by nearly a percentage point to 5.1%, and also trimmed by 0.3% points to 4.3% for next year. Both of these forecasts lie above CIBC projections.
- So how does that get the economy to its full potential a bit earlier than the prior projection? Because the Bank has once again tweaked its estimate for the economy's potential GDP, the level it can attain without lasting inflation pressures, cutting potential growth by 0.2% per year over the 2021 to 2023 period. In the text of its rate decision, it ties some of that to supply disruptions, and in the MPR, the reductions ahead are linked to a weaker path for business investment.
- We're a bit skeptical that a three year estimate for potential should have changed that much in the space of only a few months, and note that the Bank has been moving its potential GDP in both directions during the pandemic. One factor that has leaned that way has been the better pace of job creation despite the downside surprises in GDP, which hint at poor productivity growth. But hours worked haven't been that impressive, and given the volatility in labour force survey data, we might see a period in which softer job growth brings the employment data into better alignment with GDP.
- Not surprisingly, the inflation outlook shows more heat in the near term, running at 4.8% year-on-year in Q4 of this year, but decelerating to 2.1% by the final quarter of 2022. But remember, that includes any cushioning impact of rate hikes that the Bank thinks it will deliver in the year ahead, although most of it will rest on a an easing in global inflation pressures and a levelling in oil prices, as well as diminished base effects. And the Bank stated that it is currently more concerned with upside risks to inflation, as would inevitably be true when inflation is sitting above its target.
- There is still a lot of room for reasonable people to disagree on each of these key projections. We'll get a first test of this outlook in upcoming data on monthly GDP and employment, but by the time the next MPR is issued, we might have a better sense on whether supply chain disruptions are beginning to ease, and whether that in turn is opening up more room for non-inflationary growth.

Implications & actions

Re: Economic forecast — To be frank, we're surprised by the Bank's optimism on the Q3 outlook, and a bit surprised by the extent of its downward adjustment to potential growth. The combination of those two steps meant that instead of marginally pushing back the timetable for the closing of the output gap, the Bank moved it ahead by a quarter. But, as they say, the proof is in the pudding. Should Q3 GDP come in short of the Bank's forecast, that would be a first step towards delaying the output gap closing.

Re: Markets — Despite the fact that the market was already pricing in four quarter point hikes for 2022, yields jumped and the Canadian dollar rallied on the release of the statement. We'll need data to show the economy underperforming the BoC forecast, and further out, some healing of inflation pressures, to turn that tide.

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