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Bank of Canada: Moving onto the sidelines

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The Bank of Canada hiked interest rates one more time, but gave a more explicit signal than anticipated that it was now moving onto the sidelines. The 25bp increase, taking the overnight rate to 4.5%, was well anticipated by the consensus. However the change in guidance was not, with the Bank now explicitly stating that if the economy evolves as it expects, then the policy rate will be kept on hold at its current level. With the Monetary Policy Report's forecasts for GDP growth and inflation little changed from October and a touch stronger than our own, we suspect that the economy will indeed evolve in-line or even a bit weaker than the Bank suspects, and that today's hike in interest rates will mark the final one of this cycle.

Justifying today's 25bp hike, the Bank pointed to stronger-than-expected growth at the end of 2022, a tight labour market and still elevated short-term inflation expectations. The Bank's forecast of the output gap in Q3 last year was revised higher to +0.75-1.75%, signalling more excess demand than had previously been projected, although the gap is thought to have narrowed a touch in the final quarter. That's based on a 1.3% forecast for Q4 2022 GDP, which is in line with current monthly tracking projections.

The updated MPR projections contain an additional $6.5bn (0.2% of GDP) in combined federal and provincial fiscal stimulus that was announced around the time of the mid-year updates, although overall the growth projections for 2023 and 2024 are little changed relative to the October MPR. GDP growth is expected to be 1.0% this year (previously 0.9%) and 1.8% in 2024 (previously 2.0%). Both of those projections are a little stronger than our own forecasts of 0.7% and 0.9% respectively. In terms of the inflation forecasts, those have come down relative to October, but are still a touch higher than our own projections on average.

Policymakers expressed optimism that inflation was coming under control, in line with those slightly downgraded CPI forecasts. The statement and MPR pointed to an easing in the 3-month rates of core inflation relative to their peaks, and the expectation that overall inflation will come down "significantly" this year due to the energy prices, improvements in supply chains and the lagged effects of higher interest rates. The MPR also mentioned that a stabilisation of wage growth, albeit at levels still above those consistent with a 2% inflation target, meant that the risk of a wage/price spiral had declined. There was also a nod towards immigration and child care reform for helping to stabilise workforce participation even with an ageing labour force, although, overall the labour market was still classed as "tight".

Possibly because of greater confidence that inflation is easing, the Bank changed its guidance to state that if the economy evolves as it expects then the policy rate will be kept on hold at its current level, although the statement also warned that the Bank was willing to raise rates further if needed. In the press conference the Governor reiterated that the evolution of core measures of inflation, including domestically-driven services, will be key in assessing if the Bank has indeed already raised interest rates enough. While the Bank is signaling a move to the sidelines, the Governor pushed back on the prospect of rate cuts this year, stating that it is "far too early" to be talking about that.

Implications & actions

Re: Economic forecast — We had expected that today's 25bp move would be the final one for this cycle, and the change in the Bank's guidance only reaffirms that belief. Even though there is still a slight bias within its communication towards raising interest rates further, today's statement suggests that the Bank will sit on the sidelines for now and wait for

the accumulation of a few month's worth of data rather than necessarily reacting to near-term surprises. We expect that rates will stay at 4.5% throughout the balance of this year, before being eased gradually in 2024.

Re: Markets — The guidance from the Bank towards a pause in interest rate hikes from here, even if it is contingent on the economy evolving as they expect, saw bond yields and the Canadian dollar fall immediately following the decision.

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