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Bank of Canada: Standing on guard against two-way risks

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The Bank of Canada will be standing on guard for thee, but that's not just against elevated inflation, but also sluggish growth and excessive slack, a two-way risk that is keeping interest rates frozen in place. The decision to leave the policy rate at 2.25% came as no surprise given the clouded outlook ahead. The Bank assumed that oil prices will gradually decline to $75/bbl in mid-2027, still lifting near term inflation but leaving the growth outlook little changed from the prior forecast, one that only makes very gradual progress in eliminating economic slack. In its inflation projections, it still has the output gap putting downward pressure on year-on-year CPI way out in 2028.

We can sympathize with the Bank's task in having a report that is fully up to date with a rapidly evolving picture for near term oil prices. It's US$90/bbl average for Q2 of this year looks a tad low given the stalemate in US-Iran talks in the last couple of days, so near term inflation could also be a bit higher than its projections, or indeed, that our most recently published forecasts for the next few months. That said, the Bank sets policy based on the medium term outlook, and its estimate for oil prices further out seems reasonable given that both the US and Iran are under some pressure to reach a deal. In the presser, the Governor stressed that the policy implications would not be just about the level that oil prices reach at a particular point of time, but also about the persistence of that and on evidence of its propagation into other prices. So the key is really about seeing a light at the end of the Strait of Hormuz tunnel, in upcoming months, rather than on the near-term oil market squeeze.

GDP growth in 2026 and 2027 are each a tick faster than the prior forecast, but the range for potential output has also been revised up by a matching amount, implying no change in the degree to which slack will be narrowed. The BoC judges higher oil prices to have a mix of wins and losses for Canada's economy, and our own analysis suggests that only a protracted period of elevated prices that materially accelerated capital spending in the oil patch would generate a net positive for growth.

The Bank also left its neutral rate estimate unchanged, with the middle of the neutral band at 2.75%. We would argue that, given the lacklustre pace for demand in interest sensitive sectors like housing, that neutral could well be a bit lower than the Bank's central estimate.

Inflation has heated up in Canada and abroad on the oil price shock, but the Bank sees “little evidence” of a spillover to core inflation so far, but will keep an eye on that, and “will not let higher energy prices become persistent inflation”. If that sounds hawkish, it's worth noting that the Bank doesn't see that happening, projecting a spike to 3% inflation but a return to the 2% target early next year, a view we share. The Governor said in the press conference that they don't expect to see oil prices rapidly spread to other parts of the economy given the slack in the economy. He cited the distinctions between the excess supply in the economy today and a tighter economy when inflation heated up in the post-COVID expansion.

While the statement says the Bank might need to adjust the policy rate, those changes “can be expected to be small.” That sounds like a central bank that thinks it could stand pat, as it cites both reasons why it might have to cut (due to additional trade restrictions) or hike (if energy prices remain elevated and lead to a broader inflation upturn). If there was one hint of a bias, it was that the Bank mentioned "consecutive" rate hikes if inflation looked persistent, but didn't apply that same adjective when mentioning the possible need for lower rates.

Re: Economic forecast — We don't have reason to alter our call for the Bank of Canada to be on hold this year. Absent the Middle East conflict, persistent economic slack and downward pressure on core inflation might well have induced an ease. But by the time oil prices have sufficiently eased inflation fears, the window for a rate reduction will likely have passed. Our core inflation outlook is sufficiently benign to make a rate hike unwise. We're a few ticks faster than the Bank in our outlook for 2027 growth, enough to envisage a couple of quarter point hikes next year as the output gap narrows, but that's contingent on seeing USMCA talks prevent further trade barriers and provide some small relief from existing sectoral duties imposed on Canada.

Re: Markets — The Canadian dollar was little changed after the announcement, and futures markets showed little response in terms of rate expectations for the end of the year after the release, but increased rate hike expectations during the Governor's press conference.

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