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Bank of Canada: taking action, while preserving room for growth

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The Bank of Canada brought out the big guns in its fight against inflation, but for those fearing the worst, it's noteworthy that it still sees room for the economy to put in two reasonably healthy years for growth as it does that. As expected, the overnight rate was lifted by 50 basis points, and the Bank will let maturing bonds roll of its balance sheet to unwind some of what it bought under quantitative easing. Financial markets were already anticipating both of those moves, as evidenced by the lack of much of a response in the currency or two-year bond yields.

Further out, markets are anticipating a lot more to come with rates topping 3%, and there's already talk about risks of recession as the central bank starts to cool the economy's fires. But within a policy report designed to make the case for the stern action today, there are clues that point to a lower ceiling for interest rates than markets are currently assuming, and evidence that the central bank is going to be careful to avoid snuffing out economic momentum in an economy that, despite tight labour markets, still has room for significant output gains that won't stand in the way of returning to 2% inflation.

- The statement cited the inflationary and negative growth impacts from the Ukraine war, but the Bank's global growth outlook got an offsetting lift from a smaller drag from Covid-19. But for Canada, both growth and inflation data have surprised on the upside, and the Bank sees the economic momentum extending into the second quarter, with that picture supporting its choice for a larger rate hike today. Simply put, the recent data leave little doubt that the economy can live with a jump to a 1% overnight rate, and indeed, higher rates beyond that. But how high?
- The economic growth forecast for 2022-23 was little changed, with this year's real GDP nudged up two ticks to 4.2%, and next year's edged down four ticks to 3.1%. Those are somewhat above our forecasts, perhaps because we leave a bit of room for Covid-related disruptions ahead and more sensitivity to higher rates.. But what's noteworthy is that the Bank's projection allows for quite healthy growth rates by historical standards, well above what would typically be thought of as consistent with easing inflation in an economy nearing full employment, and in which demand is already running ahead of the economy's ability to meet it.
- The Bank estimates that gap is being temporarily generated by supply disruptions that are reducing output by roughly 2% of GDP, and while there isn't a lot of real science behind such calculations, the impact is clear when one compares the vigorous employment recovery with the much less stellar rebound in GDP. Since those disruptions are expected to disappear over the forecast horizon, that opens up room for more non-inflationary growth than would normally be the case. That's part of what underpins our view that the Bank if not going to be as aggressive in hiking rates as the market believes.
- We had expect the Bank's updated forecast for the neutral rate of interest to end up in the 2.25%-2.5% range (See our recent In Focus report, Canadian Rate Hikes: Where's the Finish Line, March 28, 2022.) By opting for the higher end of that range as the midpoint of its estimates, the Bank is signally a bit of upside risk to our projection for a 2023 peak of 2.25% in the overnight rate. But it's still well below the market's expectation for rates in excess of 3%, and if the Bank wants to let GDP run faster than its historical potential growth rate (just under 2%), it will have to avoid that sort of overshoot in the hiking cycle.
- The inflation forecast was revised up to end this year at 4.5% (from 3.0% previously) before easing to 2.4% by the end of 2023 (previously at 2.2%), including the cooling impact of its rate hike path. The headline CPI is seen as peaking soon, helped by an easing in the contribution from energy prices and from other supply disruptions, but also by the cooling in demand growth tied to higher interest rates ahead.

- The start of a passive process of quantitative tightening, allowing bonds to mature off the Bank of Canada's balance sheet, will pare the BoC's holdings of Government of Canada bonds by 40% in the next two years. Then what? One clue is that the Bank sees the need for it to retain higher settlement balances (and therefore higher holdings of government bonds) than it did before the pandemic, due to investor preferences for safe liquid assets, changes to the payments system, and regulatory requirements. So while the two year destination might not complete the full QT story, the Bank is signalling that it won't be fully returning to where it stood prior to QT, which will impact what's in store for its balance sheet beyond 2023.

Implications & actions

Re: Economic forecast — We're not quite as bullish on this year's growth outlook, leaving room for some headwinds from Covid at home and abroad, the impact of fiscal tightening at the federal level in the US and Canada, and a bit more sensitivity to higher rates in sectors like housing. As a result, we see no reason at this point to alter our view that, after getting rates up to 1%, the Bank will be a bit more cautious about the pace of further hikes, and will end up at 1.75% this year. There's a bit of upside risk to our call for a peak overnight rate of 2.25% next year, with the Bank now eyeing a neutral rate of 2.5%, but we're still comfortable with our view that rates won't go as far as what's now priced into markets.

Re: Markets — Two-year rates moved up only marginally and the Canadian dollar didn't find much in the way of a new direction after the release of what was, after all, a highly anticipated rate decision.

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