Economics

# ECONOMIC FLASH!

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## Bank of Canada: Dabbing the brakes slightly

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The Bank of Canada hiked interest rates by a further 50bp to take the overnight rate to 3.75% today, although that move reflected a slight dabbing of the brakes relative to the prior pace of rate increases and what was expected by the market heading into today's decision (75bp was almost fully priced in). The press conference put some emphasis on avoiding the damaging consequences of an overshoot and the need to slow rate increases in the face of an economy that has started to slow in response to past increases. Still, with the statement continuing to suggest that rates "will need to rise further" we seem to just be on a slightly more gradual path to the same destination, and as such we continue to expect that rates will peak at 4.25%.

The statement and downgraded growth forecasts within the MPR hint at an economy that is losing momentum maybe a little quicker than previously anticipated. Housing is seen to have retreated "sharply" but there was also reference to consumer and business spending softening, as well as weaker international demand. Growth forecasts of just under 1% next year and 2% in 2024 represent downgrades from where they stood previously and a near brush with recession. Indeed, growth for the final quarter of this year and the first half of next year is expected to be only in the 0-0.5% annualized range each quarter. Consumer spending in particular is expected to be weaker next year that had been expected in July.

However, the downgraded growth forecasts don't necessarily mean that the Bank expects the output gap (which is still seen at between +0.25% and +1.25% currently) closing much earlier than it did in its prior forecasts. That's because forecasts for potential growth within the economy were also downgraded reflecting, among other things, persistent supply chain issues and ongoing staff illnesses related to Covid-19. Because these supply issues are expected to be more persistent, the Bank is no longer providing an estimate of the short-term impact of these on the economy, and instead rolling them into its long-run view of potential.

The downgraded view of potential also means that, even with the weaker growth profile, the Bank still forecasts that inflation won't sustainably move back to its 2% target until 2024. The statement noted that its preferred measures of inflation are not yet showing meaningful evidence of easing. After giving advance notice in the Governor's most recent speech, the Bank has officially moved away from the heavily revised CPI-common when looking at core inflation, and will focus on CPI-trim and CPI-median going forward.

### Implications & actions

**Re: Economic forecast** — While the Bank of Canada slightly under-delivered today in terms of the size of rate hike delivered, its downgraded view of potential growth and continued commitment that interest rates "will" need to rise further doesn't suggest to us that the peak in interest rates will be any lower than we were expecting heading into today's announcement. The press conference opening statement suggested that we are getting closer to the end of the hiking cycle and that, barring a large surprise, steps of 75bps are now behind us. This is consistent with our forecast of a peak rate of 4.25%, and that rates will have to stay at that level at least through the end of 2023 to help bring inflation back down to target.

**Re: Markets** — Bond yields fell in response to the smaller than anticipated rate hike from the Bank and continued to fall during the press conference as the Governor emphasized the desire to avoid an overshoot. However, in good news for policymakers given its potential inflationary impact, the Canadian dollar was little changed and actually remained slightly stronger on the day relative to a depreciating greenback.