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Bank of Canada Mandate: Old wine in new bottles

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The government has handed the Bank of Canada a new mandate that is mostly a case of old wine in new bottles, with the existing flexible inflation targeting with a 2% CPI goal repackaged to highlight features of that approach that, to a significant degree, were already inherent in it. As we anticipated in our Week Ahead article of November 12, the mandate added language surrounding the role of full employment in achieving sustained 2% inflation, a point that Governor Macklem had already made while operating under the prior mandate. But recent events in the job market have essentially made that change moot in terms of its likely implications for monetary policy in 2022.

- The new five year mandate maintains a 2% inflation target, and the 1-3% range. Separately, it says the Bank "will continue" to use the flexibility within the 1-3% band to seek full employment "when conditions warrant". Note that the words "will continue" implies that this is something that the Bank of Canada has already been doing, and "when conditions warrant" implies that the primary goal remains the achievement of the inflation target. It also asserts that its ability to be flexible will be limited by the need to keep inflation expectations grounded at 2%. So this is not a dual mandate with an equal weighting on inflation and full employment, but is still a mandate centred on inflation.
- The statement alludes to idea that structurally low interest rates limits the ability to cut interest rates to provide appropriate stimulus, and thereby creates an incentive to leave rates lower for longer in order to ensure the economy has lifted off. But it says that this might "sometimes" be appropriate, rather than committing to that strategy. It pledges that the government will use other tools (e.g. the type of constraints put on mortgage borrowers in the past decade) to address financial imbalances that might arise when the inflation mandate ends up requiring a long period of low interest rates.
- The prior mandate, while described under the rubric of "flexible inflation targeting", was never acutely driven by short term fluctuations in the CPI, and had allowed for overshoots and undershoots when these were being driven by factors other than too little or too much economic slack. The Bank of Canada has emphasized the output gap as the driver for sustained inflation trends, and in effect, aimed to have the economy running with a zero output gap (GDP right at its non-inflationary potential) in order to achieve the 2% CPI target.
- Since full employment would typically coincide with GDP at potential, in effect, the Bank was also steering the economy towards a full employment target in order to sustain 2% inflation. The Bank had typically not referenced a target jobless rate to the degree that we've seen from the Fed, for example, but did keep track of broad measures of labour market conditions as part of its assessment of economic slack and inflation pressures. Governor Poloz had talked about slack in youth employment, for example, as a reason to not tighten, and the Bank of Canada has developed its own Labour Market Indicator and Wage Common measures to track broad conditions in the job market. The new mandate essentially commits the BoC to continuing to track and comment on these measures.
- The most recent labour force survey data have driven Canada's jobless rate to within a few ticks of the prior cycle's low. The employment rate, which also takes labour force participation into account, has also seen a full recovery. Inflation, including core measures, is now over the midpoint of the target range. Indeed, it's in real GDP measures, rather than in the temperature of the labour market or inflation, where there is still a shortfall. That GDP gap, and concerns over the near term drag from the latest Covid wave, is the reason why the central bank hasn't already raised rates.
- As a result, its unlikely that measures of labour market performance will prove to be the decisive factor for the timing of the first rate hike. Even a central bank with a specific dual mandate targeting inflation and full employment need not

hold interest rates near zero until the labour market gap was at zero. Instead, central banks would typically move off the maximal degree of monetary policy stimulus ahead of full employment, in order to avoid shooting through its target, as there are lags in the economy's response to rate hikes. Since "full employment" is a judgement call that has to depend on watching for signs of unsustainable wage inflation, policy makers have to reduce stimulus early to have the luxury of hiking gradually and letting the data provide the signals for when the labour market is at its capacity.

- While the government has rejected the explicit "average inflation targeting" approach adopted in the US, a lot of that difference is a matter of semantics and communication, and won't impact actual policy much. Both the US and Canada have already had an inflation overshoot. Moreover, the Bank of Canada would typically look through "base effects" in the early part of a business cycle. That is, it might excuse a period in which inflation is over 2% if prices were atypically low in the prior year, and not regard that as a signal of sustained price pressures. That's not materially different than an average inflation regime in practice.
- Markets are looking for a fairly aggressive pace for Bank of Canada rate hikes in 2022. Our call for 75 bps, with the first hike in April, points to a gentler first step, although we have an equivalent dose of follow up hikes in our 2023 projection. That gradualist approach isn't a reflection of any changes made to the BoC mandate, but captures our view that, at least early in the year, progress will be held back by the resurgence of Covid at home and in Canada's export markets.