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Bank of Canada: On the one hand, on the other hand

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Harry Truman famously asked for a one-handed economist, but the Bank of Canada had good reason to deliver an “on the one hand, on the other hand” announcement today. Its decision to keep its policy rate unchanged at 2.25% came as no surprise to markets given the cross currents of a weak labour market, decelerating core inflation, but the threat of an energy shock to inflation ahead. That said, markets seemed to focus more on a warning that the Bank would respond if the energy shock persisted and threatened its inflation targets, rather than on what would seem to be a more likely scenario in a shorter-lived energy shock.

The Bank still expects modest growth ahead, but weaker than it had previously expected in the near term, with “risks to growth tilted to the downside” but, on the other hand, with inflation risks having gone up due to the war. It wasn’t due to make a new forecast, so it opted not to deliver one. It effectively stayed neutral by saying that it is “ready to respond as needed” but giving no signal on which direction such as response might take.

In the opening statement for the press conference, it put a bit more emphasis on the some of the downside implications for growth from higher energy prices than on the boost to income from energy exports, citing financial conditions tightening and the squeeze on consumers. In the presser, it noted that energy prices would have to be persist to really lift energy sector activity. Still, it gave no indication that there was any debate on either cutting or hiking at this point, in line with its perspective that the implications of the energy price shock will depend critically on how long it persists, which simply is unknowable at this point.

But if, and it’s a big if, you buy into the assumption that the oil shock will not be persistent, there's actually a dovish bias to the Bank's thinking that the market isn't really picking up on, despite the fact that most observers aren't counting on a long war. A shorter period of elevated oil prices is judged as unlikely to spill over into core inflation given the existing degree of slack in the economy. The Governor did note in the press conference that they will be watching inflation expectations, but mentioned that long term inflation expectations count, and that they stayed fairly well grounded in the 2022-23 inflation upturn. It's really only in a persistent energy shock scenario in which the Bank has some fighting words.

And even before any concerns about some of the negative growth implications of a short-lived energy shock, the Bank's views on growth and inflation were consistent with a risk that they will need to cut rates further. Its prior growth forecast showed a long road back to a zero output gap, and now it says that things look even a bit worse on that score. It noted that its earlier view that the labour market was turning more favourable was erased by a couple of weak months for employment. It's essentially put a "mission accomplished" check market on where inflation currently sits, so it would have room to stimulate if the oil hit to inflation fades before the economy has seen a more vigorous recovery.

Re: Economic forecast — We don't have reason to alter our call for the Bank of Canada to be on hold this year, in part because we have no greater visibility than the Bank on how long the oil shock will persist. But that puts us on the dovish side versus market pricing, which is building in room for a hike this year. And if the oil shock is over by the summer, there will be more of a risk of a cut this year than a hike, judging by the Governor's comments.

Re: Markets — Yields are up on the day as we write, although we also had a hot reading on the US PPI and higher oil prices filtering into global inflation concerns.

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