



Economic Flash!

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Bank of Canada: A Long and Winding Road

The Long and Winding Road would be the appropriate musical score for the Bank of Canada's July's message, underscoring that the path to a full recovery is both lengthy and uncertain. What is now less uncertain is the central bank's response to that outlook, which is likely to imply holding overnight rates at 0.25% through 2022, and undertaking a sufficient dose of bond purchases to keep yields low across the rest of the yield curve for the coming year.

The Bank's central economic forecast is qualitatively similar to our own, although somewhat more pessimistic in terms of growth through 2021. These days, given the margin of error and the size of the swings, the fact that the BoC's call is below ours by a bit over a half percent in each of the next two years isn't really that material. Some of the gap might owe to the BoC's more pessimistic take on the US for 2020 than the one we published in mid-June, with the very recent news on the virus likely weighing on its assessment.

It sees Canadian real GDP dropping 7.8% this year, with growth of 5.1% in 2021 and 3.7% in 2022. The initial opening up of economic slack was not as large as the plunge in GDP, because the economy's ability to supply goods and services was also sharply curtailed. While potential output will recover as disruptions clear out, its path will be lower than the pre-recession outlook, capturing weaker capital spending, reduced immigration, permanent business closures and skills mismatches for displaced workers.

Nevertheless, potential output will be recovering over time sufficiently to leave material economic slack in 2020 and 2021, and a residual output gap still lingering through 2022. That has the Bank of Canada projecting that we won't see a sustained 2% CPI rate, its key policy target, until post-2022. That's key to translating the Bank's forward guidance, in which it pledges to keep the overnight rate where it is until inflation is sustainably at 2%. While the outlook could change, it's consistent with our view that the timing of the first BoC hike could be similar to that for the Fed, in early 2023.

The BoC did cite research showing that changing consumer spending patterns mean that actual living costs haven't dropped as much as the CPI. But we don't see that as material for monetary policy, since consumer patterns will shift back again as the virus fades away, and the Bank's discussion still puts a lot of weight on the outlook for the conventional headline CPI index.

The Bank of Canada didn't say anything new about its asset purchase program, but that's in part because it wasn't yet pressed to do so. Yields across the curve have been well behaved, despite an onslaught of deficit financing to be done. Moreover, the stated policy is at this point only setting a minimum of \$5 bn per week in Government of Canada bonds and committing to continue that until "the recovery is well underway."

Its language suggests that it's committed to do enough to prevent an untimely material steepening of the curve, particularly if that were to threaten five year rates, as it favourably cited the benefits of its asset

purchase program for mortgage borrowers. But the phrase “well underway” also suggest that QE will end before the policy rate is hiked, implying that the BoC will tolerate a steeper curve as the economy and vaccine research both make progress.

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