



# Economic Flash!

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## *Bank of Canada: A Fine Balancing Act*

If the Bank of Canada wanted to make sure it acknowledged some of the positive developments in terms of wage growth and inflation, while at the same time not giving a sense that interest rates will be rising again immediately, it pulled off a fine balancing act.

There were enough hints within the statement that further rate hikes will be seen later in the year, with the pick-up in core inflation seen as consistent with “little slack” remaining in the economy and stating at the end that “some progress” had been made on key issues such as wages and inflation. However, at the same time there were still mentions of “escalating” risks to the global economy from trade policies and that even though higher interest rates will be needed over time “some monetary policy accommodation” will be required to keep inflation on target. Sum it all up and you have a central bank happy to move interest rates higher still, but only very gradually, and we stick to our forecast for the next hike coming in July, followed by a hold for the balance of the year.

Changes in key forecasts incorporated within the MPR also hint that Poloz and co. could make another hike in the summer, but then take things very slowly from there. In moving its forecast for Q1 GDP down significantly to 1.3%, from 2.5%, it has gone from setting a high bar for near-term growth to setting a fairly low bar. If growth bounces back in February and March as we expect, Q1 GDP could well beat that forecast and give the BoC an excuse to raise rates in July.

However, in contrast the Bank of Canada is now setting a higher bar for growth in the longer-term, given its upgrade to economic potential. Potential output growth was revised up to 1.8% for 2018-20 and 1.9% in 2021, compared to 1.6% in 2018-19 in the January report. That upgrade, combined with slower growth recently, lowered the estimate of the output gap to -0.75 to +0.25 this quarter. Also, the Bank highlighted how much of a negative impact recent policy changes and trade uncertainties with the US are having on growth. The base-case since April 2017 has already incorporated negative judgments related to lowered investment competitiveness due to tax reform and uncertainty regarding trade policy. These impacts combined are expected to have reduced business investment levels by 3% and exports by 1.5% by the end of 2020.

The Bank also hinted that it won't be overacting in terms of interest rates to any pick-up in core inflation over the coming months, particularly the common component measure which upon its initial use appeared to be policymakers' favourite. A footnote within the inflation section of the MPR stated that “CPI-common appears to have been more affected by minimum wage increases than other core measures”. That suggests that even if the common component rises towards the top end of the BoC's 1-3% inflation band, it won't necessarily be met with interest rate hikes. The continued caution regarding drivers of inflation, and higher bar set for economic growth in the longer term, suggest that the pace of rate hikes from here will be very gradual.

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