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Economic Flash!

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Bank of Canada: On Course, But Not Racing Around the Track

Except at the very end of a long tightening cycle, there's no such thing as a truly "dovish" announcement of an interest rate hike. In raising rates a quarter-point today, as was widely expected, the Bank of Canada had to use its statement, and the accompanying Monetary Policy Report, to make the case that the growth and inflation outlook were firm enough that the economy justified, and could live with, another notch higher in rates, with more on the way if all goes according to plan.

Neither core inflation nor Canadian economic growth rates are racing around the track. Further rate hikes could be as slow in coming as the July move was, being delivered a full half-year after the Bank's last move in January. That's not likely the view of Governor Poloz today, but "data dependence" means that any slippage in growth, or fresh trade war concerns, have plenty of time to alter that thinking.

As in April, the Bank's starting point was an economy running close to its non-inflationary potential. The difference was that in the intervening months, we saw evidence of a return to job gains and a pick-up in growth to over 2% for Q2, after three softer quarters. That's the magic number for the Bank of Canada, since it now sees growth in the 2% range as consistent with holding inflation near its target. We say "near" since the Bank is signaling that, in terms of the overall CPI pace, it's willing to see inflation average 2.4% this year, and 2.1% in the subsequent two years, after several years of undershooting the target.

Of course, that includes looking through the temporary impacts of recent gasoline price hikes on the headline CPI figures, with core inflation running roughly on target. The Bank concedes that, for now, its underlying wage series aren't showing the heat they would expect, given other measures of labour market tightness.

What's key to the rate outlook ahead is the extent to which Canada can hit that 2% growth target in the face of further interest rate hikes, and how quickly new evidence will come in to make the case that it can. The Bank rightly notes that housing appears to be stabilizing, but it will still cease to be a growth contributor next year. The consumer spending outlook also has it contributing more than a half-point less to GDP growth than it did in 2017, while government spending will begin to provide a smaller boost come 2019.

That leaves more of the burden on exports and business investment. While providing extensive coverage of the drags on these sectors from ongoing trade frictions, the Bank sees a more than offsetting lift from strong global demand, firmer commodity prices and tight capacity use. **We are more skeptical that businesses will in fact add that needed capacity in Canada**, particularly if the exchange rate against the US dollar firms in response to higher rates.

The MPR explains that the level of GDP in 2020 will be about two-thirds of a percent lower due to trade barriers already imposed and their impact on confidence (i.e. about a 0.2% hit per year to growth), but that of course would not include the hit if autos are hit by US protectionism. Even if, as we expect, the auto tariff is only held out as a threat to be imposed if NAFTA talks fail, that will be an additional hit to Canadian business confidence that might not be fully captured in the Bank's outlook.

As well, the Bank's practice is to assume that the recent average of $70/bbl for WTI continues, providing a favourable terms of trade shock for Canada, or at least countering some of the weakness seen in other commodities. Our forecast allows for a modest retreat as OPEC ramps up production, joined by ongoing US output growth.

Even in the near term, we see the Bank as likely to face a bit of a disappointment on Q2 GDP growth, which we project to be nearly a half-point slower than the BoC forecast in annual rates. Thereafter, our forecast is similar to the Bank of Canada's, but we're likely incorporating a somewhat slower pace to rate hikes to achieve that.

Markets haven't really changed their medium term view on the Bank of Canada, which rightly sees a gentle climb in rates over the next couple of years. But odds of a hike by December have moved up on the announcement, as we anticipated in our Week Ahead commentary. That suggests room for the very front contracts to reverse course a bit if, as we expect, there's another six-month pause on the rate hike path.