

Contributors

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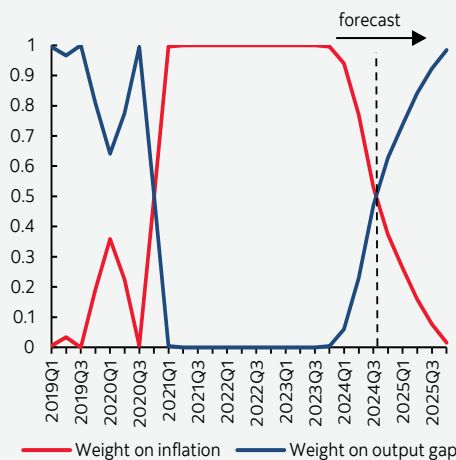
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Chart 1

Time-Varying Weight in Reaction Function



Source: Scotiabank Economics.

Shifting Priorities at the Bank of Canada

- As the reduction in inflation takes hold and economic activity slows down, the Bank of Canada seems to be shifting its priority from inflation control to worries about growth.
- Using a monetary policy reaction function that estimates the weight on inflation and the output gap over time, we find empirically that that Bank of Canada is now putting more weight on the output gap. This is a break from the last two years in which the estimated weight on inflation dominated that placed on the output gap. Our model suggests that as of 2024Q4, the BoC will focus more on eliminating this economic slack than on fighting inflation.
- Our current forecast is that the Bank of Canada cuts by 25 bps at each of the two remaining meetings this year. This work suggests there is a risk that Governor Macklem will be more aggressive than that if he indeed is putting more weight on growth going forward. That would translate into a risk of a 50 bps cut at one of these meetings.

Inflation has been steadily declining since its peak level of 8% (y/y) in June 2022. It has been within the upper bound of the Bank of Canada 1–3% range since January 2024 and it hit its 2% target for the first time since the pandemic in August 2024. In that same month, core inflation excluding food and energy was at 2.4%—not yet at the 2% target but approaching. While upside risks to inflation remain numerous, the improvement in inflation creates room for the Bank of Canada to shift some of its attention from fighting inflation to the slowing economy and to eliminate excess supply within its flexible inflation targeting regime. Announced in late 2021, this regime allows it to more formally actively seek to eliminate slack in the economy, measured by either the output gap or the unemployment gap, when conditions warrant.

In an interview with the Financial Times in September, the Bank of Canada governor is quoted saying “as you get closer to the [inflation] target, your risk management calculus changes. You become more concerned about the downside risks.” He also said that the BoC does not want to see more slack in the economy. These point towards a shifting in priorities if inflation continues its decline towards the 2% target and economic slack and excess supply persist. This shifting in priorities opens the door for a supersized cut, all else equal.

To consider this within our own framework for forecasting the Bank of Canada policy rate, we revisit our monetary policy priority index (please refer to this [note](#) for further detail). In short, we estimate the weights on the inflation gap and output gap in the Bank of Canada’s reaction function by allowing them to vary over time and sum to 1. Thus, at any given time, the Bank of Canada can decide to prioritize targeting inflation, closing the output gap or a combination of both. The closer past and future inflation is to target, the more weight we expect the BoC to put on closing the output gap relative to the inflation gap, and vice versa.

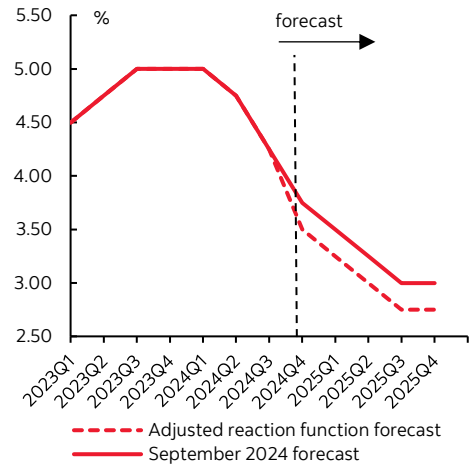
Chart 1 graphs the time-varying weights on the inflation gap and the output gap over recent history and forecast period. We see during the post-pandemic inflationary period when inflation was significantly above target, the weight in the reaction function fully shifted to inflation control, leaving the weight on the output gap near zero, as the Bank of Canada focused solely on reducing inflation. However, starting 2023Q4, as inflation continued to normalize and excess supply began to open up, the weights started to shift, with the weight on inflation gradually falling while that on the output gap increased. In 2024Q3, there was equal weight on both gaps, after which, our model suggests there is more weight on closing the output gap than on inflation. By end of 2025, the weight is

entirely on the output gap, with the weight on inflation gap near zero, as we forecast core inflation to return to the 2% target by mid 2025 and to stay there throughout.

Chart 2 graphs the resulting forecast for the monetary policy rate if we incorporate these shifting priorities into our Bank of Canada reaction function. The resulting forecast indicates a risk of an additional 25 bps of cuts in 2024 relative to our forecast, for a total of 75 bps of cuts during the remainder of 2024. With two more Bank of Canada decisions left, this implies a potential of a 50 bps cut in one of the two meetings if economic growth is to continue softening while inflation remains close to target. However, this risk of an additional cut would quickly diminish if disinflationary pressures are subdued due to stronger household spending than we currently forecast (witness the sharp rise in retail sales so far in 2024Q3 for example), stronger housing rebound, higher oil prices, and new supply chain pressures from the US port strikes.

Chart 2

Monetary Policy Rate



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