BoC Delivers An Overdue Hawkish Taper

- **GoC bond purchases were reduced to $3B/week from $4B+**
- **Forecast upgrades were applied across the world into Canada**
- **Spare capacity now forecast to shut in 2022H2…**
- **…with inflation sustainably on target by then**
- **The inferred policy bias supports ending QE this year…**
- **…and hiking possibly earlier and faster than markets expect**
- **Is the BoC signalling a run-hot inflation bias?**

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The Bank of Canada met almost all of our expectations for a hawkish taper accompanied by pulled forward guidance that spare capacity would shut in 2022 with inflation above target next year. Where they surprised was concentrated in a decision to leave the maturity composition of purchases unchanged within the tapered flow of Government of Canada bond purchases down to C$3B/week as I had thought they might have extended maturity while tapering.

Markets reacted by driving CAD appreciation of about 1½ cents to the USD as the currency vaulted to the top of the class among currency performers to the USD. Canada's yield curve jumped by 2–4bps from 2s through 10s and flattened across 10s30s because of the concentrated effects of the taper, more hawkish implied forward rate guidance and long-end optimism that inflation risk may be contained somewhat by a BoC narrative shift.

Overall, I'm impressed. I think the BoC has done the right thing here. One can quibble that they likely should have adjusted their narrative more quickly as vaccine trials were reported and fiscal stimulus plans took off in the US and Canada alongside evidence of a more resilient economy than they feared. One should be concerned that sticking to this bias for too long resulted in an excessive commitment to stay on hold to 2023. Nevertheless, they are courageous enough to now stand apart from the pack of most global central banks with their changes and guidance today. The suite of evidence suggests that the emergency conditions have passed or are increasingly passing and so should emergency stimulus that is at risk of doing more harm than good.

It is extraordinarily unfortunate, however, that a leak by one media outlet ahead of time botched the headlines and sparked some market participants to position cover into the BoC communications only to get whipsawed when the real headlines hit. This may have involved a material financial consequence to varying parties and should merit further investigation by the BoC and others.

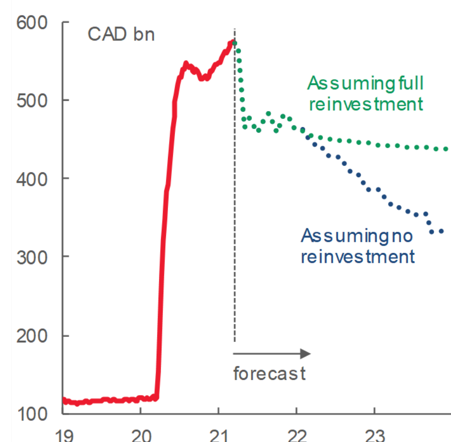
So what did the Bank of Canada do in the suite of communications including the statement (here), Monetary Policy Report (here), the opening statement to Governor Macklem's press conference (here) and the Q&A session?

The Bank of Canada's Monetary Policy Report (MPR) Canadian Macroeconomic Projections, annual % change

	2020e	2021f	2022f	2023f
GDP				
July '20 MPR	-7.8	5.1	3.7	
Oct '20 MPR	-5.7	4.2	3.7	
Jan '21 MPR	-5.5	4.0	4.8	2.5
Apr '21 MPR	-5.4	6.5	3.7	3.2
CPI Inflation				
July '20 MPR	0.6	1.2	1.7	
Oct '20 MPR	0.6	1.0	1.7	
Jan '21 MPR	0.7	1.6	1.7	2.1
Apr '21 MPR	0.7	2.3	1.9	2.3

Sources: Scotiabank Economics, Bank of Canada

Chart 1



Sources: Scotiabank Economics, Bank of Canada.

Taper Delivered

They tapered down to C$3 billion of Government of Canada bond purchases per week from $4B+ as expected. The reduction will be effective next week. Note that the '+' part of the purchase guidance has now been struck out which implies that the theoretical adjustment is even greater than the expected $1B reduction as it goes from an average over $4B/week down to $3B.

Conditional Purchase Guidance Maintained

Forward guidance applied to the purchase program was generally left unchanged. The BoC repeated the conditional nature of future decisions by stating "Decisions regarding further adjustments to the pace of net purchases will be guided by Governing Council's ongoing assessment of the strength and durability of the recovery."

I would advise pencilling in a further taper at the July MPR meeting. If Governor Macklem continues to adhere to prior guidance that net purchases would end before spare capacity is eliminated then that probably counsels fully ending purchases later this year conditional upon when the output gap shuts (see next point).

Spare Capacity to Shut Next Year

The BoC now forecasts that spare capacity will close in 2022H2 instead of prior guidance this wouldn't happen until 2023. Our forecast is that the output gap will shut later this year. Four considerations likely contribute toward explaining this difference and how BoC guidance could change again from here.

For one thing, **we're incorporating more US and Canadian fiscal stimulus—especially the former—than the BoC is so far.** The BoC does not appear to be factoring in assumptions on how much of the proposed American Jobs Plan and pending American Families Plan may pass through Congress and hence how much may leak out to Canada. Fact upon passage rather than conjecture during the horse trading is likely the operating belief here. Nevertheless, a street shop doesn't have the luxury of putting on horse blinders and assuming away 100% of the trillions that the Biden administration is talking about. Therefore, when the BoC says in its MPR that "Fiscal stimulus starts to wind down in 2022, creating a drag on growth," treat it as a forecast assumption waiting for a positive reassessment that could close spare capacity earlier than they say.

The BoC also has to factor in the full amount of the Canadian Federal Budget's $101B of added stimulus over three years instead of its forecast assumption—set before the Budget's release—that it would deliver $85B.

Third, the BoC raised its estimates of how fast the supply side of the economy will grow as actual GDP growth takes off. They did so through a modest upward adjustment to potential GDP growth but the range they are using is still miles wide. You can check out the numbers in table 2 of the MPR, or take my word for how they think potential will land somewhere between St. John's and Victoria throughout the forecast horizon. Time and actual data across a suite of indicators will tighten up this understanding.

For another, **the BoC is likely being cautious in altering its narrative more slowly than a street shop has to and doing so in increments toward a gradual bias shift.** Macklem put that this way: "We're not going to count our chickens before they've hatched." True, but every good farmer still needs to plan ahead. Given uncertainty and the fact that central bankers get paid in asymmetrically flat fashion to manage risk not opportunity, they tend to avoid abrupt changes in views and skew the risks to the downside. To go from spare capacity shutting in 2023 instead of later this year would have whipsawed markets to an even greater extent even if the BoC thought it possible. Instead, the BoC took a first step in that direction today and abandoned one of the pillars of its policy stance since the pandemic began that it would take into 2023 to close spare capacity and by corollary rates would be on hold at least until then. In its attempt at explaining away housing strength as entirely fundamentals driven, the BoC is seeking to absolve itself of any responsibility for sparking housing excess through an overly generous commitment period that was slow to adjust to new information since last Fall. The signal to borrowers is to be on greater guard now.

Positive Global Forecast Revisions

In order to arrive at earlier closure of spare capacity, the BoC upped its growth forecasts across the board.

- World growth was pulled forward and is now forecast to be 6.8% this year (5.6% prior), 4.1% next (4.6% prior) and 3.3% in 2023 (3.9% prior).
- Ditto for US growth at 7% this year (from 5%), 4.1% next year (from 3.9% and 1.3% in 2023 (from 2.0%). Again, be careful here in that the implied slowing assumes away the likely trillions in additional US fiscal stimulus that is likely to be forthcoming.
- China was also upgraded to grow by 9.5% this year (from 8.4%) and slightly lower in 2022 and 2023 (5.3% in both years).
- Other global forecasts were relatively little changed and of less relevance to Canada.

Positive Canada Forecast Revisions

Canada's macro forecast was upgraded. The BoC now thinks Canada will grow by 6.5% this year (from 4.0% previously), brought 2022 a bit lower to 3.7% (from 4.8%) but raised 2023 to 3.2% (2.5% prior). The takeaway is that the BoC thinks actual GDP will surpass even the upper end of its ranges for potential GDP in each of 2021, 2022 and 2023. By corollary, the output gap increasingly swings into excess aggregate demand throughout their projection horizon. While it's true that the range of potential GDP is highly uncertain (and so is actual GDP in both directions…) the BoC is betting even without factoring in additional US fiscal stimulus that the economy will have enough momentum to drive a rising push into excess demand conditions throughout 2021–23 and that's a pretty hawkish message.

Inflation Forecasts Revised Higher

Now here's where things get even more interesting. The BoC upped its inflation forecasts to 2.3% (1.6% prior) in 2021, 1.9% in 2022 (1.7% prior) and 2.3% in 2023 (2.1% prior). On a higher quarterly frequency basis it expects CPI inflation to surpass 2% on average starting from 2021Q4 through to the end of its projection horizon in 2023Q4.

But what does it think of core? The BoC does not formally forecast core inflation measures. It nevertheless probably has a similar view on core to that which it presents for headline inflation given the BoC's tendency to treat core as the operational guide to its inflation targeting framework because headline and core measures have a tendency to converge upon one another over time. Box 5 on page 18 of the MPR, however, adds considerable near-term doubt at least in terms of how the BoC views current core inflation. Basically, they point to multiple measures of core inflation even beyond the trimmed mean, weighted median and common component gauges and tend to exhibit a bias toward measures that are lower than the trimmed mean and weighted median measures for reasons explained in the box. If there is a way to over-complicate the measurement of inflation in a scattered approach then the BoC is definitely up to the task! The takeaway is probably that they think true core inflation is lower than what is derived from the average of the three measures published by Statistics Canada, **but the suite of them on average are probably expected to converge to target if not rising above target throughout the forecast horizon.**

What is the BoC Signalling About an Inflation Overshoot?

How can that happen you say? Why would the BoC forecast three years of inflation over 2%? Doesn't the BoC target 2% in symmetrical fashion? Macklem was asked this question in the press conference and **whether an overshoot reflects a desire to make up for prior undershoots in a flexible average inflation targeting sense.** Of course his answer was no, that instead the overshoot is a consequence to forward guidance that they will not act pre-emptively by hiking ahead of the achievement of the inflation target rather than around when it occurs. I don't buy that. In fact, it's rather Fed-like imo. Macklem's response gets harder to accept the further out in the forecast horizon that inflation is forecast to overshoot since it implies that the BoC is either going to tolerate it or thinks it will be incapable of staying on target. So what's going on? We can't ignore the possibility that after years of undershooting the inflation rate (see my earlier BoC deck), the BoC is finally trying to operationalize the theoretically symmetric nature of the 2% target by indeed allowing for a prolonged modest overshoot. If so, then the BoC is following the Fed in that regard and should say so. We'll see when the announce the results of their strategic review later this year.

Please see the accompanying statement comparison.

RELEASE DATE: April 21, 2021

The Bank of Canada today held its target for the overnight rate at the effective lower bound of ¼ percent, with the Bank Rate at ½ percent and the deposit rate at ¼ percent. The Bank continues to provide extraordinary forward guidance on the path for the overnight rate, reinforced and supplemented by the Bank's quantitative easing (QE) program. **Effective the week of April 26, weekly net purchases of Government of Canada bonds will be adjusted to a target of $3 billion. This adjustment to the amount of incremental stimulus being added each week reflects the progress made in the economic recovery.**

The outlook has improved for both the global and Canadian economies. Activity has proven more resilient than expected in the face of the COVID-19 pandemic, and the rollout of vaccines is progressing. A number of regions, including Canada, are **experiencing a difficult third wave of infections and lockdowns**. The more contagious variants of the virus are straining healthcare systems and affecting hard-to-distance activities, and have introduced a new dimension of uncertainty. The recovery remains highly dependent on the evolution of the pandemic and the pace of vaccinations.

Global economic growth is stronger than was forecast in the January Monetary Policy Report (MPR), although the pace varies considerably across countries. After a contraction of 2 ½ percent in 2020, the Bank now projects global GDP to grow by just over 6 ¾ percent in 2021, about 4 percent in 2022, and almost 3 ½ percent in 2023. The recovery in the United States has been particularly strong, owing to fiscal stimulus and rapid vaccine rollouts. The global recovery has lifted commodity prices, including oil, contributing to the strength of the Canadian dollar.

In Canada, growth in the first quarter appears considerably stronger than the Bank's January forecast, as households and companies adapted to the second wave and associated restrictions. Substantial job gains in February and March boosted employment. However, new lockdowns will pose another setback and the labour market remains difficult for many Canadians, especially low-wage workers, young people and women. As vaccines roll out and the economy reopens, consumption is expected to rebound strongly in the second half of this year and remain robust over the projection. Housing construction and resales are at historic highs, driven by the desire for more living space, low mortgage rates, and limited supply. The Bank will continue to monitor the potential risks associated with the rapid rise in house prices. Meanwhile, strong growth in foreign demand and higher commodity prices are expected to drive a robust recovery in exports and business investment. Additional federal and provincial fiscal stimulus will contribute importantly to growth. The Bank now forecasts real GDP growth of 6 ½ percent in 2021, moderating to around 3 ¾ percent in 2022 and 3 ¼ percent in 2023.

The Bank has revised up its estimate of potential output in light of greater resilience to the pandemic and accelerated digitalization. The virus and lockdowns have had very different impacts across sectors, businesses, and groups of workers, creating an unusual degree of uncertainty about the amount of slack in the economy and how long it will take to be absorbed. To gauge the evolution of slack, the Bank will look at a broad spectrum of indicators, including various measures of labour market conditions.

Over the next few months, inflation is expected to rise temporarily to around the top of the 1-3 percent inflation-control range. This is largely the result of base-year effects—year-over-year CPI inflation is higher because prices of some goods and services fell sharply at the start of the pandemic. In addition, the increase in oil prices since December has driven gasoline prices above their pre-pandemic levels. The Bank expects CPI inflation to ease back toward 2 percent over the second half of 2021 as these base-year effects diminish, and inflation is expected to ease further because of the ongoing drag from excess capacity. As slack is absorbed, inflation should return to 2 per cent on a sustained basis some time in the second half of 2022.

Even as economic prospects improve, the Governing Council judges that there is still considerable excess capacity, and the recovery continues to require extraordinary monetary policy support. We remain committed to holding the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. **Based on the Bank's latest projection, this is now expected to happen some time in the second half of 2022.** The Bank is continuing its QE program to reinforce this commitment and keep interest rates low across the yield curve. **Decisions regarding further adjustments to the pace of net purchases will be guided by Governing Council's ongoing assessment of the strength and durability of the recovery.** We will continue to provide the appropriate degree of monetary policy stimulus to support the recovery and achieve the inflation objective.

RELEASE DATE: March 10, 2021

The Bank of Canada today held its target for the overnight rate at the effective lower bound of ¼ percent, with the Bank Rate at ½ percent and the deposit rate at ¼ percent. The Bank is maintaining its extraordinary forward guidance, reinforced and supplemented by its quantitative easing (QE) program, which continues at its current pace **of at least $4 billion per week**.

The global economy is recovering from the economic effects of COVID-19, albeit with ongoing unevenness across regions and sectors. The US economic recovery appears to be gaining momentum as virus infections decline and fiscal support boosts incomes and consumption. New fiscal stimulus will increase US consumption and output growth further. Global yield curves have steepened, largely reflecting the improved US growth outlook, but global financial conditions remain highly accommodative. Oil and other commodity prices have risen. The Canadian dollar has been relatively stable against the US dollar, but has appreciated against most other currencies.

In Canada, the economy is proving to be more resilient than anticipated to the second wave of the virus and the associated containment measures. Although activity in hard-to-distance sectors continues to be held back, recent data point to continued recovery in the rest of the economy. GDP grew 9.6% in the final quarter of 2020, led by strong inventory accumulation. GDP growth in the first quarter of 2021 is now expected to be positive, rather than the contraction forecast in January. Consumers and businesses are adapting to containment measures, and housing market activity has been much stronger than expected. Improving foreign demand and higher commodity prices have also brightened the prospects for exports and business investment.

Despite the stronger near-term outlook, there is still considerable economic slack and a great deal of uncertainty about the evolution of the virus and the path of economic growth. The labour market is a long way from recovery, with employment still well below pre-COVID levels. Low-wage workers, young people and women have borne the brunt of the job losses. The spread of more transmissible variants of the virus poses the largest downside risk to activity, as localized outbreaks and restrictions could restrain growth and add choppiness to the recovery.

CPI inflation is near the bottom of the 1-3 percent target band but is likely to move temporarily to around the top of the band in the next few months. The expected rise in CPI inflation reflects base-year effects from deep price declines in some goods and services at the outset of the crisis a year ago, combined with higher gasoline prices pushed up by the recent run-up in oil prices. CPI inflation is then expected to moderate as base-year effects dissipate and excess capacity continues to exert downward pressure. Measures of core inflation currently range from 1.3 to 2 percent.

While economic prospects have improved, the Governing Council judges that the recovery continues to require extraordinary monetary policy support. We remain committed to holding the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. **In the Bank's January projection, this does not happen until into 2023.** To reinforce this commitment and keep interest rates low across the yield curve, the Bank will continue its QE program until the recovery is well underway. **As the Governing Council continues to gain confidence in the strength of the recovery, the pace of net purchases of Government of Canada bonds will be adjusted as required.** We will continue to provide the appropriate degree of monetary policy stimulus to support the recovery and achieve the inflation objective.

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