Scotiabank

GLOBAL ECONOMICS

SCOTIA FLASH

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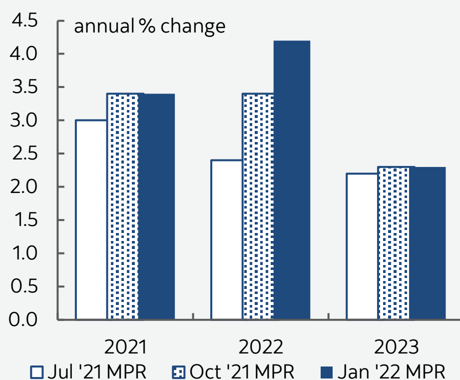
Contributors

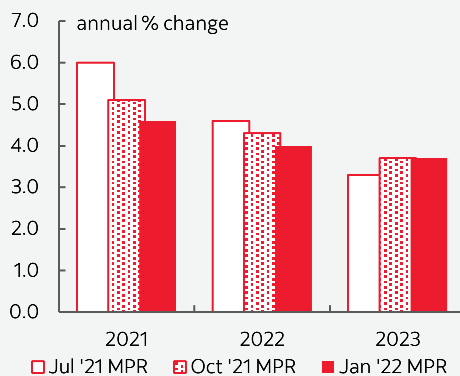
Derek Holt
VP & Head of Capital Markets Economics
Scotiabank Economics
416.863.7707
derek.holt@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report.*

Chart 2



Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report.*

BoC Pulls a Chicken Hawk Move

- **The BoC held its policy rate unchanged while guiding future tightening**
- **We lost today's battle, but BoC guidance suggests were on the right side of the war**
- **The BoC's forward rate guidance tool is unreliable**
- **BoC will fall further behind inflation and amplify housing imbalances**

The Bank of Canada passed on a rate hike today against our expectations that we had pegged at better than even odds and with congratulations to the shops that got the battle right even if not the reasons. If the BoC nevertheless follows through and translates the material shift in policy guidance that they provided today into concrete action, then our more hawkish than consensus forecast may yet win the battle as consensus might have misjudged the path from here.

That nevertheless remains to be seen not only given the course of developments to come, but also significantly because of the apparent unreliability of BoC forward rate guidance. It also remains apparent that the central bank has retained an ongoing run-hot bias toward inflation and house prices as it is far behind the appropriate stance of monetary policy for this point in the cycle.

Please see the accompanying statement comparison, the Monetary Policy Report (**here**) and Governor Macklem's opening remarks to his press conference (**here**).

As a consequence to today's rate hold and because a hike was mostly priced, financial conditions eased through lowering market-driven borrowing costs and a mild depreciation in the C$ that pared half of its post-statement weakening as the press conference unfolded. With inflation ripping and housing demand soaring the BoC actually eased financial conditions today and into the Spring mortgage pipeline. The BoC describes conditions as having tightened by referencing the rise in nominal bond yields but did not acknowledge that the more relevant real borrowing rates have plunged.

WHAT THEY DID

There were seven main developments:

1. First, the policy rate was unchanged at 0.25%.
2. Second, forward rate guidance was hawkish toward future steps and the pace of adjustments especially during the press conference during which Macklem said the following:

   "Everybody should expect interest rates to be on a rising path."

   "We've been very clear that we are announcing a significant shift in policy and to expect a rising rate path and the time for emergency policy is gone. "

   "We all agreed it was paramount to take action today to take steps to avoid higher inflation expectations in the nearer term from migrating into the longer-term."

   "When we say 'a path' it does not mean one move, it means a number of steps. "

   "There needs to be a series of steps. As we get further down that path the decisions will become more finely balanced and more data dependent."
3. Third, On balance sheet guidance, Governor Macklem said that the BoC will hold GoC bond holdings constant "at least until it begins to raise the policy interest rate" at which point they will consider allowing roll-off. That is unchanged. The Governor's

remark on reinvestment plans during the press conference seemed to intimate they would lean more toward gradually reducing reinvestment flows rather than going cold turkey which matches the scenario outlined in chart 3. Macklem guided that the BoC is not considering asset sales with the qualifier being "at this point."

4. Fourth, the BoC upgraded its forecasts for growth and inflation. At 4% GDP growth this year and 3.5% next year they even have a slightly stronger growth profile than we do (3.7%, 3.3%).
5. At the same time, the BoC upgraded its inflation forecast to 4.2% this year and 2.3% in 2023 to show a sustained overshoot of its 2% inflation target throughout the projection horizon. The BoC is hedging its bets between the verbiage that says inflation is transitory versus the numbers that say not so much relative to the 2% target. Then again, its inflation forecasts have performed poorly to date.
6. The BoC even finally acknowledged that "wage gains are picking up."
7. Potential GDP growth assumptions were left unchanged at "about 1.6%" per year over 2021–23. As a consequence to the combined forecasts for potential and actual GDP growth and where it judges the starting point for the supply side of the economy, the BoC now says that "Governing Council judges that overall slack in the economy is absorbed."

So far we're pretty happy. Strong growth? Check. Hot sustained inflation? Check. Wages accelerating? Check. Slack gone? Check.

So they hiked, right? Nope.

THE BOC'S FORWARD GUIDANCE PROBLEM

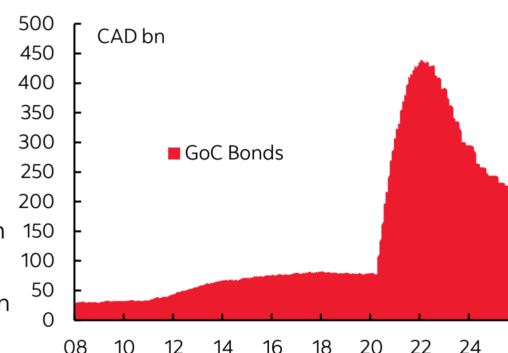
The rub here lies in the fact that everything in today's BoC narrative said hike and the ducks lined up very well relative to our assessments and expectations for the drivers of the decision, but they still passed on the opportunity to do so.

The prime reason? Governor Macklem strongly violated his own longstanding prior forward guidance that said they would hike when spare capacity shuts. Today the BoC said it is shut right now, but they held the policy rate unchanged anyway and guided that a rate hike will now lag this development.

Had they said spare capacity won't shut until, say, Q2 or repeated the guidance it will happen in the "middle quarters" of 2022 then we could have debated that, but it would have been more consistent with holding the rate unchanged today. I must have missed the speech when it was said that the policy rate would rise *after* the closure of spare capacity because the last speech I read from the Governor dropped all reference to its former forward rate guidance which if unintended was a huge oversight. The BoC had been following a fairly methodical approach to exiting its GBPP program, but slipped up today in terms of actioning its prior forward rate guidance.

Chart 3

Bank of Canada Balance Sheet: Scenario 4*



*Monthly purchases of CAD 4.5bn/mth for Q1-'21. Each subsequent quarter, purchases reduced by CAD 1.0bn/mth. until 0. Then full roll-off GoC bonds.
Sources: Scotiabank Economics, Bank of Canada.

What further complicates things is the guidance that the BoC will be very data dependent into each decision. That makes a March hike less than automatic. In fact, will they hike if January jobs tank as seems likely and even if it's transitory? The messaging around doing so as temporarily weak data is likely to be rolling in may be more awkward than had they just hiked today.

So why did the BoC do that? It's possible the BoC wanted to send a message that it won't be pushed by markets, but I'd hope that wasn't the case… Governor Macklem emphasized that they "are mindful" toward the effects of omicron which seemed to figure prominently in the decision to pass today, despite the fact he said they are looking through it as a transitory shock. Despite the fact that housing is ripping. Despite the fact that properly measured inflation is tripling the BoC's 2% target. Despite the fact that slack is gone.

IMPLICATIONS

What I think the main implication is for the short-term is that the BoC will allow the Spring housing market to rip again in perhaps one last big surge before its signals suggest that it could begin rapid rate hikes thereafter if such guidance is to be trusted. Great. House prices will rip again and then hit borrowers with higher rates instead of acting a bit more pre-emptively. Low interest rates are clearly exacerbating underlying supply-demand imbalances in the housing market. During the press conference, SDG Rogers pinned the housing challenges on the supply side but low interest rates are making this worse! The BoC seems to be dramatically downplaying the role of easy money as a contributor to hot housing markets which I find to be an untenable position and one that raises risks further out in our forecast horizon.

RELEASE DATE: January 26, 2022

The Bank of Canada today held its target for the overnight rate at the effective lower bound of ¼ %, with the Bank Rate at ½ % and the deposit rate at ¼ %. ***With overall economic slack now absorbed, the Bank has removed its exceptional forward guidance on its policy interest rate.*** The Bank is continuing its reinvestment phase, keeping its overall holdings of Government of Canada bonds roughly constant.

The global recovery from the COVID-19 pandemic is strong but uneven. The US economy is growing robustly while growth in some other regions appears more moderate, especially in China due to current weakness in its property sector. Strong global demand for goods combined with supply bottlenecks that hinder production and transportation are pushing up inflation in most regions. As well, oil prices have rebounded to well above pre-pandemic levels following a decline at the onset of the Omicron variant of COVID-19. Financial conditions remain broadly accommodative but have tightened with growing expectations that monetary policy will normalize sooner than was anticipated, and with rising geopolitical tensions. Overall, the Bank projects global GDP growth to moderate from 6¾ % in 2021 to about 3½ % in 2022 and 2023.

In Canada, GDP growth in the second half of 2021 now looks to have been even stronger than expected. The economy entered 2022 with considerable momentum, and a broad set of measures are now indicating that economic slack is absorbed. With strong employment growth, the labour market has tightened significantly. Job vacancies are elevated, hiring intentions are strong, and **wage gains are picking up.** Elevated housing market activity continues to put upward pressure on house prices.

The Omicron variant is weighing on activity in the first quarter. While its economic impact will depend on how quickly this wave passes, it is expected to be less severe than previous waves. **Economic growth is then expected to bounce back and remain robust over the projection horizon,** led by consumer spending on services, and supported by strength in exports and business investment. After GDP growth of 4½ % in 2021, the Bank expects Canada's economy to grow by 4% in 2022 and about 3½ % in 2023.

CPI inflation remains well above the target range and core measures of inflation have edged up since October. Persistent supply constraints are feeding through to a broader range of goods prices and, combined with higher food and energy prices, are expected to keep CPI inflation close to 5% in the first half of 2022. As supply shortages diminish, inflation is expected to decline reasonably quickly to about 3% by the end of this year and then gradually ease towards the target over the projection period. Near-term inflation expectations have moved up, but longer-run expectations remain anchored on the 2% target. The Bank will use its monetary policy tools to ensure that higher near-term inflation expectations do not become embedded in ongoing inflation.

While COVID-19 continues to affect economic activity unevenly across sectors, **the Governing Council judges that overall slack in the economy is absorbed, thus satisfying the condition outlined in the Bank's forward guidance on its policy interest rate. The Governing Council therefore decided to end its extraordinary commitment to hold its policy rate at the effective lower bound. Looking ahead, the Governing Council expects interest rates will need to increase, with the timing and pace of those increases guided by the Bank's commitment to achieving the 2% inflation target.**

The Bank will keep its holdings of Government of Canada bonds on its balance sheet roughly constant at least until it begins to raise the policy interest rate. At that time, the Governing Council will consider exiting the reinvestment phase and reducing the size of its balance sheet by allowing roll-off of maturing Government of Canada bonds.

RELEASE DATE: December 8, 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's extraordinary forward guidance on the path for the overnight rate is being maintained.*** The Bank is continuing its reinvestment phase, keeping its overall holdings of Government of Canada bonds roughly constant.

The global economy continues to recover from the effects of the COVID-19 pandemic. Economic growth in the United States has accelerated, led by consumption, while growth in some other regions is moderating after a strong third quarter. Inflation has increased further in many countries, reflecting strong demand for goods amid ongoing supply disruptions. ***The new Omicron COVID-19 variant has prompted a tightening of travel restrictions in many countries and a decline in oil prices, and has injected renewed uncertainty.*** Accommodative financial conditions are still supporting economic activity.

Canada's economy grew by about 5½ percent in the third quarter, as expected. Together with a downward revision to the second quarter, this brings the level of GDP to about 1½ percent below its level in the last quarter of 2019, before the pandemic began. Third-quarter growth was led by a rebound in consumption, particularly services, as restrictions were further eased and higher vaccination rates improved confidence. Persistent supply bottlenecks continued to inhibit growth in other components of GDP, including non-commodity exports and business investment.

Recent economic indicators suggest the economy had considerable momentum into the fourth quarter. This includes broad-based job gains in recent months that have brought the employment rate essentially back to its pre-pandemic level. Job vacancies remain elevated and wage growth has also picked up. Housing activity had been moderating, but appears to be regaining strength, notably in resales. The devastating floods in British Columbia and uncertainties arising from the Omicron variant could weigh on growth by compounding supply chain disruptions and reducing demand for some services.

CPI inflation is elevated and the impact of global supply constraints is feeding through to a broader range of goods prices. The effects of these constraints on prices will likely take some time to work their way through, given existing supply backlogs. Gasoline prices, which had been a major factor pushing up CPI inflation, have recently declined. Meanwhile, core measures of inflation are little changed since September. The Bank continues to expect CPI inflation to remain elevated in the first half of 2022 and ease back towards 2 percent in the second half of the year. The Bank is closely watching inflation expectations and labour costs to ensure that the forces pushing up prices do not become embedded in ongoing inflation.

The Governing Council judges that in view of ongoing excess capacity, the economy continues to require considerable 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 October projection, this happens sometime in the middle quarters of 2022. We will provide the appropriate degree of monetary policy stimulus to support the recovery and achieve the inflation target.

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