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GLOBAL ECONOMICS

SCOTIA FLASH

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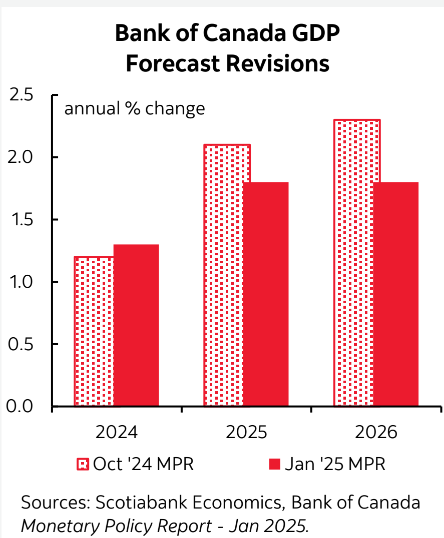
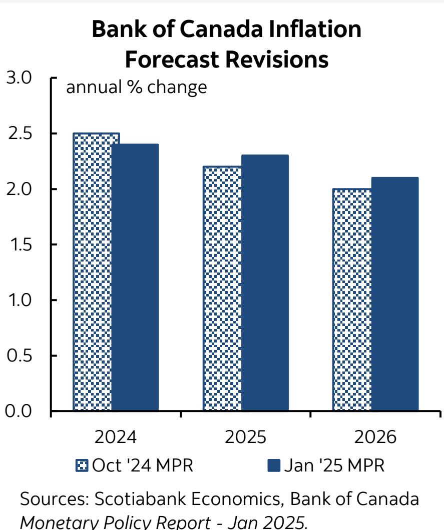
Chart 1



Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report - Jan 2025.*

Chart 2



Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report - Jan 2025.*

BoC is Done if No Tariffs; Unclear With Tariffs

- **The BoC cut 25bps to 3% for a cumulative 200bps of easing as expected…**
- **…and announced QT will end in March, earlier than guided**
- **BoC cut the deposit rate by 30bps to address CORRA spread to the overnight rate**
- **The base case guidance and forecasts sound very much like they're on hold now**
- **Tariff scenarios inject ambiguity on the direction and timing of the policy rate**
- **Could the GFC's 'flexible inflation targeting' return?**
- **Beware the risk of 'Team Transitory' messing up again**

The Bank of Canada cut its overnight rate by 25bps as universally expected. They announced the end of Quantitative Tightening as well.

The suite of communications indicated that if extreme assumptions about tariffs are not realized, then they are probably done cutting and will let lagging effects of cuts take over.

The tariff scenarios, however, inject ambiguity. I though Macklem did a good job at explaining this ambiguity, but different shops will hear what they wish. I'll share what I heard and what I see in their projections and I've added two alternative scenarios.

The statement is **here** along with the statement comparison in the pandemic. The MPR with forecasts and tariff scenarios toward the end is **here**. Governor Macklem's opening remarks to his press conference are **here**. And I've attempted to provide a complete transcript of the press conference in this note.

Because the BoC does not know what may happen going forward and does not wish to signal further changes in its base case, it took the step of removing the forward guidance sentence about considering future reductions.

MARKET REACTION

There was a minimal market reaction. Canada's two-year yield fell by about 2bps or so from the start of the communications to the end. USDCAD wa firmly unchanged at about 1.4440. Markets remain priced for a significant chance at another cut on March 12th and under 50bps of additional cuts by year-end.

In fact, US Commerce Secretary Lutnick then had more influence over USDCAD than the BoC. Lutnick remarked that efforts to curtail fentanyl could result in less tariff risk for Canada, prompting the USD to broadly sell off including nearly half penny appreciation by CAD. I think Lutnick is teeing up an off ramp from the tariff craziness that might make this 'Colombia Part Two'—a threat that never arises or lasts for a very short period on some last minute photo op compromise notwithstanding the compelling evidence that despite anecdotes, Canada is not the source of America's fentanyl problem. A further illustration of how this could happen is that the White House reversed its decision yesterday to freeze all federal grants amid a strong backlash; the volatility of plans and communications coming from this US administration has been stunning in just the first week or so.

QUANTITATIVE TIGHTENING ENDED

I'm a little surprised that they took the step of ending quantitative tightening at this meeting despite flagging it as a risk for today. Delivering a speech before this meeting saying they would do so soon was an indication that it was a risk as opposed to the normal timing for a balance sheet speech around March. But Deputy Governor Gravelle said they would end QT sometime over 2025H1 before they hit their upwardly revised estimate of settlement balances this summer before a large bond redemption in September. When

pressed, he said there were four meetings, and it would happen some time over H1. There was no explanation as to why they chose to do so at this meeting.

Operational details were provided at the end of the BoC's policy statement.

Regardless, I think the projections that I provided in **this** note right after DepGov Gravelle's speech less than two weeks ago still broadly hold but can be pulled forward by a quarter or so.

BASE CASE—CUTS ARE DONE

Their base case is indicating they are done at a policy rate of 3%. Their base case assumes no tariffs not because they're certain there will not be any, but because they don't know what will happen just like the rest of us, and to provide a framework of thinking going into such a potential shock that is clear of potentially arbitrary assumptions on tariffs.

Their forecasts (charts 1, 2) show that growth is expected to pick up, and that this pick-up starts outpacing potential growth from the beginning of 2025 onward, thus narrowing and shutting slack. They are factoring in tighter immigration policy to reduce potential growth while also flagging how lower rates are helping to stimulate the household sector which is what we're seeing in the data.

As a result, their base case revised up their inflation projections and they view the risks around the 2% inflation target as balanced. Absent tariffs, it's a constructive outlook and they're not indicating appetite toward doing more. I don't buy their dismissal of momentum in core inflation measures in m/m SAAR terms and so I think that's an added reason they'd probably never admit.

WITH TARIFFS—IT DEPENDS!

Seeing some of the other interpretations out there has me thinking this is a classic case of people hearing what they wish. Full-on confirmation bias is behind some interpretations that what Macklem said today is that he would unambiguously ease like there is no tomorrow. I didn't hear that. I heard him say it depends over and over. I didn't hear him screaming he would cut or cut aggressively in a tariff scenario. He went through the different outcomes and possibilities. And given their 'transitory' track record, take it with a lot of salt.

On what does it depend? Well, for starters, on their assumptions in the scenario that everyone gets hit by a 25% universal US tariff, everyone retaliates with their own equal measures, and that the tariff hit is permanent. I'll take the other side of that one. Hello, mid-terms, you say you got elected to be a better steward of the US economy did you?! Presto, one or both chambers lost.

Macklem argued that with extreme scenario assumptions on tariffs in a scenario when the growth hit dominates and the tariff impact on inflation is merely a one-off price level adjustment that doesn't create spillover effects, they're cutting more. Probably a lot more. Hence one of our scenarios showing very large cuts.

But he also said in a scenario with tariffs in which growth is hit, and the tariff impact does create spillover effects, they're going to focus more on inflation and less on growth. That could mean either they're cutting less, maybe not at all, and possibly hiking. Three years of persistent inflation in their tariff scenario sounds awfully hard for an inflation-targeting central bank to look through.

So pick your scenario!! Go ahead and forecast Trump if you want to trade the Canadian front end. Slap a total buy on the front-end and tell them to go buy lottery tickets while you're at it. That's good investing with other people's money, you see. And good luck.

My take remains that we need to be open-minded around the base case scenario and how tariffs might impact developments. That's always been my point.

I would add two more scenarios to what Macklem discussed.

One is that if he looks through tariffs and cuts to come to the rescue of growth then he may be signalling a tolerance for going back to when he was Carney's partner at the BoC in the GFC and they embraced 'flexible inflation targeting' that worked the full range of the bands and signalled tolerance for significant deviations from 2% inflation for a significant period. If so, then that would be reflected in a steeper curve not just through a richer front-end but also higher longer-term yields including the key 5-year Canada government bond yield.

Another scenario is to be wary of making the same mistake as part of 'Team Transitory' that they made in the pandemic with all the dovish narratives and forecasts that got whiplashed once 'Macklem the Dove' turned. I didn't believe them then, and am skeptical now. The one-off price level adjustment effect of tariffs is assumed by some folks to mean there would be no persistence, no spillover, no behavioural changes, and no deepening of problems on the supply side of the economy that the BoC has admitted they need to incorporate more fully in their models so they don't make the same mistake sounding dovish for too long as they did coming out of the pandemic.

And it's not just the impact domestically. Tariffs imposed by the US that is in excess aggregate demand could be likely to result in high pass through by US firms with pricing power and little fear someone else will take their domestic market share. That could ripple through supply chains into Canada as well.

POLICY RATE SPREAD

Note that the end of the BoC statement includes the market notice on adjusting the depo rate spread and changes to terms and conditions for ORR operations. Effective January 30th, the deposit rate will be set at a spread of 5bps below the overnight rate. They indicated this was to improve the effectiveness of the framework. Narrowing the CORRA spread to the policy rate appears to be the main objective.

PRESS CONFERENCE TRANSCRIPT

Here is my attempt at providing a press conference transcript in the absence of a formal one provided by the BoC. Any errors or omissions are to be blamed on my typing abilities.

Q1. Does CAD depreciation mean the limit of policy divergence with the Fed has been reached, limiting the ability of the BoC to provide support in a trade conflict?

A1. If you're asking has exchange rate weakness has limited our decision to date then the answer is no. This is a more material move in the Canadian dollar. This is a material depreciation. It will start to have some impacts. It makes our exports more competitive but tariffs will make them much less competitive. It means the cost of everything we import will become higher. Fresh fruits and vegetables will happen quickly, more generally pass through evolves over time. The other implication is any weakness in the Canadian dollar makes investment imported from the US more expensive. We've assumed a 70 cent dollar in our projections [ed. they go roughly at market]. As developments around tariffs unfold we will have to build in financial market reactions in our projections as we set policy going forward.

Q2. You have said monetary policy may not be able to offset 25% tariffs, but do you think QE will?

A2. We're a long way from quantitative easing. We've only used it once. The bar remains very high going forward.

Q3. To what extent are tariffs baked into your forecasts?

A3. We're very clear that our forecasts assume there are no new tariffs. The risks around our projections factor into our decision. What we see is inflation has remained pretty close to 2% since last summer. The economy is still in excess supply. That slack is putting downward pressure on inflation We want to see growth pick up and we are seeing that to absorb that slack. Those things suggested that a further cut made some sense. Then there is the threat of tariffs. There is no doubt that weighed on our decision. The more we can get the economy on a solid footing before it faces new tariffs the better. From that risk management perspective that reinforced the decision to cut the policy rate by 25bps.

Q4. If you only have the policy rate, what is the BoC's role in a trade war scenario?

A4. First we need to analyze and assess what a trade war would do. There is a lot we don't know, how high, how long, what response, how fiscal would adapt. But there are some things that are fairly clear. Economic activity would be lower. Growth would be lower for a period and then eventually come back to where it was, but the whole path of the economy would be lower. The path for inflation would be higher. We can't lean against both weaker growth and higher inflation at the same time. We're going to be assessing the relative weight of those two. If the weakness in the economy comes faster than the higher inflation then monetary policy will focus more on growth. On the other hand if inflation comes first then monetary policy will have to focus more on inflation. We're looking at multiple scenarios. Monetary policy cannot offset the economic consequences of a protracted trade conflict. The economy will work less efficiently. Monetary policy cannot change that, cannot offset it. What it can do is help the economy adjust so the adjustment is less unpleasant than it otherwise would be. We have gotten inflation down, the economy is in a better place, monetary policy is in a better place to react to this potential source of uncertainty

Q5. Does the BoC see potential tariffs as a one time increase in price levels? How concerned are you about the impact tariffs could have upon inflation expectations?

A5. If we do our job properly then yes it's a one time price adjustment. A big increase in tariffs will push inflation up. The lags in monetary policy can't address this. What we don't want to see is initial price increases feed through other prices and become persistent inflation. That is a key thing we will be focused on in ensuring inflation comes back down to 2%.

Q6. Some economists think inflation is warming and that the BoC take a more moderate approach to easing now. What went into your discussion on this?

A6. <Macklem> We said we would be considering further rate cuts and we would take a more gradual approach to monetary policy. We did go more gradual, cutting 25 instead of 50. <Rogers> now, saying they use core gauges to evaluate momentum in underlying inflation. Any one can be a more helpful signal than others. Core measures are a little above headline inflation. There are particularities around trim and how it is calculated that led us not to put much emphasis on it at this point. 'Chart 9', the heat map, says it all about inflation right now.

Q7. Do you think fiscal policy needs to play a bigger role in responding to tariffs and what actions can provincial governments take?

A7. We leave fiscal policy to them. Monetary policy is a very blunt instrument. Fiscal policy can be more targeted. Those decisions are decisions of elected governments and we will leave it to them.

Q8. Are you at the end of your latitude on the Canadian dollar's response already to tariffs?

A8. We discussed why we're seeing changes in the exchange rate. It's true the fact we decreased the policy rate has been a factor, but our analysis indicates the rate gap to the US is not the most important factor. The most important factor is uncertainty tied to the threat of tariffs.

When there is more information about tariffs I'm anticipating that financial markets will adjust. If the dollar depreciates even more then we will have to take that even more into consideration in our analysis. We do not have any control over the exchange rate. It's a flexible exchange rate that allows us to manage the policy rate based on Canadian's needs.

Q9. What is your base case on tariffs? Growth goes down and inflation goes up at the same time?

A9. The scenario we assumed is a severe scenario. Every country is hit by 25% and every country retaliates and it is a permanent tariff shock. What it shows is that yes this would have a severe effect on the Canadian economy. Growth in year 1 after tariffs would be 2.5–3% lower than it otherwise would have been. That would be called a recession. The second thing we want to stress is that the scenarios are quite sensitive to how would Americans and Canadians respond to these tariffs. If you're an American then US tariffs get paid by Americans. How do they respond, by paying more or substituting to other imports or domestic production? Similarly, if Canada retaliates, do importers take tariffs on their margins, or pass it through quickly? We don't have good historical examples to estimate what's happened over history. We're trying to show this would have a very severe effect. How big and how quickly and how people react creates a zone of uncertainty.

Q10. What would happen to interest rates if there are tariffs?

A10. I'll be very blunt. I can't give you a definitive answer because there is a lot we don't know. I can say we'll do everything we can to be a source of stability. This is a complex shock as growth goes down and inflation goes up. We'll have to weigh which one's bigger and the timing in what time period. We'll have to do our best to adjust interest rates to be a source of stability. We'll be looking at whether the weakness in the economy and downward pressure on inflation dominates in which case we can focus more on growth. On the other hand, if inflation is bigger than the growth impact then we'll have to focus more on inflation. Monetary policy can't offset the economic effects of tariffs. Economic activity can smooth that adjustment to make it less abrupt than it otherwise would be.

Q11. How should we interpret your decision to remove any rate guidance in your statement today?

A11. There is a lot of uncertainty and it didn't seem useful to provide guidance. We don't know what the US is going to do and even when we do know more we'll have to do more work. Our job is to maintain price stability. That means to maintain price stability and avoid inflation either above 2% or below 2%.

Q12. You said in the past that inflation would be transitory in the pandemic. Would you agree that one time price increases can evolve into spikes in inflation expectations?

A12. This is exactly the scenario we would want to guard against. Initially tariffs can mean a one time price increase but they can reverberate. It's why we would need to react if inflation takes off and the forces driving inflation take over.

RELEASE DATE: January 29, 2025

The Bank of Canada today reduced its target for the overnight rate to 3%, with the Bank Rate at 3.25% and the deposit rate at 2.95%. ***The Bank is also announcing its plan to complete the normalization of its balance sheet, ending quantitative tightening. The Bank will restart asset purchases in early March, beginning gradually so that its balance sheet stabilizes and then grows modestly, in line with growth in the economy.***

Projections in the January *Monetary Policy Report* (MPR) published today are subject to more-than-usual uncertainty because of the rapidly evolving policy landscape, particularly the threat of trade tariffs by the new administration in the United States. Since the scope and duration of a possible trade conflict are impossible to predict, ***this MPR provides a baseline forecast in the absence of new tariffs.***

In the MPR projection, the global economy is expected to continue growing by about 3% over the next two years. Growth in the United States has been revised up, mainly due to stronger consumption. Growth in the euro area is likely to be subdued as the region copes with competitiveness pressures. In China, recent policy actions are boosting demand and supporting near-term growth, although structural challenges remain. Since October, financial conditions have diverged across countries. US bond yields have risen, supported by strong growth and more persistent inflation. In contrast, yields in Canada are down slightly. The Canadian dollar has depreciated materially against the US dollar, largely reflecting trade uncertainty and broader strength in the US currency. Oil prices have been volatile and in recent weeks have been about $5 higher than was assumed in the October MPR.

In Canada, past cuts to interest rates have started to boost the economy. The recent strengthening in both consumption and housing activity is expected to continue. However, business investment remains weak. The outlook for exports is being supported by new export capacity for oil and gas.

Canada's labour market remains soft, with the unemployment rate at 6.7% in December. Job growth has strengthened in recent months, after lagging growth in the labour force for more than a year. Wage pressures, which have proven sticky, are showing some signs of easing.

The Bank forecasts GDP growth will strengthen in 2025. However, with slower population growth because of reduced immigration targets, both GDP and potential growth will be more moderate than was expected in October. Following growth of 1.3% in 2024, the Bank now projects GDP will grow by 1.8% in both 2025 and 2026, somewhat higher than potential growth. As a result, excess supply in the economy is gradually absorbed over the projection horizon.

CPI inflation remains close to 2%, with some volatility due to the temporary suspension of the GST/HST on some consumer products. Shelter price inflation is still elevated but it is easing gradually, as expected. A broad range of indicators, including surveys of inflation expectations and the distribution of price changes among components of the CPI, suggests that underlying inflation is close to 2%. The Bank forecasts CPI inflation will be around the 2% target over the next two years.

Setting aside threatened US tariffs, the upside and downside risks around the outlook are reasonably balanced. However, as discussed in the MPR, a protracted trade conflict would most likely lead to weaker GDP and higher prices in Canada.

With inflation around 2% and the economy in excess supply, Governing Council decided to reduce the policy rate a further 25 basis points to 3%. ***The cumulative reduction in the policy rate since last June is substantial. Lower interest rates are boosting household spending and, in the outlook published today, the economy is expected to strengthen gradually and inflation to stay close to target***. However, if broad-based and significant tariffs were imposed, the resilience of Canada's economy would be tested. We will be following developments closely and assessing the implications for economic activity, inflation and monetary policy in Canada. The Bank is committed to maintaining price stability for Canadians.

RELEASE DATE: December 11, 2024

The Bank of Canada today reduced its target for the overnight rate to 3¼%, with the Bank Rate at 3¾% and the deposit rate at 3¼%. The Bank is continuing its policy of balance sheet normalization.

The global economy is evolving largely as expected in the Bank's October Monetary Policy Report (MPR). In the United States, the economy continues to show broad-based strength, with robust consumption and a solid labour market. US inflation has been holding steady, with some price pressures persisting. In the euro area, recent indicators point to weaker growth. In China, recent policy actions combined with strong exports are supporting growth, but household spending remains subdued. Global financial conditions have eased and the Canadian dollar has depreciated in the face of broad-based strength in the US dollar.

In Canada, the economy grew by 1% in the third quarter, somewhat below the Bank's October projection, and the fourth quarter also looks weaker than projected. Third-quarter GDP growth was pulled down by business investment, inventories and exports. In contrast, consumer spending and housing activity both picked up, ***suggesting lower interest rates are beginning to boost household spending. Historical revisions to the National Accounts have increased the level of GDP over the past three years, largely reflecting higher investment and consumption. The unemployment rate rose to 6.8% in November as employment continued to grow more slowly than the labour force. Wage growth showed some signs of easing, but remains elevated relative to productivity.***

A number of policy measures have been announced that will affect the outlook for near-term growth and inflation in Canada. ***Reductions in targeted immigration levels suggest GDP growth next year will be below the Bank's October forecast. The effects on inflation will likely be more muted, given that lower immigration dampens both demand and supply. Other federal and provincial policies—including a temporary suspension of the GST on some consumer products, one-time payments to individuals, and changes to mortgage rules—will affect the dynamics of demand and inflation. The Bank will look through effects that are temporary and focus on underlying trends to guide its policy decisions.***

In addition, the possibility the incoming US administration will impose new tariffs on Canadian exports to the United States has increased uncertainty and clouded the economic outlook.

CPI inflation has been about 2% since the summer, and is expected to average close to the 2% target over the next couple of years. Since October, the upward pressure on inflation from shelter and the downward pressure from goods prices have both moderated as expected. Looking ahead, the GST holiday will temporarily lower inflation but that will be unwound once the GST break ends. Measures of core inflation will help us assess the trend in CPI inflation.

With inflation around 2%, the economy in excess supply, and recent indicators tilted towards softer growth than projected, Governing Council decided to reduce the policy rate by a further 50 basis points to support growth and keep inflation close to the middle of the 1-3% target range. ***Governing Council has reduced the policy rate substantially since June. Going forward, we will be evaluating the need for further reductions in the policy rate one decision at a time.*** Our decisions will be guided by incoming information and our assessment of the implications for the inflation outlook. The Bank is committed to maintaining price stability for Canadians by keeping inflation close to the 2% target.

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