BoC To Hike Next Week

Scotiabank Economics expects the Bank of Canada to raise its overnight rate by 25bps next Wednesday in a statement-only affair. We expect a neutral-hawkish bias in a nod to how there are further hikes to come beyond simply unwinding the two 25bps cuts in 2015. We believe the central bank remains on the path toward raising its policy rate by about one full percentage point by the end of next year in a more front-loaded set of moves—and likely more increases than priced in by markets through 2018.

Growth has been far exceeding the Bank of Canada's forecasts for an extended period. The Canadian economy has grown by 4.2%, 2.7%, 3.7% and 4.5% from 2016Q3 to 2017Q2, respectively. That translates into a four quarter average growth rate of 3¾% which far exceeds the experiences of Canada's developed economy peer set. One might quip that Canada has achieved US President Trump's wish of 4% growth for his own country. The catch-up to the economy's fortunes that has been played by BoC forecasts is shown in chart 1 in comparison to our current forecast for this year's growth rate. The economy has surpassed everyone's expectations by leaps and bounds and especially in the case of the perma-bears. As I wrote at the time, it remains debatable whether the BoC should have eased policy in 2015 in response to the commodity-induced terms of trade shock.

As previously argued, the risk bias at the BoC has to sharply shift toward taking out insurance against upside risks. The interest-sensitives are being led by strong growth in consumption that also got a hefty boost from Ottawa's sharply enriched childcare benefits (chart 2). Spare capacity is shut and the economy is tripping into excess aggregate demand. There is no need for emergency life support—if there ever was. All three core inflation measures appear to be bottoming especially once controlling for some one-offs like auto prices (chart 3). Even alongside higher rates, our models suggest core inflation to be materially closer to the BoC's 2% inflation target by the end of 2018. Without rate hikes there is a risk that inflation will overshoot its target for an extended period of time. Export growth is benefitting from past adjustments to the smoothed level of the currency and from income growth abroad particularly in the US economy which appears to be continuing into Q3. There are enough areas of strength in the Canadian economy to offset the effect of rate hikes on the interest sensitives and still result in moderated growth.

Indeed the whole point is that Canada needs the slower growth that would arise from tightening policy levers. If the almost emerging-markets style of growth that has been unfolding over the past four quarters were to continue unabated then imbalances and inflationary consequences would put Canada at the outer edge of the global experiment over how fast an economy can grow and for how long without stoking pressure points that would be difficult to reverse.

Of course hiking next week is not a slam dunk. While our models—and judgement—suggest that strong economic momentum and stabilized inflation require a more rapid and larger number of rate hikes than previously predicted, there are reasons to wait until October to continue the tightening cycle.

1. The BoC has not set up markets and consensus for a September hike and has been rather quiet of late. However, the BoC didn't feel much compelled to

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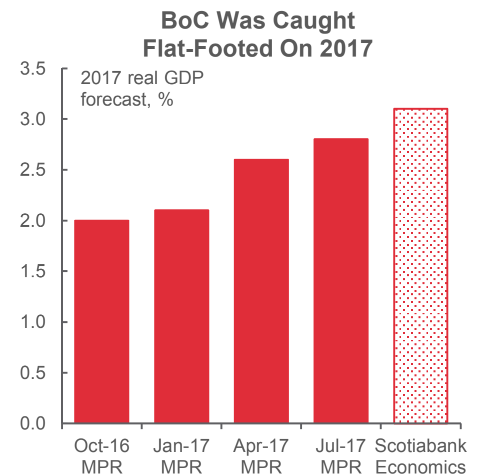
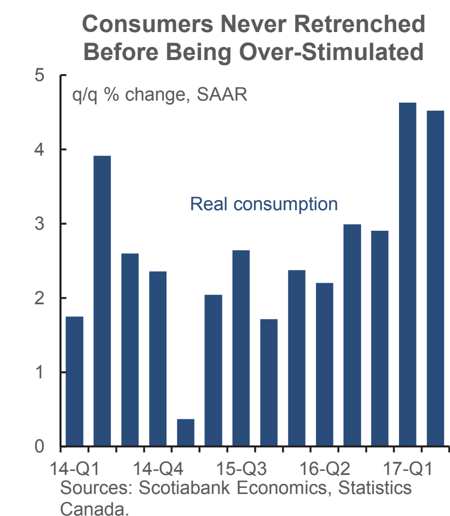
Chart 1



Sources: Scotiabank Economics, Bank of Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

provide such a set-up when it shocked markets in June and the forecast guidance in the July MPR leans toward continuing a hiking cycle in our view. On balance, we continue to believe that Governor Poloz does not pay much heed to forward guidance.

2. CAD appreciation may be a limiting factor, but a) the BoC looks at smoothed levels of the currency against a broadened basket of developed and emerging market currencies over time, and most of what has happened this year was to unwind the overshoot in USD strength. Therefore, the reason why the currency has appreciated must be considered. Going forward we think that global (including US) income growth effects on Canadian exports can offset the deterioration in price competitiveness.

3. The BoC might wait for the US debt ceiling debate to be resolved but we think this shouldn't interrupt the picture a) because the impact upon Canada might involve a weaker CAD and lower bond yields as an offset to b) a transitory shock to the US economy and markets when weighed against the long lagging effects of monetary policy adjustments.

4. The BoC paused along the way in 2015, so it might by extension tighten policy in fits and starts now and spread out hikes. That said, there was more debate and uncertainty over the impact of the commodity shock on Canada back in 2015 whereas there is no debating the torrid pace of growth that Canada seems to have settled into today and how the BoC may already be behind the curve.

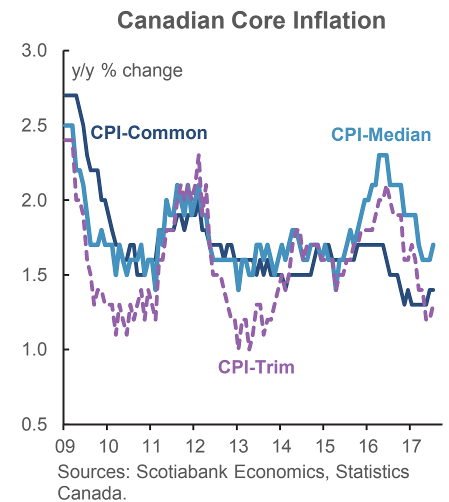
5. Inflation is still low so why rush a hike? No other developed economy world is tripping into excess aggregate demand and so the connection with upside risks to inflation forecasts into 2018 is the strongest in Canada especially when coupled with our expectations for much firmer wage growth. Our view on inflation is anchored in an augmented Philips curve approach applied to Canada that includes unit labour costs and an exchange rate and this approach leads to the expectation that core inflation will gradually rise over the monetary policy horizon of the next 12-18 months even in the face of our expectations for tightened monetary policy. Chart 4 shows our model tracking of inflation.

6. Is growth going to prove durable going forward? There is a very legitimate argument that growth is being brought forward and faces eventual downside risks. This argument has been heard repeatedly over 2017 but clearly there is more going on in the economy that has been persistently underestimated. That counsels taking out insurance against continuing to underestimate growth and adjusting monetary policy conditions as informed by the data and the broader course of events.

7. There are still material risks facing global bond markets and trade policy but, at this point, we judge those risks to be much more benign than may have been feared in the immediate aftermath of the US election. Indeed, if the US administration is unable to deliver policy choices that equity markets have factored into valuations, then the shock effect may include a weaker Canadian dollar and lower bond yields as automatic stabilizer effects that would perhaps further stimulate the Canadian economy while we expect US growth to prove resilient in the absence of fiscal stimulus.

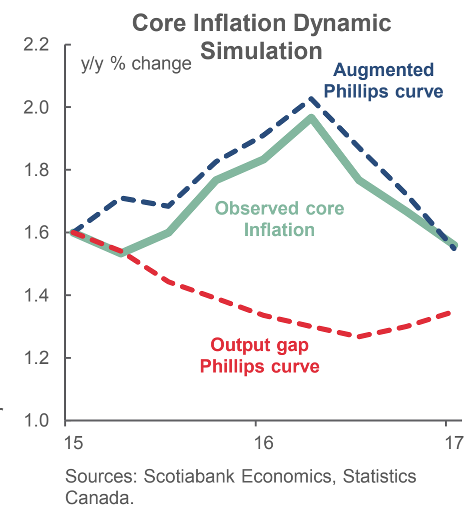
8. Last but by no means least is the housing connection and whether inflated markets limit the BoC's ability to raise rates. Cooler housing markets, however, would be welcomed by policy makers. We continue to reject hard landing scenarios for Canadian housing markets.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

Chart 4



Sources: Scotiabank Economics, Statistics Canada.

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