Bank of Canada to Wait for Clarity

- **We now forecast the next Bank hike will be in April, followed by only one more increase in 2018. We had previously argued that the Bank would next raise rates in December.**
- **Economic conditions warrant an earlier rise, but Governor Poloz's recent focus on downside risks leads us to believe he will take a longer pause before raising rates again. The probability of a rise in December or January is high, at slightly less than 50%.**

Based on incoming data and Scotiabank's Global Macroeconomic Model, we continue to think that the Bank of Canada should raise rates in December, but it is now clear, based on Governor Poloz's comments at the Bank's press conference on 25 October, that the Governor is inclined to wait longer than we think necessary before acting. As a result, we now expect rates to be next increased in April (chart 1).

The economic case for another rate increase in December or early next year remains solid in our view, and the Governor seems to agree: he acknowledges that growth is strong, that the output gap is likely closed, and that inflation is on the rise. For these reasons, he has made it clear that the Bank of Canada is data-dependent and that each meeting is 'live' for further increases in the target overnight rate. However, Governor Poloz has made it equally clear that he is in no rush to raise rates, that he is placing heavy emphasis on downside risks to the outlook, and that he is comfortable pushing the limits of growth and, in so doing, he is also inclined to accept a potential rise in inflation above the Bank's two percent target. Given that clarity on many of the risks that preoccupy the Governor will not be greater until well into 2018, it is unlikely that he will feel comfortable enough to move on rates before point that unless economic and inflation data surprise to the upside in the meantime. There is a risk in all of this that the Governor downplays signs of strength by focusing excessively on downside risks, as he did for much of the first half of 2017.

While the Bank's mandate is to target inflation, a delay in the resumption of interest rate increases will amplify financial stability risks and could, ultimately, make attainment of the Bank's inflation target more challenging over time. Recall that the Governor has time and again talked of the risks associated with increasing household debt and indicated concern about house price levels in certain areas of the country. Low interest rates in the presence of strong growth naturally feed these worrisome dynamics.

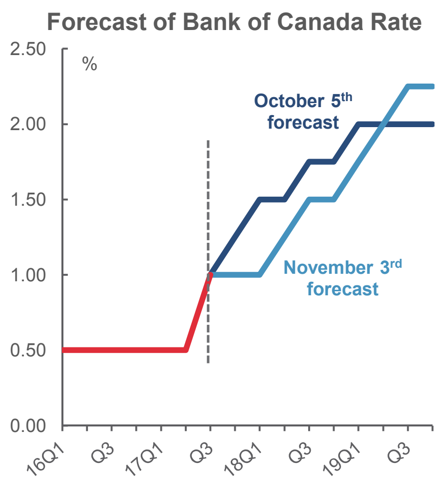
UNCERTAINTY IN THE EYES OF POLOZ: THE CASE FOR A DELAYED INTEREST RATE RESPONSE

– **Household debt.** The Governor is of the view that Canada's record level of average household debt in relation to personal income amplifies the impact of monetary policy on the economy. The magnitude of this impact, if any, is highly uncertain. Yet, the Governor has made it clear that he will proceed cautiously in raising interest rates in order to gauge how households react to higher borrowing costs. The early evidence suggests not much of an impact from rising rates: (witness the record motor vehicle sales in Canada through

CONTACTS

Jean-François Perrault, SVP & Chief Economist
416.866.4214
Scotiabank Economics
jean-francois.perrault@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Bloomberg.

October) owing, in part, to the offsetting impact of ongoing gains in household asset values. More time may be required for the Governor to have a better sense of the economy's response to the 50 bps increase—or "removal of insurance"—he has implemented so far in 2017. From the Governor's opening statement at the October 25th *MPR* press conference:

> *"We do find that the economy is likely to respond more to higher interest rates at today's debt levels than historically. Even so, we have to allow for the possibility that these improved estimates fall short of the mark. Furthermore, we have to watch how the household sector reacts to the new rules around mortgage underwriting. It will take time to understand the impact of these changes as well as the economy's sensitivity to higher interest rates."*

– **Trade-related risks loom large.** The latest round of negotiations and the Bombardier and softwood lumber decisions amplified fears that NAFTA might be terminated or that negotiations, and therefore uncertainty, will last longer than earlier thought. This appears to be the risk that concerns Governor Poloz the most. We remain confident that negotiations will end in either a mutually beneficial modernization of NAFTA and/or limited harm to the existing agreement, but we are not blind to the risks of a failure to negotiate. If the Governor considers it prudent to hold off any monetary action until there is more certainty over the negotiations' outcomes, he is unlikely to feel that he will be in a position to move again until after the end-March 2018 revised deadline for the NAFTA talks. From the *MPR*:

> *"The prospect of a notable shift toward protectionist global trade policies is the most important source of uncertainty affecting the outlook. Recent developments, such as the use of targeted discretionary measures by the United States, are increasing uncertainty about the status of current and future trade agreements. However, the Bank of Canada has chosen not to fully quantify the implications of more-protectionist policies. More clarity is needed in order to narrow the range of possibilities, particularly regarding the specific details and timing of any policy changes."*

– **Effects of macroprudential measures**. The Bank of Canada is counting on the Office of the Superintendent of Financial Institution's (OSFI) recently announced changes to mortgage qualifying rules (the B-20 rules) to slow the housing market. Given the January 2018 implementation date for these changes, we won't have a good sense of how the B-20 rules are impacting housing activity until the spring, at the earliest.

– **Testing the waters.** With inflation still below target, and some uncertainty about the rate of growth of potential GDP ("the level of potential output could be as much as up to 1% higher than expected by the end of 2020", according to the *MPR*), the economy could be allowed to run hot at the risk of generating inflation slightly above the Bank's two percent target.

Given the Governor's concerns, we think it unlikely that he will have greater clarity on the risks listed above until at least April, hence our call for the next interest rate move to occur then in conjunction with the publication of the spring *Monetary Policy Report*. Moreover, using our Scotiabank's Global Macroeconomic Model on the Canadian economy but imposing the Bank of Canada's adjustment for its assessment of trade-related uncertainty and its projections of the early effects of the B-20 rules, both of which may be too strong, the optimal monetary policy response is to raise interest rates in April.

DESPITE THESE RISKS, ECONOMIC CONDITIONS SUGGEST INTEREST RATES SHOULD RISE IN DECEMBER OR JANUARY

– **Inflation**, as measured by the average of the three measures that the Bank of Canada considers the best gauge of underlying inflation, has clearly bottomed and is rising. From its year-on-year low point of 1.3% in May, this measure of inflation has accelerated at its most rapid pace in over 6 years. Moreover, the Governor has indicated that a number of temporary factors continue to exert downward pressure on inflation—factors that should lift in the coming months;

– **Output growth** is expected to remain well above the Bank of Canada's (now re-iterated) view that the potential output growth rate is approximately 1.5%. While it is true that growth in the second half of 2017 (average of 2.1%) is forecast to be well below that observed in the first half of the year (average of 4.1%), and that growth in 2018 (2.2%) is expected to be well below growth in 2017 (3.1%), all these readings suggest that the output gap will move further into excess demand during 2018;

– **The augmented Phillips Curve still lives in Canada.** Given the reasonably strong relationship between the output gap in Canada and inflation, once we control for a few other factors, greater excess demand should lead to higher inflation;

– **Business sentiment is strong** globally, contributing to a global revival in investment. The same is occurring in Canada, where a range of indicators, including the Bank of Canada's *Business Outlook Survey*, imply investment is on an upswing. If sustained over time, this has the potential to add to the economy's productive capacity; in the shorter-run, the increase in investment boosts aggregate demand and thus adds to inflationary pressures;

– **NAFTA concerns are likely overstated.** Though there is the potential for concerns about NAFTA to interfere with firms' capital spending plans, there is as yet little evidence that this is occurring. The primary drivers of capital spending decisions appear to remain solid economic fundamentals, which are exacerbating capacity constraints in some sectors;

– **Wages in Canada and the United States are finally rising faster than inflation** as sustained demand for labour appears to be leading to higher wages. As noted by the Bank of Canada, however, unit labour costs fell in the first half of the year, which suggests an ability of firms to absorb higher wage costs without passing them on to consumers or other businesses. Wage data for the second half of the year (only July to September is so far known) imply that unit labour costs might increase significantly. Reports of increasing labour shortages in certain sectors and regions imply that wages will continue to rise and may ultimately add to inflationary pressures;

– **We anticipate an acceleration of US growth** in 2018, to about 2.4%, from 2.2% in 2017. This is slightly more rapid than expected by the Bank of Canada, and it implies that the Canadian economy will get more of a lift from our southern neighbour;

– In addition to these economic motivations, which are ultimately all directly linked to the Bank's inflation-targeting mandate**, financial stability considerations** also loom large:

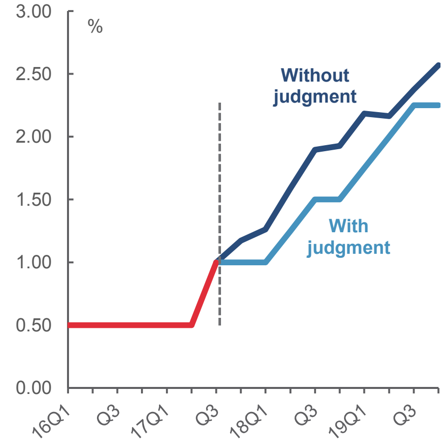
  ◊ The pace of household debt accumulation is unlikely to slow significantly absent a rise in interest rates. Governor Poloz has indicated that the relatively high level of household indebtedness likely amplifies the impact of interest rates on the economy and is, thus, a justification for proceeding cautiously with further increases in interest rates. While this may be a reasonable approach, it comes with the obvious effect of encouraging households to borrow even more as interest rates remain lower for longer; and

  ◊ Efforts to cool housing markets have been largely ineffective to date. Markets would undoubtedly be even frothier absent the range of macroprudential measures that have already been taken, but fundamentals remain powerful drivers of activity. So long as the economy and labour markets remain strong, interest rates are likely the most powerful tool to curb demand for housing in the absence of a strong supply response to dampen prices; and

– **Finally, we believe the Bank of Canada should tighten monetary policy in an opportunistic way to accumulate stimulative firepower in the event of an economic slowdown.** We do not anticipate a recession in our forecast horizon but there is always a chance that one could materialize. Based on our forecast, the Bank's policy rate would be 2.25% by the end of 2019, leaving the Bank with relatively little conventional ammunition in the event of a serious slowdown in growth. Unconventional measures, such as quantitative easing and negative interest rates are likely to be of limited assistance in Canada if additional monetary action were needed in the future. This is not to say that the Bank of Canada should tighten just to give itself additional room to cut in the year ahead, but it does argue for the Bank to consider raising rates a bit more aggressively in the presence of strong growth and rising inflationary pressures.

Given the vigour of the recovery, and the above-potential growth expected by both Scotiabank Economics and the Bank of Canada, our model implies a need to raise interest rates in late-2017 or early-2018. We impose negative judgement on the outlook to account for the Governor's concerns. In the absence of this judgement, the stronger US growth we are now forecasting, combined with a weaker loonie suggest that rates would need to be higher (chart 2). The risks to inflation appear to be tilted to the upside given the momentum we see not just in inflation measures themselves, but also in wages. Moreover, investment appears to be accelerating as we head into the year-end, and motor vehicle sales, perhaps the single clearest demonstration of consumer spending power, continue to hit record levels. For these reasons, we believe the Bank of Canada should raise rates sooner (i.e., in December or January) rather than later (i.e., March or beyond). We consider the probability of a rise in December or January to be slightly less than 50%. An earlier move would also help mitigate financial stability concerns and could help expand the Bank's space to move in the event monetary stimulus is needed in the future. Nevertheless, on the basis of the Governor's recent comments and the concerns highlighted in the *MPR*, we now believe the next rate increase from the Bank of Canada will be in April 2018. It should be sooner, but recent events imply it won't be.

Chart 2 **Forecast of Bank of Canada Rate**



Sources: Scotiabank Economics, Bloomberg.

	2017		2018				2019			
	Q3	Q4f	Q1f	Q2f	Q3f	Q4f	Q1f	Q2f	Q3f	Q4f
					(%, end of period)					
Bank of Canada Rate	1.00	1.00	1.00	1.25	1.50	1.50	1.75	2.00	2.25	2.25
Canada (Yields, %)										
3-month T-bill	1.00	1.05	1.10	1.30	1.50	1.60	1.80	2.10	2.35	2.40
2-year Canada	1.52	1.50	1.65	1.80	1.95	2.05	2.10	2.25	2.40	2.45
5-year Canada	1.75	1.75	1.90	1.95	2.05	2.20	2.30	2.40	2.50	2.60
10-year Canada	2.10	2.10	2.20	2.25	2.35	2.45	2.55	2.60	2.65	2.80
30-year Canada	2.48	2.45	2.55	2.60	2.75	2.90	3.00	3.10	3.15	3.20

Sources: Scotiabank Economics, Bloomberg.