BoC Lets the Rate Cut Genie Out of the Bottle

- BoC stays on hold as expected…
- ...but opens the door to easing…
- ...by flagging 'resilience' concerns
- The BoC projects that spare capacity will widen by year-end…
- ...and it's unclear that it will subsequently narrow
- CAD depreciated by nearly a penny to the USD…
- ...while the GoC 2yr yield dropped 11bps…
- ...as markets increased the probability of a cut as soon as December

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The Bank of Canada left its policy rate unchanged at 1.75% as expected and opened the door to easing as soon as the December meeting. A lot can change between now and December 4th, but the incremental information reinforces our off-consensus call for a December cut.

Markets immediately pounced on key aspects of the communications by driving the Canada two year yield down by 11bps while CAD depreciated by almost a full cent to the USD. Some of this reaction may be a positioning overshoot by investors caught flat footed. OIS market probabilities of a rate cut jumped with now a decent one-in-three chance assigned to December. Despite some efforts to dial back the tone of the statement and MPR a bit in the press conference, the currency and short-term rates remained one-way bets. In short, Poloz has let the rate cut genie out of the bottle and it may be difficult to put it back in later if he needs to.

One key is the changed guidance in the concluding paragraph.

> "Governing Council is mindful that the resilience of Canada's economy will be increasingly tested as trade conflicts and uncertainty persist."

That is what leaves the door wide open to an insurance cut or cuts. Nevertheless, if they are that worried that the economy will be "increasingly tested" then why tempt fate, just cut and get in front of it. Poloz dismissed this in the press conference by noting they discussed an insurance cut but decided against one "at this time" which is simply a truism given they didn't act today while leaving the door open. He referenced balanced arguments in terms of upsides and downsides that influenced a hold decision at this meeting, but still concluded he's more concerned about the downside risks.

The problem with this approach to sort of teeing up a cut is that it can trap the central bank into such an outcome either through having to awkwardly disappoint market expectations if they don't follow through, and/or by begetting weak data if, say, consumers postpone purchases on credit in anticipation of a future rate reduction. Think of buying a big ticket item on credit? Hold off is the message here. For a Governor who is loath to provide forward guidance, I find such an approach to be unusual and it is definitely out of sync with other global central banks like the Fed that have generally opted to front-load more insurance.

The BoC revised global growth (see table) a little lower with world GDP growth projected to be 3.1% next year and 3.3% in 2021, both down a tick. They are, however, relatively high on US economic growth and revised *up* their growth projection to 1.9% next year and 1.7% in 2021. That's higher than consensus and

Summary of Annual Growth & Inflation Forecasts

	2019	2020	2021
Global Real GDP (%)			
International Monetary Fund	3.0	3.4	--
Bank of Canada	2.9	3.1	3.3
Bloomberg Consensus	3.1	3.1	3.1
Scotiabank Economics	2.9	3.1	3.3
Canadian Real GDP (%)			
Bank of Canada	1.5	1.7	1.8
Bloomberg Consensus	1.5	1.6	1.7
Scotiabank Economics	1.6	1.8	1.9
Canadian CPI Inflation (%)			
Bank of Canada	2.0	1.8	2.0
Bloomberg Consensus	2.0	2.0	1.9
Scotiabank Economics	1.9	2.0	2.2
US Real GDP (%)			
Federal Reserve	2.2	2.0	1.9
Bloomberg Consensus	2.1	1.7	1.8
Scotiabank Economics	2.0	1.5	1.9
US Core PCE Inflation (%)			
Federal Reserve	1.8	1.9	2.0
Bloomberg Consensus	1.8	2.0	2.0
Scotiabank Economics	1.8	1.9	2.0

Note: Forecasts as of October 23rd, 2019
Sources: Scotiabank Economics, IMF, Bank of Canada, Federal Reserve, Bloomberg.

particularly high relative to our own projection for 1.4% growth in 2020 and 1.8% in 2021. At issue is how potential disappointment to their US forecast and how that could trickle into Canada could explain reticence toward cutting today.

It's worth spending some time on the output gap dynamics. The BoC says spare capacity is between 0% and 1% and is projected to narrow. There are important cautions to point out here.

First, the BoC revised down its growth projections for Canada to 1.7% in 2020 and 1.8% in 2021, both down two-tenths. Further, it revised its 2019Q3 growth down to 1.3% (1.5% previously) and issued its first 2019Q4 forecast at 1.3%. If that comes true, then Canada's GDP growth rate will be proven to have been rather moribund for four out of the five quarters from 2018Q4 to 2019Q4; the average would be 1.8%, but excluding the one strong quarter in Q2 would leave average growth over this period at about 0.8% q/q annualized. The economy could well be judged to have stalled out.

Compared to the BoC's wide range of potential GDP growth estimates, Canada will open a little more spare capacity into year-end. The BoC estimates potential GDP growth at 1.9% for 2019, 1.7% in 2020 and 1.8% in 2021 using the mid-points of their ranges. Growth around a half percentage point lower than this over 2019Q3–Q4 would widen spare capacity further from its present levels into year-end.

This is an important distinction to the statement's reference to how "the current modest output gap will narrow over the projection horizon." It won't do so in the near term according to their forecasts. Whether it materially does so later is debatable. The BoC's 1.7% and 1.8% actual GDP growth in 2020 and 2021 respectively is at best in line with the mid-point of their potential GDP growth range over that same period. To narrow spare capacity appears to require going to the lower end of their potential GDP growth ranges.

Further, it may be useful to clarify the starting point in output gap measures. The MPR stated that the gap is between 0% and 1%. Technically that's correct, but it may imply to the reader that the lower bound estimate is an economy with zero spare capacity. There is high measurement uncertainty around output gaps (!), but that isn't the BoC's estimate. Their updated figures on the web site (here) show the two methodologies estimating gaps at -0.4% and -0.7% in 2019Q3. Ergo, the starting point for spare capacity is around -½%. To repeat the point above, it will widen into year-end if growth performs as they expect.

If this comes true, then that's a mechanism toward a cut over the next meeting or two as Q3 and Q4 data gets digested. Toward year-end, the BoC's output and inflation targeting framework may come under greater pressure but the BoC is clearly expressing a desire to see if this is what happens before acting. Indeed, forecasting sustained softness in GDP growth that is below potential over 2019H2 and with little lift beyond leaves the door open for an insurance cut to avoid total stall speed.

The BoC's inflation forecast was revised down very slightly to 1.8% in 2020 (from 1.9%) and left unchanged at 2.0% in 2021. The BoC cautions that downside risk to headline inflation into 2020 may be driven by base effect energy arguments. Nevertheless, at no point does it project an overshoot and frankly it always projects inflation to rise to be on target over time.

The BoC may have referenced unease toward the level of the currency. The second paragraph's efforts to reference how the C$ is still "near its July level" despite leading references to negative developments since the July MPR is potentially a warning shot that the BoC would view C$ strength in the current climate of global trade tensions as an unwelcome development. I realize that the BoC has moved well beyond type 1 or 2, or MCI references to dollar impacts, and that the BoC is usually careful to avoid explicit currency references and cannot single handedly guide it. That doesn't, however, mean that it's unreasonable to think the BoC would entertain easing to mitigate a further erosion of trade competitiveness. Further to this point, it's premature to boldly declare that the rotation of the sources of growth away from housing and the consumer toward exports and investment has "already occurred" as the press conference asserted. Most economies globally are dealing with negative shocks to both exports and investment.

The BoC is hanging some of its policy stance in no small part upon a contentious view regarding the impact of protectionism on inflation. I'm still of the view that the BoC's warning that protectionism nets out to be inflationary is highly debatable. That view didn't work so well in the 1930s!! The issue is whether protectionism hits the supply side harder than demand or vice versa with both feeding off of each other such that the net result could well be disinflationary and bad for growth. I think that's a key reason why the BoC is holding out against global easing relative to other central banks. The implication that tight monetary policy would be maintained in a souring global economy is wide open to challenge.

On the risk that easing could spark stability concerns in housing finance and housing markets more generally, the Governor flagged tightened macroprudential rules including B20 stress tests as something that could mitigate this effect but it would not be zero and there remain uncertainties.

Please see the attached statement comparison embedded within the full write-up. Please see the full Monetary Policy Report here.

RELEASE DATE: OCTOBER 30, 2019

The Bank of Canada today maintained its target for the overnight rate at 1 ¾ percent. The Bank Rate is correspondingly 2 percent and the deposit rate is 1 ½ percent.

The outlook for the global economy has weakened further since the Bank's July *Monetary Policy Report (*MPR*).* Ongoing trade conflicts and uncertainty are restraining business investment, trade, and global growth. A growing number of countries have responded with monetary and other policy measures to support their economies. Still, global growth is expected to slow to around 3 percent this year before edging up over the next two years. Canada has not been immune to these developments. Commodity prices have fallen amid concerns about global demand. **Despite this, the Canada-US exchange rate is still near its July level**, and the Canadian dollar has strengthened against other currencies.

Growth in Canada is expected to slow in the second half of this year to a rate below its potential. This reflects the uncertainty associated with trade conflicts, continuing adjustment in the energy sector, and the unwinding of temporary factors that boosted growth in the second quarter. Business investment and exports are likely to contract before expanding again in 2020 and 2021. At the same time, government spending and lower borrowing rates are supporting domestic demand, and activity in the services sector remains robust. Employment is showing continuing strength and wage growth is picking up, although with some variation among regions. Consumer spending has been choppy, but will be supported by solid income growth. Meanwhile, housing activity is picking up in most markets. The Bank continues to monitor the evolution of financial vulnerabilities in light of lower mortgage rates and past changes to housing market policies.

The Bank projects real GDP will grow by 1.5 percent this year, 1.7 percent in 2020 and 1.8 percent in 2021. This implies that the current modest output gap will narrow over the projection horizon. Measures of inflation are all around 2 percent. CPI inflation likely will dip temporarily in 2020 as the effect of a previous spike in energy prices fades. Overall, the Bank expects inflation to track close to the 2 percent target over the projection horizon.

All things considered, Governing Council judges it appropriate to maintain the current level of the overnight rate target. **Governing Council is mindful that the resilience of Canada's economy will be increasingly tested as trade conflicts and uncertainty persist.** In considering the appropriate path for monetary policy, the Bank will be monitoring the extent to which the global slowdown spreads beyond manufacturing and investment. In this context, **it will pay close attention to the sources of resilience in the Canadian economy—notably consumer spending and housing activity—as well as to fiscal policy developments.**

RELEASE DATE: SEPTEMBER 4, 2019

The Bank of Canada today maintained its target for the overnight rate at 1 ¾ percent. The Bank Rate is correspondingly 2 percent and the deposit rate is 1 ½ percent.

As the US-China trade conflict has escalated, world trade has contracted and business investment has weakened. This is weighing more heavily on global economic momentum than the Bank had projected in its July *Monetary Policy Report* (MPR). Meanwhile, growth in the United States has moderated but remains solid, supported by consumer and government spending. Commodity prices have drifted down as concerns about global growth prospects have increased. These concerns, combined with policy responses by some central banks, have pushed bond yields to historic lows and inverted yield curves in a number of economies, including Canada.

In Canada, growth in the second quarter was strong and exceeded the Bank's July expectation, although some of this strength is expected to be temporary. The rebound was driven by stronger energy production and robust export growth, both recovering from very weak performance in the first quarter. Housing activity has regained strength more quickly than expected as resales and housing starts catch up to underlying demand, supported by lower mortgage rates. This could add to already-high household debt levels, although mortgage underwriting rules should help to contain the buildup of vulnerabilities. Wages have picked up further, boosting labour income, yet consumption spending was unexpectedly soft in the quarter. Business investment contracted sharply after a strong first quarter, amid heightened trade uncertainty. Given this composition of growth, the Bank expects economic activity to slow in the second half of the year.

Inflation is at the 2 percent target. CPI inflation in July was stronger than expected, largely because of temporary factors. These include higher prices for air travel, mobile phones, and some food items, which are offsetting the effects of lower gasoline prices. Measures of core inflation all remain around 2 percent.

In sum, **Canada's economy is operating close to potential and inflation is on target.** However, escalating trade conflicts and related uncertainty are taking a toll on the global and Canadian economies. In this context, the current degree of monetary policy stimulus remains appropriate. As the Bank works to update its projection in light of incoming data, Governing Council will pay particular attention to global developments and their impact on the outlook for Canadian growth and inflation.