

## BoC Signals A December Hold, But A Case For Easing Remains

- We think the BoC will hold on December 4th...
- ...but cut twice in Q1 and Q2
- Poloz provided strong forward guidance against near-term easing
- Did Poloz hint at revising the neutral rate estimate lower...
- ...and does that imply less present stimulus than he lets on?
- Why the BoC may still ease

**Scotiabank Economics expects the Bank of Canada to hold its policy rate at 1.75% on December 4<sup>th</sup>. We forecast two rate cuts in 2020Q1 and 2020Q2.**

After turning incrementally more dovish on October 30<sup>th</sup>, Governor Poloz used language today that—barring a large shock—sets a high bar for easing in about two weeks' time. In so doing, Poloz marginally tightened financial conditions at an awkward juncture within the global outlook. The two-year Canada yield jumped by about 5bps and the C\$ appreciated by about half a cent to the USD. OIS markets now see the chances of a BoC cut at about 40% odds in January, roughly a fair coin toss by the March meeting and with a full cut priced by the June meeting.

The key phrases that Governor Poloz delivered are listed below. Poloz usually prefers to avoid providing forward guidance and pre-judging outcomes, but **the message below looks awfully like explicit forward guidance that he's on hold** after opening the door with a more cautious stance on October 30<sup>th</sup>. A cut in December would be the granddaddy of all communications flip-flops.

- "We're neutral."
- "Lower interest rates don't stimulate anything. They just reflect the fact that the neutral rate has moved lower as damage has been done to the global economy."
- "We think we have monetary policy conditions about right."
- "The Fed has cut down to where we are."
- "We're watching and waiting."
- "We're fortunate that inflation is at 2% at the starting point. If this were like 2013 onward and we had weak inflation then it would be different. Other countries are below inflation targets."
- "We'll have to watch that and see if the worst is behind us or not. We think we will have lost over \$1 trillion in global output by the end of next year. If growth picks up a little next year that's still lost output."
- "The CDN economy is in a good place overall. There are regional differences."
- "We are still quite stimulative where we are today. We want to do what we can to boost that trend line." Poloz picked up this last remark by noting payments system modernization as an example.

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Chart 1

### BoC Inflation Forecasts

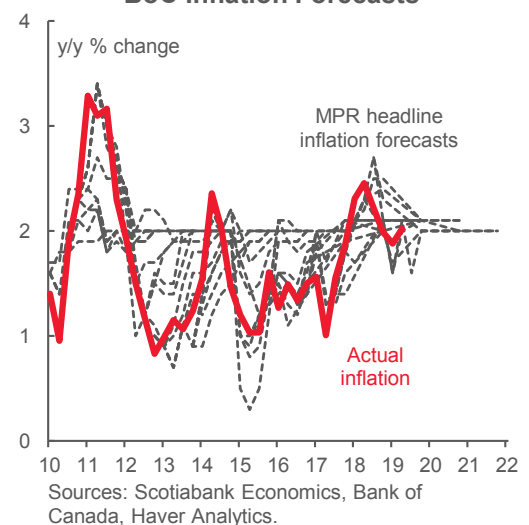
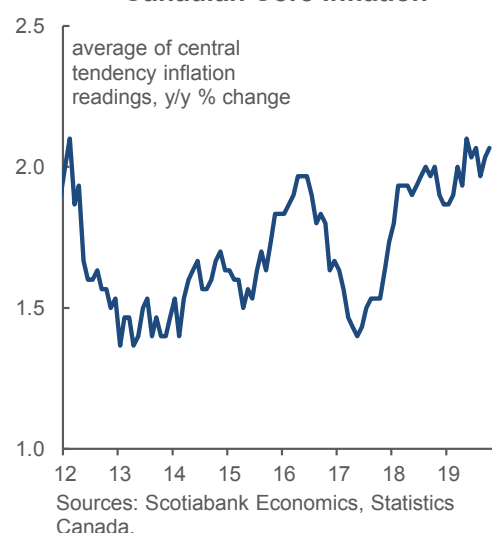


Chart 2

### Canadian Core Inflation



- "For me the glass is always half full"
- "Those other countries are now experiencing what Canada experienced first with the NAFTA uncertainty." [One could note that a major difference is the BoC was hiking throughout the period of NAFTA uncertainty starting with the first hike in July 2017 through to the last hike in November 2018. As other central banks dealt with trade shocks this year, their bias has been to ease.]
- "We still have to watch financial stability and we have tighter macroprudential rules but we've got to keep watching it."
- "Exports are soft. Investment is soft. Housing and services are doing well. Manufacturing is not. Does that spill over into confidence now and the rest of the economy? We're watching."

Some of these comments raise knock-on issues. For one, if rates don't stimulate because neutral rates have moved lower during the trade wars, then **is the BoC leaning toward another downward revision to its neutral rate estimate?** If so, then **does that lower the BoC's estimate of the degree of stimulus** that they think they are providing? That's a material point. The current policy rate of 1.75% is less stimulative to the economy if the neutral rate is no longer 2¾% at the mid-point of the 2¼%–3¼% range the BoC last estimated in April 2019 and is now somewhere below that. Our shop's view for some time has been that the neutral rate is somewhat lower than the BoC's estimate and the direction of risks to this is likely still skewed toward lower rather than higher. If so, maintaining the same unchanged degree of stimulus during global trade wars could merit lowering the policy rate in tandem with the neutral rate.

For another, the Governor appeared to conflict with the tone of Senior Deputy Governor Wilkins' remarks on Tuesday when she indicated the reasonableness of easing as insurance against forward risks but held back the last time because of stability concerns. Poloz is indicating it's about more than that and walked back much of the caution the BoC injected with a more dovish slant at the October 30th decision.

The argument toward easing is mainly predicated upon several points outlined below and beyond the plethora of external global risks that could weigh upon the outlook and markets.

Canada presently has a small amount of slack in the economy that could rise and thus put some downward pressure upon inflation. The BoC estimated that the output gap sits between -0.4% of potential GDP and -0.7% as at the October 30<sup>th</sup> MPR. Call it about -½%. Modest slack is not projected to close any time soon. The BoC forecasts 1.3% GDP growth in Q3 and Q4. That rests below the mid-point of the BoC's estimate for potential growth which is 1.8% in 2019, 1.7% next year and 1.8% in 2021. Actual growth below the economy's non-inflationary speed limit could point to a marginal widening of spare capacity. The BoC's forecast growth beyond that period also does not lean toward shutting spare capacity with GDP projected to grow by 1.7% in 2020 and 1.8% in 2021. By corollary, widening spare capacity may challenge the objective of durably remaining at the 2% inflation target. The BoC does not forecast core—at least publicly—but its headline CPI forecast points to 1.8% in 2020 and 2.0% in 2021. **It would be consistent with such forecasts to take out insurance by easing monetary policy if the BoC is strictly adherent to its output gap and inflation setting framework.** One possible reason for not easing is that the BoC wants to ensure that growth does indeed turn out to be weak instead of just a forecast. One could counter that such an approach is opposite to that of the Fed's in that instead of front-loading stimulus the BoC prefers to act afterward.

**Not only does the BoC forecast below-target inflation, given the BoC's track record of fairly persistently over-estimating future inflation, why wouldn't it wish to err on the side of easing amidst such uncertainty?** Chart 1 shows actual inflation (solid line) plotted alongside inflation projections drawn from each of the BoC's Monetary Policy Reports over time (dashed lines). The one constant has been to persistently forecast the closure of slack and the return toward the inflation target within the forecast horizon versus the fact it has only really come true this year. As chart 2 shows, actual core inflation has persistently undershot the BoC's 2% inflation target about 90% of the months since 2010. The BoC's inflation targeting mandate is supposed to be symmetric and flexible. After years of undershooting, I fail to see how it is achieving this mandate within the context of a 1–3% target *range* that its own macro projections hint at faced risk to the downside of 2%.

**Three related issues linger.** As argued in yesterday morning's note, **the BoC may be too worried about inflaming housing and mortgage markets this time like it did when it eased in 2015.** Obviously worry in itself is legitimate given the history of bubbles often induced by monetary policy. But the question at hand is whether cutting the policy rate would further inflame

housing. Mortgage and housing markets recovered in many areas this year in part because a globally correlated bond rally drove fixed mortgage rates lower including the key five year fixed rate. Cutting the variable rate once or twice is unlikely to do more than to remove a front-end kink in the rates curve rather than drive a flood of variable rate activity. The stimulus would more likely flow to companies' working capital financing requirements and exporters through the currency than housing markets. The shape of the rates curve today is very different to before the BoC began easing in 2015 and lit up the entire term structure of rates by lowering and flattening the yield curve. Today's term rates are externally driven by carry; cutting short-term rates would remove a borrowing inequity. See chart 3.

A related issue is whether stability issues are the *prima facie* concern at the BoC or whether they should be left to the Federal Government, OSFI and other regulators to address while the BoC pursues its core mandate.

Second, **if the BoC is holding out for fiscal policy, then such stimulus could be too little, too late and too transitory in terms of its impact upon growth.** A Fall statement is likely to be delivered sometime after Parliament reconvenes on December 5<sup>th</sup>. We'll need to see what it contains as it may offer some stimulus, but more may have to wait until a Winter budget. By the time the effects hit the economy, we may be looking at next Spring or Summer. Further, mapping the pre-election Liberal platform onto stimulus effects on GDP results in modest incremental stimulus in the low tenths of percentage points of GDP next year. The level of stimulus may hang in, but the platform's math suggests the incremental effects on growth subsequently wane.

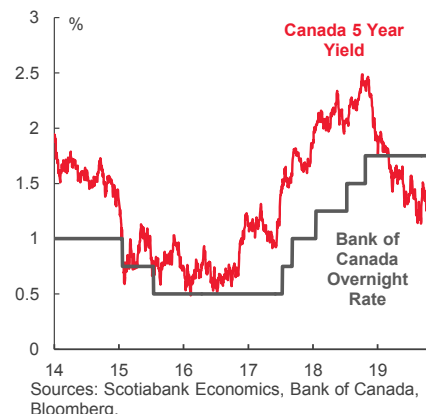
Besides, quite frankly, **where has fiscal stimulus worked to sustainably boost the economy's prospects and durably raise inflation to target?** It's not impossible that Canada applies more stimulus with greater success by learning from other examples, but the breadth of evidence makes this a potentially tall order. The record is soft whether applied in economies with slack (Japan, Canada) or excess demand (US) such that while monetary policy offers no assurance of policy success, handing the baton to fiscal policymakers may be even less assured of sustained success. The global consensus that believes life would be grand if fiscal policy jumped into higher gear should be discomforted by the track record attached to where this has been attempted. Japan's protracted stimulus efforts resulted in sparkling roads and transit amidst mountains of debt, moribund growth and weak inflation. China's big ticket stimulus left it with spare capacity across multiple industries, empty cities, stability issues of its own and low core inflation. The US Tax Cuts and Jobs Act of January 2018 plus the February 2018 spending bill provided a temporary boost to growth at the expense of subsequent growth while core PCE inflation remains below the Fed's target. Canada attempted to stimulate infrastructure spending and offered generous child benefit hand-outs but the net effect ranged from disappointment to transitory effects upon consumer spending followed by a prolonged soft patch. In the current context, there is also no guarantee that provinces would follow Federal fiscal stimulus to magnify the outcomes and some major provinces could quite possibly use the transitory effects to accelerate their own targeted paths back to balance in a classic free-rider fashion. Indeed, Canada's relative advantage in borrowing costs to the US may, in part, owe itself to less supply pressure on the stock of government debt now and expected in future.

Third, **if the Fed cuts again into 2020 as we forecast, then staying parked at 1.75% on the BoC's overnight rate risks driving currency appreciation.** CAD has already appreciated to the USD by around four cents this year as short-rate spread to the US collapsed on Fed cutting and certainly not with much help from commodity drivers. Remaining on hold if the Fed returns with easing next year could drive a further deterioration in export competitiveness by pushing USDCAD down toward the 1.30 mark or below and it's doubtful the BoC would welcome such a development.

In conclusion, Governor Poloz is right to be proud of his staff. Any good boss would motivate his team and his team has done very good work across multiple areas. Acknowledging this should not, however, result in overstating the BoC's success at achieving the inflation mandate to date. It also should not cloud an understanding of the symmetrical and flexible track record in ways that are consistent with one's own macro forecasts.

Chart 3

### Bank of Canada Overnight Rate & 5 Year Bond Yield



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