The BoC Embraced An Easing Bias—With Scope For Turning More Dovish Yet

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

- **The BoC turned more dovish than expected…**
- **...adding to our conviction toward two forecast rate cuts**
- **The BoC now expects persistent slack to weigh on core inflation**
- **The real downside risk to inflation is not spare capacity…**
- **…as the BoC's own research downplays output gaps…**
- **...but rather a reversal of transitory idiosyncratic drivers**
- **Poloz wants greater, more persistent downside than forecast…**
- **...and he may well get it**
- **CAD sank and short-term yields rallied…**
- **...as markets raised and pulled forward easing bets**

The Bank of Canada's full suite of communications included its latest statement (here), the January Monetary Policy Report (here), the opening remarks to the press conference (here) and the press conference Q&A that will inform perspectives offered below.

Even with our forecast for two rate cuts by Summer that is more dovish than consensus and markets, the full suite of communications from the Bank of Canada offered a more abruptly dovish turn than we had anticipated. Key is that the BoC is now signalling more downside risk to core inflation than previously and than we have been forecasting but guiding in terms of downside risks. That adds to conviction in favour of two cuts.

The impact of the broad suite of communications drove a sharp rally in the Canadian government two year yield (-7bps), nearly a penny depreciation in the C$ relative to the USD, and a sharp increase in the probabilities of rate cuts at upcoming meetings. OIS markets are now pricing about one-in-four odds of a cut in March, nearly even odds of a cut versus a hold in April and a full cut priced by Fall. Markets are probably still underpricing easing prospects in favour of a richer front-end and depreciated currency; why bother even getting out of bed to deliver just one rate cut. The BoC has much of the cover it may need in today's communications to ease as soon as March if the data tracking cooperates.

I'll explain how the BoC turned more dovish and how it could yet go more dovish. In particular, I'll come back to how the BoC is putting far too much stock in output gap measures to forecast inflation and waiting for more evidence of building slack while ignoring good arguments for how the central bank may only be temporarily on its inflation target for rather serendipitous reasons owing to transitory idiosyncratic factors.

HOW THE BOC WENT MORE DOVISH

The ingredients that made the communications dovish to markets included the following.

1. Governor Poloz bluntly stated in the press conference **"Yes, obviously the door is open to a rate cut."** Righto, you can perhaps stop reading now if that's all you wish to hear.

2. When asked what changed compared to prior relatively hawkish and at times strident guidance last Fall, Poloz said:

> "We considered whether we should be looking at an insurance rate cut in October when we considered risks to the output gap and inflation forecast but the risk of courting greater financial vulnerabilities. Coming forward to now, **some of those downside risks have actually crystallized and we are now assessing whether we need an easing of monetary policy conditions by evaluating the data."**

3. Nevertheless, when asked if he would cut for insurance purposes or whether a meaningful shortfall would be required in future to trigger a cut, **Poloz indicated he wouldn't do an insurance cut and would instead have to have higher conviction that one is needed.** Many central bankers think the same way. They wish to see obvious evidence that the backward looking data has already soured before acting, by which point it can be more difficult to turn the picture around.

4. **The statement itself removed reference to how the BoC "judges it appropriate to maintain the current level of the overnight rate target" which was initially taken as dovish but Poloz downplayed that later in the press conference.** He did so by stating that "we like to downplay the importance of individual words. The analysis we do suggests there is some downside risk to the outlook for inflation." Then again, one could well put it back to the Governor that if individual wording changes should be downplayed, then why did you make them in the first place? Further, the Governor noted that "All things considered, then, it was Governing Council's view that the balance of risks does not warrant lower interest rates at this time." The "at this time" qualifier is the key in that it makes the statement a truism.

5. **The BoC revised estimates and forecasts for growth, slack and inflation. Each will now be elaborated upon.**

THE BANK OF CANADA EXPECTS A MUTED REBOUND

There was a small downward revision to annual GDP growth at 1.6% this year (1.7% prior) but that masks substantial changes in the quarterly distribution of GDP forecasts.

The 2019Q4 GDP forecast was revised down a percentage point to 0.3% (1.3% prior). Our best real time forecast guesstimate is derived from our 'nowcast' that points to -0.3% GDP growth after including this morning's wholesale figures. By corollary, **we're about a half percentage point weaker than the BoC is for Q4** but with a considerable amount of data still pending for December and revision risk to prior months.

An added factor that Poloz is now emphasizing is that retail sales data may understate consumption growth by excluding Amazon's sales out of the country and hence this is offered as one reason for going higher on Q4 than nowcast tracking would suggest. The spending will only be captured in the quarterly accounts. This is a change compared to not long ago when the Governor said that this effect was of modest significance (speech here). We need to see some actual evidence that this is going to prove to be meaningful rather than what appears to be loose conjecture at this point.

The BoC's first stab at a forecast for 2020Q1 is 1.3% which is quite a weak rebound. In fact, that puts them at the bottom of the current Bloomberg consensus for Q1. This is key because the BoC signals little faith in the magnitude of a rebound versus viewing the underlying drivers of weak growth as being more widespread.

THERE IS MORE SLACK IN THE ECONOMY

The BoC estimated there to be more slack in the overall economy which was more dovish to the inflation outlook at least in terms of the way they look at it.

The BoC's output gap estimate is now -0.25% to -1.25% as at the end of 2019 and hence a -0.75% mid-point. The integrated framework measure of the output gap sits at a point estimate of -0.8% and the extended multivariate filter approach to estimating the output gap sits at -0.6%. **With their GDP projection for 2020Q1 at 1.3%, a touch more slack would occur at the end of Q1.**

Chart 9 in the MPR shows that actual GDP growth is projected to run below potential GDP growth over 2020H1, roughly at potential shortly after and then just a smidge above in 2021.

The BoC is therefore forecasting persistent slack throughout its 2020–21 projection horizon and Governor Poloz confirmed this when queried during the press conference.

Poloz offered two cautions on their current estimates of slack. For one, he said "we believe that the excess capacity is **not uniformly distributed**, but is concentrated on the Prairies and in Newfoundland and Labrador." In other words, more energy dependent regions of the country. Recall the BoC's mandate is nevertheless to target broad economy-wide conditions as they influence the overall inflation target, not regional dynamics.

Second, Poloz noted that "our estimate of the output gap is based on a partially updated estimate of the economy's potential. So, there may be more uncertainty around the current estimate than usual. We will have a more fulsome update in the April MPR."

Recall that the BoC does annual revisions to potential growth estimates in April each year. **I think the BoC will revise potential growth higher in April as it continues to assess the implications attached to developments in the cap-ex cycle.** One relevant development was better than expected investment last Q3 including upward revisions. Another is that the BoC has "only incorporated a little bit of" the improved prospects for business investment due to the likelihood that Canada ratifies NAFTA 2.0 and the BoC may do more of this in April. If the BoC does so, then by corollary it would be inferring greater slack than what it is guiding now.

THE BOC EXPECTS PERSISTENTLY SUB-TARGET CORE INFLATION

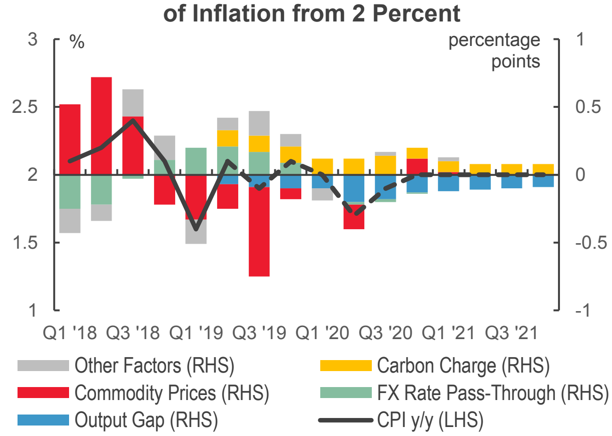
While headline inflation forecasts were little changed, the BoC is implying persistent downward pressure on core inflation.

Headline inflation was minimally revised up by 0.1 to 1.9% this year and left unchanged at 2.0% in 2021.

While the BoC does not publish 'core' inflation forecasts, the key to what they anticipate lies in chart 15 on page 17 of the MPR that was also emphasized in the opening statement to the press conference and during the press conference itself. That chart (replicated in chart 1) puts numbers to the following remark about headline CPI:

> "The boost from the federal carbon pollution charge is expected to roughly offset modest downward pressures from economic slack."

Quarterly Contribution to the Deviation of Inflation from 2 Percent



Sources: Scotiabank Economics, Bank of Canada MPR Jan 2020.

Within the chart, the only real upside on the CPI projection is the carbon charge. The output gap is a persistent projected drag on inflation throughout 2020–21. The implication is that whereas they don't publish core CPI projections, **they are messaging that even with headline expected to be on target, core is expected to run beneath the 2% target and by a meaningful amount that appears to be on the order of about -¼% through much of 2020 and persistently dragging on inflation by a lesser amount in 2021.**

The BoC's communications on output gap drivers of inflation were nevertheless needlessly confusing. The statement noted that inflation is on target with the economy close to capacity, yet it forecasts notable slack that it expects to persist with core inflation under persistently lower pressure.

It's unclear whether the BoC noted the softer than anticipated core inflation numbers including revisions this morning (recap here). There were no remarks on the report but at a minimum one could say the weakening reinforced the dovish messaging.

A tangential point is that **the BoC should publish forecasts for its own core CPI measures either individually or on average.** Other central banks including the FOMC do publish core inflation forecasts and it's rather silly that the BoC does not publish the metrics that it rolled out amidst great fanfare earlier in Governor Poloz's term.

Nevertheless, take the BoC's inflation forecasts with a big grain of salt not only because of its past track record, but also because it revealed the following in the MPR:

> "A complementary perspective using statistical analysis of the Bank's forecast errors suggests that a 50 percent confidence interval around the base-case projection widens from ±0.2 percentage points in the first quarter of 2020 to ±0.6 percentage points by the end of 2021. Over the same period, a 90 percent confidence band widens from ±0.6 to ±1.4 percentage points."

SO WHY DID THE BOC NOT CUT NOW?

There were two reasons offered for why the BoC was not prepared as of yet to ease monetary policy.

One is ongoing concern over **financial stability** matters:

> "In forming this view, we weighed the risk that inflation could fall short of target against the risk that a lower interest rate path would lead to higher financial vulnerabilities, which could make it even more difficult to attain the inflation target further down the road. Clearly, this balance can change over time as the data evolve."

The BoC is saying that they would need to see developments perform worse than what is already forecast in order to ease policy because cutting rates now could magnify future difficulty in staying on the inflation target if it caused greater imbalances that made the household sector more vulnerable to future negative shocks.

Second, the BoC wants to monitor more data:

> "In this regard, Governing Council will be watching closely to see if the recent slowdown in growth is more persistent than forecast."

The bar for a rate cut or cuts is therefore set at disappointing what they are already forecasting. During the press conference, Poloz went on to say that if the slowdown proved to be more persistent than what is built into the base case outlook, then they will assess this risk compared to other risks that they would be adding to including fuelling financial vulnerabilities that could be a problem later. In other words, the BoC wants to see more evidence the economy is in trouble before it tilts the balance in favour of easing and potentially courting greater financial stability concerns. Poloz did re-emphasize that the BoC thinks financial vulnerability has diminished due to the B20 stress test on mortgage approvals and other federal and provincial housing measures.

When pressed to define a period during which persistence of downside risks will be evaluated, Poloz was somewhat ambiguous. He noted that if Q4 is weaker than expected then it would be a sign for greater caution, bvut that depends, for instance, on whether it provided reason to turn more upbeat on Q1 or not. He left the door open to define persistence on the fly as not being a "purely mechanical exercise."

One added possibility is that they want to see the Spring housing market by way of advance signals such as mortgage pre-approvals.

Poloz went on to emphasize that while inflation targeting is the BoC's only objective, that doesn't make it incompatible with concerns toward financial stability. He noted that if they were to ease and add to imbalances and then an external shock arrived that posed downside risk to the economy, then at more elevated levels of indebtedness it might make it even harder to get the economy back on track. Poloz argued that while keeping inflation on target in the short-term is important, you could be creating financial vulnerabilities later and they matter to the inflation mandate.

IS THE BOC UNDERESTIMATING DOWNSIDE RISKS TO INFLATION?

A noteworthy but not terribly surprising omission from today's communications is that the BoC did not once reference potentially transitory and idiosyncratic factors driving inflation to around the target. This is a startling omission on two counts in my view and it demonstrates that the BoC is among the few central banks that seems to have an ironclad faith in their output gap framework for forecasting inflation with little tolerance toward considering other perspectives.

One count involves pointing to **the BoC's own research from March 2018 (here) that says that gaps are not terribly useful at all when it comes to forecasting headline or core inflation.** The BoC research piece on this topic from March 2018 is linked below. I'm emphasizing it because I believe the BoC is going to be surprised lower on inflation for reasons not just having to do with output gaps and widening slack and this is a significant part of the explanation for the easing forecast that I wrote about in the Canadian rates outlook (here). The BoC did not once throughout today's communications refer to idiosyncratic factors that are temporarily distorting inflation.

The BoC research paper's conclusions were as follows:

> "We find that most output gap estimates do not appear to add much information to simple models with lags of inflation in forecasting total CPI inflation and CPI-median"
>
> "However, some output gaps, for instance those estimated with a simplified version of the Integrated Framework, help reduce forecast errors for CPI-common and CPI-trim inflation."
>
> "But these improvements are rarely statistically significant, which partly reflects the fact that the sample of real-time data we could use to study out-of-sample forecasts is relatively small (about 10 years)."

OTHER POINTS

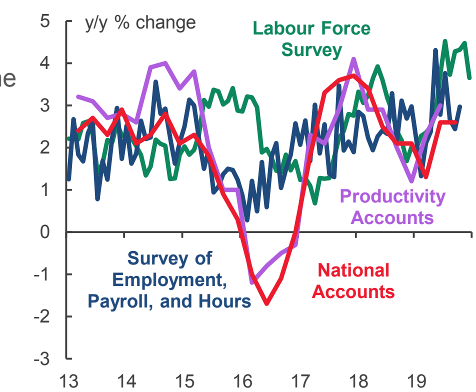
In tracking the path to March/April and onward, there are two other areas where the statement guidance may be vulnerable.

One is that the BoC points to how "wages continue to firm" which isn't totally accurate. Their preferred wage common measure of gains lags because it is drawn from four separate readings two of which are only available quarterly until Q3, but the measures are all correlated with one another (chart 2). **Thus, the already evident deceleration in the wage growth figure within the Labour Force Survey indicates a cycle top may be in play** (chart 3). Indeed, forecasting out a shift in year-ago base effects combined with evidence that the month-ago seasonally adjusted changes are waning points to sharply lower wage growth by mid-year.

Also, the BoC statement said that the "recent federal income tax cut" will help spending. Poloz wound back some of that in the press conference but there is an argument for going further. Take the CPP hike out of the increased basic exemption that itself is around a 0.1% impact on GDP growth and then take account of the fact that the provinces are all going the other way and there is zero net incremental fiscal stimulus in Canada. The onus is on the BoC to step up to the plate if stimulus is needed. We will monitor the Federal Winter budget and the upcoming round of provincial budgets that may influence the BoC's forecasts in the April and June MPRs, but at this point we don't expect material Federal stimulus and provinces are unlikely to reverse course.

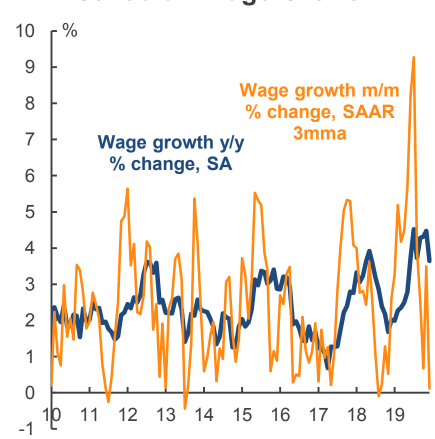
Please see the accompanying statement comparison.

The Relationship between Canadian Wage Growth Measures



Sources: Scotiabank Economics, Statistics Canada, Bank of Canada.

Canadian Wage Growth



Sources: Scotiabank Economics, Statistics

RELEASE DATE: JANUARY 22, 2020

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 1½ percent.

The global economy is showing signs of stabilization, and some recent trade developments have been positive. However, there remains a high degree of uncertainty and geopolitical tensions have re-emerged, with tragic consequences. The Canadian economy has been resilient but **indicators since the October *Monetary Policy Report* (MPR) have been mixed.**

Data for Canada indicate that growth in the near term will be weaker, and the output gap wider, than the Bank projected in October. The Bank now estimates growth of 0.3 percent in the fourth quarter of 2019 and 1.3 percent in the first quarter of 2020. Exports fell in late 2019, and business investment appears to have weakened after a strong third quarter. **Job creation has slowed and indicators of consumer confidence and spending have been unexpectedly soft.** In contrast, residential investment was robust through most of 2019, moderating to a still-solid pace in the fourth quarter.

Some of the slowdown in growth in late 2019 was related to special factors that include strikes, poor weather, and inventory adjustments. **The weaker data could also signal that global economic conditions have been affecting Canada's economy to a greater extent than was predicted.** Moreover, during the past year Canadians have been saving a larger share of their incomes, which could signal **increased consumer caution**. This could dampen consumer spending but help to alleviate financial vulnerabilities at the same time.

Looking ahead, Canadian business investment and exports are expected to contribute modestly to growth, supported by stronger global activity and demand. The Bank is also projecting a pickup in household spending, supported by population and income growth, as well as by the recent federal income tax cut. In its January MPR, the Bank projects the global economy will grow by just over 3 percent in 2020 and 3 ¼ percent in 2021. For Canada, the Bank now forecasts real GDP will grow by 1.6 percent this year and 2 percent in 2021, following 1.6 percent growth in 2019.

While the output gap has widened in recent months, measures of inflation remain around 2 percent. This is consistent with an economy that, until recently, has been operating close to capacity. The Bank expects inflation will stay around the 2 percent target over the projection horizon, with some fluctuations in 2020 from volatility in energy prices. Meanwhile, labour markets in most regions have little slack and wages continue to firm.

In determining the future path for the Bank's policy interest rate, Governing Council will be watching closely to see if the recent slowdown in growth is more persistent than forecast. In assessing incoming data, the Bank will be paying particular attention to developments in consumer spending, the housing market, and business investment.

RELEASE DATE: DECEMBER 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.

The Bank's October projection for global economic growth appears to be intact. There is nascent evidence that the global economy is stabilizing, with growth still expected to edge higher over the next couple of years. Financial markets have been supported by central bank actions and waning recession concerns, while being buffeted by news on the trade front. Indeed, ongoing trade conflicts and related uncertainty are still weighing on global economic activity, and remain the biggest source of risk to the outlook. In this context, commodity prices and the Canadian dollar have remained relatively stable.

Growth in Canada slowed in the third quarter of 2019 to 1.3 percent, as expected. Consumer spending expanded moderately, underpinned by stronger wage growth. Housing investment was also a source of strength, supported by population growth and low mortgage rates. The Bank continues to monitor the evolution of financial vulnerabilities related to the household sector. As expected, exports contracted, driven by non-energy commodities. However, investment spending unexpectedly showed strong growth, notably in transportation equipment and engineering projects. The Bank will be assessing the extent to which this points to renewed momentum in investment.

CPI inflation in Canada remains at target, and measures of core inflation are around 2 percent, consistent with an economy operating near capacity. Inflation will increase temporarily in the coming months due to year-over-year movements in gasoline prices. The Bank continues to expect inflation to track close to the 2 percent target over the next two years.

Based on developments since October, ~~**Governing Council judges it appropriate to maintain the current level of the overnight rate target.**~~ Future interest rate decisions will be guided by the Bank's continuing assessment of the adverse impact of trade conflicts against the sources of resilience in the Canadian economy—notably consumer spending and housing activity. ~~**Fiscal policy developments will also figure into the Bank's updated outlook in January.**~~