Canada's Economy Is Dragging the BoC Toward a Change in Narrative and Earlier than Guided Exits

- **GDP growth doubled the BoC's expectations in Q4…**
- **...and preliminary tracking continues to exceed BoC expectations**
- **Spare capacity is closing fast**
- **Inventories stabilized in Q4 after prior drawdowns…**
- **...and are likely to be a supportive influence to this recovery**
- **The economy continued growing during December and January, despite lockdowns and restrictions**
- **Biden's stimulus will make Canada great again…**
- **…as Canada's Spring budget risks overheating**

CDN GDP, m/m Dec // q/q Q4 SAAR, %:
Actual: 0.1 / 9.6
Scotia: 0.3 / 7.6
Consensus: 0.1 / 7.3
Prior: 0.7 / 40.5
January preliminary guidance: +0.5 m/m

Canada's economy is tracking GDP growth at a pace that is so far six times faster than the Bank of Canada's annualized forecasts for 2020Q4 and 2021Q1. Including January's guidance, the level of GDP has now recovered to over 97% of where it was back in February before the pandemic struck and dragged the economy about 18% lower over the span of just two months in March and April (chart 1). The economy remains on track to close spare capacity much sooner than the Bank of Canada has projected which is in keeping with our expectations for earlier rate hikes than the BoC's 2023 guidance indicates. That probably points toward a coming narrative reset in the BoC's April MPR.

GDP growth smashed expectations and the BoC's forecasts which is the point of comparison because of the policy implications. Growth landed at 9.6% q/q at a seasonally adjusted and annualized rate in Q4. Early tracking for Q1 points to 3.3% annualized growth (chart 2). Compare that to the BoC's January forecast that predicted growth of 4.8% in Q4 followed by a -2.5% annualized contraction. The GDP profile that stems from 9.6% followed by 3.3% compared to the BoC's forecasts for those same quarters has growth tracking a cumulative annualized 6.4% rate over the half year versus the BoC's 1.1% projection. That's a forecast beat of six times the anticipated rate of growth. Major upward forecast revisions are ahead at the BoC and will be present in the April MPR with possible statement guidance next week.

What it means is that the traditional measure of the output gap is probably around –2% now in Q1 (chart 3). That's ten percentage points of less slack than was the case back in Q2 of last year as the economy shut down. I've used the mid-point of the BoC's estimates for potential growth and married them to the pattern to date in actual GDP growth and preliminary Q1 tracking. If vaccines combine with imported benefits of massive US fiscal stimulus and further fiscal stimulus in Ottawa's Spring budget then we could very easily shut spare capacity this year—

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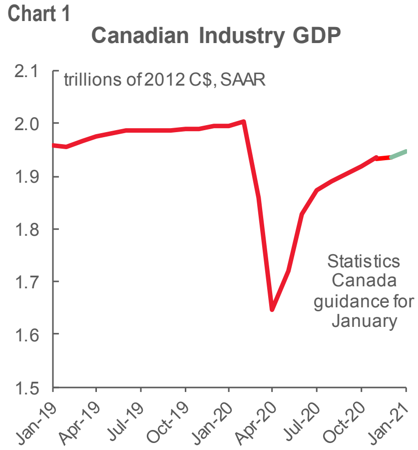
Chart 1

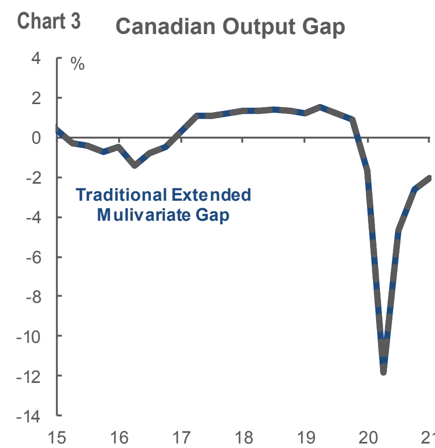


Sources: Scotiabank Economics, Statistics Canada.

Chart 2

Sources: Scotiabank Economics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada.

maybe even by summertime—and begin edging into excess aggregate demand. For a central bank so wedded to its output gap framework and how it connects to inflation forecasts, it is going to be increasingly difficult for it to credibly say that we'll have spare capacity for another three years yet and to do so with a straight face. They should be altering the narrative as the stimulus put in place almost a year-ago was set for a very different world than the one we've transitioned toward.

Inventories contributed seven of the 9.6 percentage points of GDP growth in Q4. That is not a bad thing and be careful with some of the numbers you may have seen. In fact, it's a very constructive development to the outlook and it requires some context. Inventories were massively depleted through the first three quarters of this year and then posted a very small rise of just C$1.7 billion in Q4. Because they were up by just C$1.7 billion in Q4 but the prior quarter was down by C$36.8 billion, the GDP math drove inventories to contribute a large share of the GDP gain even though they barely changed in the final quarter.

I would expect a lot more of a focus upon a desired inventory build as the recovery proceeds. Witness yesterday's US ISM-manufacturing report including the sector anecdotes. The aggregate economy-wide inventory-to-sales ratio has declined from the peak in the second quarter of last year when sales tanked (chart 4). As growth continues to accelerate in our forecasts, either restocking will need to occur or the inventory-to-sales ratio is going to get back to extremely lean levels. This is to be expected as supply chains recover from the pandemic's hit and the earlier hits from Trump's trade wars. Chart 5 shows that inventory depletion had become the norm in Canada for several quarters until the Q4 contribution to growth that provided an exaggerated sense of the modest dollar swing.

Inventories cannot be divorced from imports in an open economy like Canada's. Imports were up in Q4 by enough to shave 3.3 points off of annualized GDP growth. As inventories stabilize, they will tend to coincide with less of a draw down in imports and a shift toward outright higher imports. Therefore as supply chains recover, it's important to take the inventory contribution net of the import subtraction for an overall net contribution of 3.9 percentage points to GDP growth out of the overall 9.6 percentage point GDP growth rate.

Chart 6 shows the weighted contributions to GDP growth by category. Consumer spending was a drag of about 0.26 percentage points off of GDP growth which isn't really new information given tracking and the effects of lockdowns and restrictions. Government spending added 0.29 points. Housing contributed 1.6 ppts to GDP growth while business investment added 0.3 points entirely through higher equipment spending as investment in nonresidential structures fell. Export growth added 1.5 ppts and the decline in imports acted as less of a leakage on GDP so it added 3.3 ppts to GDP growth.

Chart 7 shows the break down of the 0.1% GDP growth by sector during December. Chart 8 does the same thing but in weighted terms to overall GDP growth that makes it clearer which sectors did the heavy lifting.

StatsCan's preliminary guidance for January points to a 0.5% m/m gain but the flash estimate does not share details beyond general guidance that wholesale, manufacturing and construction led the way. That's frankly amazing during tightened restrictions.

Chart 4

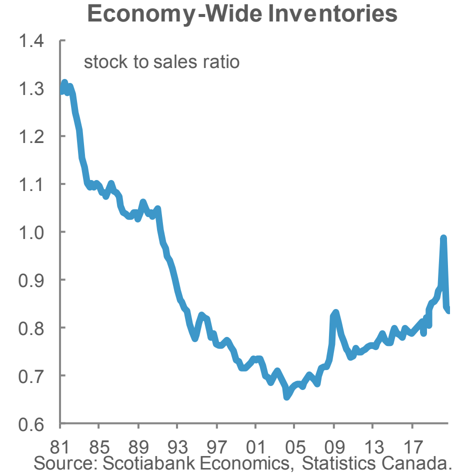


Chart 5

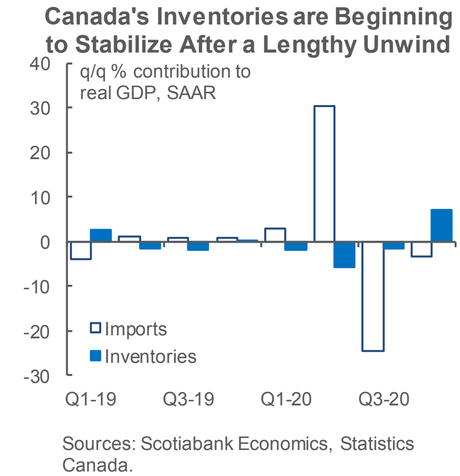


Chart 6

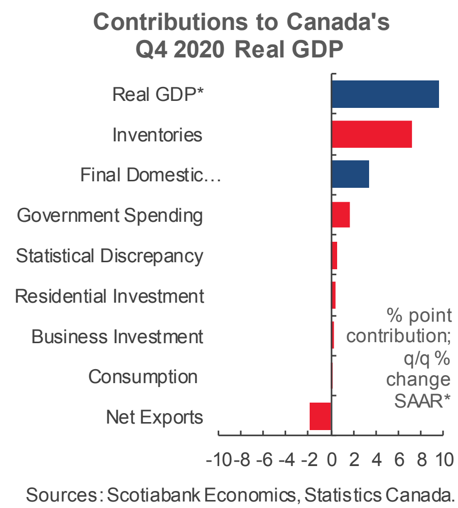


Chart 9 makes is clear that with the exception of a handful of sectors, much of the economy is clawing its way back toward February GDP levels. The few sectors that are behind the most are clearly the ones that have been hit hardest by the pandemic. They are also the ones with potentially the most to gain should behaviour start to respond favourably to vaccinations over 2021 into 2022.

Now clearly this kind of momentum has to continue in order for the Bank of Canada to get to tightening monetary policy. I think it could very well do so. The US Biden administration's massive fiscal stimulus that adds a dozen points of nominal GDP in just two bills spread about three months apart from one another will likely partially leak out into demand for Canadian exports. If the Biden administration then adds another infrastructure bill later this year that uses the budget reconciliation method then further imported stimulus effects into Canada could be felt. Add to that C$70–$100 billion of Canadian federal stimulus in a Spring budget all on the cusp of inoculation of the US population by summer with Canada to follow and we are staring down the barrel of a very powerful set of growth drivers.

The massive stimulus that the BoC put in place almost a year ago was helpful and set in the context of a devastating shock sans vaccines and set against the prevailing narrative that fiscal policy had routinely underwhelmed in scope and sustainability. That stimulus also seriously underestimated what the vast majority who kept their jobs would do with very low interest rates, witness this morning's home sales report out of Vancouver that was already among the world's very priciest.

Strike out those assumptions and now the massive monetary stimulus is looking a tad out of place in a forward-looking sense. My view is that the next steps toward curtailing monetary policy stimulus should arrive as soon as next week if not in the April MPR that revisits all forecasts. Ending the Provincial Bond Purchase Program on the May timeline is a strong possibility and provinces gave a free pass to do so with front-loaded issuance. Curtailing GoC bond purchases by at least C$1B per week—if not more—is another. If the purchase program ends before the output gap shuts as Governor Macklem has been guiding, then that points toward its conclusion over the coming year. That, in turn, paves the way for getting away from an emergency policy rate setting as the emergency is rapidly passing.

Chart 7

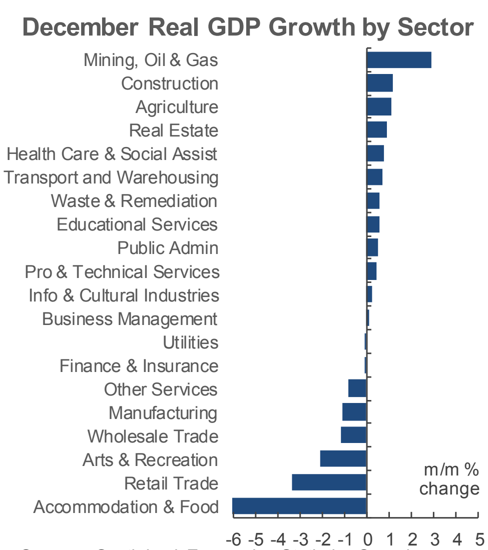


Chart 8

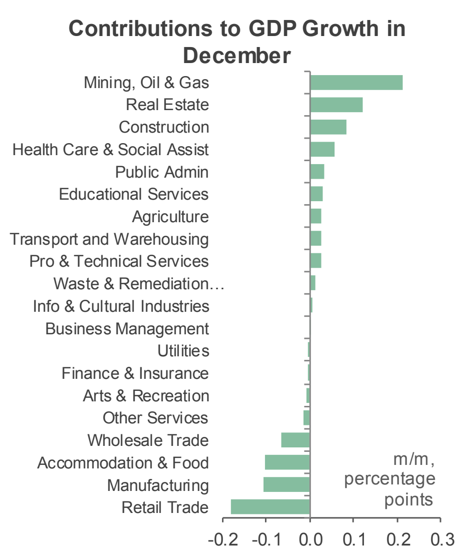


Chart 9