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GLOBAL ECONOMICS

SCOTIA FLASH

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Slow and Steady Just Won't Cut It With Growth Blowing Away the BoC's Forecasts

- **The ink is barely dry on the BoC's growth forecasts…**
- **…and they are already being blown out of the water…**
- **…even before the lagging effects of high commodity prices really kick in**
- **Why quick rate hikes are the best defence against a higher peak and recession**

Contributors

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Canadian GDP, m/m % change, SA, February:
Actual: 1.1
Scotia: 0.8
Consensus: 0.8
Prior: 0.2
Advance March guidance: +0.5

Canadian GDP figures heaped additional evidence onto the pile that portrays the Bank of Canada being way behind in enforcing its inflation mandate. We need to be careful toward which measure of GDP growth is compared to the Bank of Canada's forecasts, but the evidence suggests that even with the ink barely being dry on their April 13th MPR their forecast is already being totally blown out of the water. At a minimum this reinforces our expectation for a 50-50-50 path toward a neutral policy rate and I will explain why I still think the BoC should be acting even faster.

GROWTH IS FAR ABOVE THE BANK OF CANADA'S EXPECTATIONS

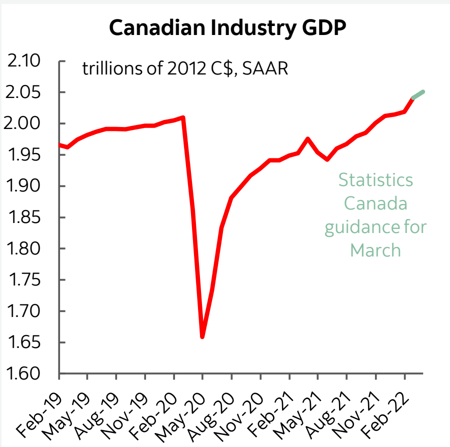
Growth is charging ahead at a much faster pace than the BoC had anticipated even just a couple of weeks ago when it issued its fresh forecasts. Back then they said Q1 GDP growth was expected to be 3% in Q1. That's using expenditure-based GDP. I think growth is looking a lot firmer than that after proper adjustments to tracking and also firmer than our own April forecast for 4% Q1 GDP growth.

A starting point is that income-based GDP growth landed at 5.6% q/q SAAR in Q1 with new information being that February GDP advanced faster than initially guided by StatCan (1.1% instead of 0.8%) and March GDP was tentatively guided to have grown by a further 0.5% m/m. The 5.6% figure doesn't directly compare to the BoC's forecast for expenditure-based GDP and so we have to make some proxy adjustments albeit with high uncertainty given data limitations.

The difference between expenditure-based (that the BoC, ourselves and others forecast) and income-based GDP is primarily that the former considers *how* higher output was achieved including through swings in inventory investment and import leakage effects whereas the latter is deficient in this regard. To get a number that compares to the BoC's 3% growth we therefore need to make some assumptions on inventories and imports. Upon making those adjustments, Q1 GDP growth on an expenditure basis is likely to be at least as strong as the income-based estimates and perhaps stronger.

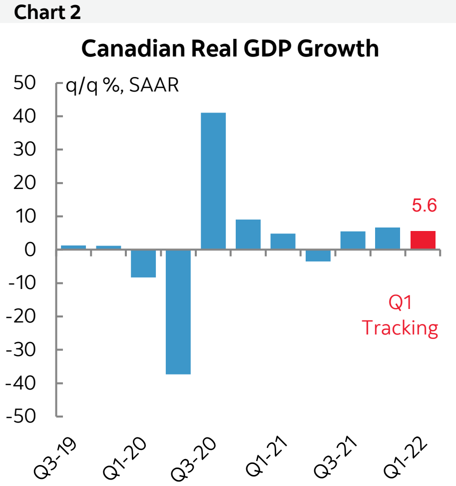
Let's start with imports. We get March trade figures next week so the first quarter data is incomplete. Still, up to now, it looks like import volumes were down by just over 17% q/q SAAR in Q2 assuming March lands flat in order to focus the effects on what we know so far. Export volumes look to have contracted by just under 12%. Therefore if import volumes fell by more than export volumes in percentage and flow terms then the net trade balance improved. In other words, there was a net addition to GDP growth from the decline in imports that exceeded the decline in exports which means imports were less of a leakage effect on GDP accounting. So far, that would mean that expenditure-based GDP could land *higher* than the 5.6% estimate for income-based GDP from StatCan this morning.

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

What about inventory investment? That should be a drag on GDP growth but with the big caveat we only get retail inventories on a quarterly lagging basis and so we only have manufacturing and wholesale inventories figures to go with in terms of monthly tracking up to February. Manufacturing and wholesale inventory additions significantly cooled in inflation-adjusted terms during Q1 compared to Q4. The additions were still positive into Q1 but the flow pace was cooler which means that inventory investment should subtract from Q1 GDP growth on an expenditure-basis. That said, I struggle to get that drag over 1% with aforementioned caveats. I'd really struggle to get a pace of inventory drawdown that would be large enough to offset the income-based GDP tracking and import effects cited above.

The punchline is that expenditure-based GDP that the BoC forecasts is likely to land at least as strongly as the income-based GDP figures suggest which means growth in Q1 is tracking around double or more what the BoC forecast.

By extension, that means that the economy pushed further into excess demand than they had estimated and materially so. In the output gap framework that means that even if the Phillips curve is as flat as it before the pandemic—though it's probably not—then more excess demand would mean more inflationary impulses going forward than what the BoC had judged in its MPR forecasts just two weeks ago.

It's also important to note that the economy hasn't even really begun to see the lagging positive effects of the terms of trade shock via higher commodity prices and the trickle-down effects on incomes. That effect would be among the influences behind why the BoC's forecast for Q2 growth was 6%.

BOC IMPLICATIONS

So that now takes us to what the BoC can and should do with its policy rate. The strong guidance from the BoC is that they will hike by 50bps on June 1st, that a series of hikes are planned in order to fairly quickly get into the 2–3% neutral policy rate range before then either pausing or re-loading for another run higher depending on conditions.

The BoC says that even 50 is unusual compared to their history of rate moves. Ok, but then again, during all of those past moves since the BoC adopted inflation targeting about three decades ago we've never had inflation as high as it is now so I'm not sure how relevant it is to say that 50bps should be the ceiling for rate hikes now simply because it was in the past. The Bank of Canada has never been this far behind its inflation mandate with a policy rate that is still so low.

So why not go faster? Some worry about stability issues and recession risk. I worry more about the longer run stability issues and recession risk if we *don't* move faster. My view is that the merits to moving quickly in response to negative inflation shocks like the GFC and pandemic apply in symmetrical fashion in the face of serial positive inflation shocks. Ben Bernanke once noted that in hindsight he wished the Fed had done more sooner when the GFC hit and that thinking is partly what guided global central banks to throw everything they had at it when the pandemic first struck.

An economy that is in excess demand with almost 400,000 more jobs than it had before the pandemic and inflation 3–4 times its target should already have a policy rate that is at least in the neutral policy rate range if not above. Dragging out hikes even longer would mean that the policy rate would remain below neutral for longer and continue to apply excessive stimulus to overheating conditions. In turn, that would raise the risk that inflation persists at higher rates for longer and hence central banks may have to hike their policy rates to much higher terminal rates. By extension, the odds of recession would go up the higher the terminal rate goes above neutral.

To funding, asset-liability management and credit teams it should be understood that this point in the cycle contains no free lunch. Moving rapidly is the best chance of being able to top out at a lower terminal policy rate later and avoiding recession. Moving slowly raises the odds of a higher terminal rate and recession and instability.

My personal preference remains that the BoC should be hiking faster than 50bps in June. 50 would still leave the policy rate well below neutral in June despite the abundance of evidence that the economy is far beyond equilibrium conditions that should require something higher than a neutral policy rate. The BoC should not be captive to the irrelevant historical period of rate moves that existed around much lower inflation rates and inflation risk than we face at present. It should adapt its pace with the times.

Some of this aggressive path is priced with the policy rate climbing toward 2.5% by September. If the BoC goes more slowly then excessive stimulus for longer would likely add to terminal rate assumptions. Going faster could lower terminal rate assumptions and should be treated more seriously as a policy option by Governing Council.