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GLOBAL ECONOMICS

SCOTIA FLASH

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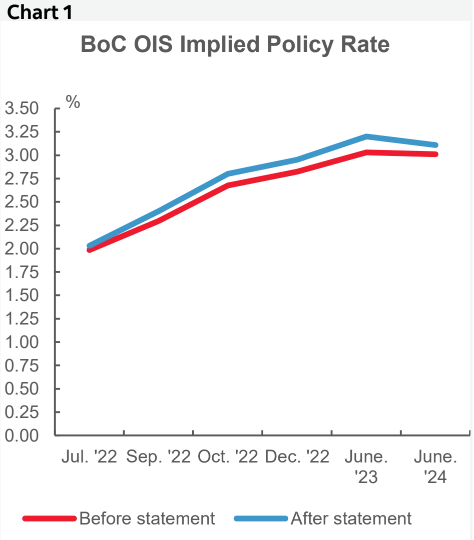
Chart 1



Sources: Scotiabank Economics, Bloomberg.

BoC Lights Up Hike Pricing

- **Bank of Canada hikes 50bps to 1.5% as forecast…**
- **…but by less than markets had priced…**
- **…yet yields jumped higher and CAD appreciated…**
- **…as forward guidance signals greater and faster hike pressures**
- **July's meeting may be a more suitable backdrop for delivering a bigger hike**

The Bank of Canada (statement here) hiked its overnight rate by 50bps as all economists expected but by less than markets were pricing. Scotiabank Economics has consistently led consensus on the pace and timing of hikes and we see the BoC as still sitting a great distance below where it is likely to take the policy rate. Instead of a lighter-than-priced hike being taken in a relatively dovish sense by markets, the offset was a more hawkish nod in the final sentence that signals heightened worries at 234 Wellington Street.

The result was to drive the 2-year GoC yield up by about 7bps while the 5-year yield also cheapened by a similar amount. The Canadian dollar slightly appreciated to the USD and somewhat more versus several other crosses since stronger than expected US ISM-mfrg data arrived at the same time. Chart 1 shows the meeting-by-meeting price adjustments before and after the statement.

The key is what they mean when they say they are "prepared to act more forcefully if needed" to meet its inflation target. The exact reference is in the final paragraph:

> "The pace of further increases in the policy rate will be guided by the Bank's ongoing assessment of the economy and inflation, and the Governing Council is prepared to act more forcefully if needed to meet its commitment to achieve the 2% inflation target."

That's the first statement-codification of "forcefully" whereas previously it was verbalized by the Governor (here). Adding "more" ups the ante. More forcefully than merely forcefully might sound like the sort of economic Kremlinology that could only fascinate economists, but it had to be a deliberate warning to markets. The question is how and by how much. As shown in the accompanying statement comparison, this final sentence also removed reference to how "the timing" of rate hikes will be guided by ongoing assessments which signals they're really in a bigger rush now. That was also a very deliberate move.

Given that the BoC has already been hiking at a 50-point clip twice-in-a-row now, "more forcefully" than prior off-statement references to simply act "forcefully" could well mean faster than 50 at a time is in the cards. So it should be.

Alternatively, "more" forcefully and removing "timing" could combine to mean a more compressed pattern of hikes which would be consistent with our 100bps of further hikes in the next two meetings. It could also mean that the BoC is signalling a higher terminal rate objective. All three being delivered simultaneously is entirely feasible which would have the BoC picking up the size of hikes in July, the pace into the Fall, and a higher terminal rate than they may have previously believed likely.

The other reason I think this line is signalling more openness to something greater than 50 is that we already knew that they want to get into the neutral range fairly quickly before either pausing or continuing. That's one reason why we previously had 50-50-50 June–July–Sept moves in our forecast. To be more forceful than prior guidance to get there "quickly" sounds like they want to pick up the size of the moves unless they mean more quickly than merely quickly which just seems like a flagrant abuse of the English language.

July would be a suitable setting for this given they'll present fresh forecasts including a need to raise their inflation forecasts again and there will be a full press conference to explain the hastened move. If jobs, hours and maybe wages accelerate again in next week's release after last month's possible distortions due to the Good Friday holiday and sickness and the June 22nd CPI update with freshened weights spikes higher again then the stage may be set.

Also note that the BoC probably has a preliminary understanding of what consumers and businesses are telling it on the path to its July 4th release of its latest business and consumer surveys. Interviews were conducted over the back half of May for businesses and before that for consumers. They may already have a sense of likely further pressure on measures of inflation expectations, wage pressures, capacity pressures and hiring plans. Why they take a hamster's age to turn around the results in a formal report still escapes me. That may have played into today's intensified concern especially given the concern that high inflation is driving higher expected inflation which could be very difficult to contain. Anecdotes don't make for data, but evidence of this may be drawn from the fact that multiple large North American companies are delivering off-cycle wage hikes amid tight labour markets and a rising cost of living alongside some instance of labour strife.

With that, we'll await what we hope to be further guidance from Deputy Governor Beaudry in tomorrow's post-statement Economic Progress Report" speech and the ensuing press conference. Headlines appear at 10:45amET and the presser will be held at ~12:15pmET. It wouldn't be out of character for the BoC to drop something like they did today and then leave us hanging into July.

On inflation guidance, there was nothing in this statement to assuage concerns about how the BoC is reading the risks. Quite the contrary in fact. They note that Canadian inflation is "expected to move higher in the near term." They observe that various factors are "boosting inflation" and "putting further upward pressure on prices" with "wage pressure intensifying" in the US as the Canadian economy "is clearly operating in excess demand." The BoC has wiped from its vocabulary any references to transitory, base effects, narrowly based and reopening effects and done a full 180' turn on inflation risk. That's about as alarmist as a non-excitable bunch of central bankers would likely ever get in signalling inflation worries.

Other more trivial matters include the following points:

- They could have softened the wage growth reference but did not. That's probably wise for now, but something to monitor going forward. Month-over-month growth in average hourly wages has dropped off in recent months. The year-over-year rate cooler to 3.4% in April from 3.7% the month before. We think wages will reaccelerate over 2022 in keeping with the m/m acceleration we saw from last summer until early this year, but it's uncertain. The BoC is not signalling such uncertainties when it says "wage growth has been picking up and broadening across sectors" while flagging elevated job vacancies and labour shortages.
- The BoC is still contradicting itself in paragraph 2. They say inflation continues to rise in Canada and globally "largely driven by higher prices for energy and food" which isn't true and hence they take that back in the same paragraph by noting "almost 70% of the CPI categories now show inflation above 3%." It's a similar ratio for over 4%. Food and energy combine to account for about 23% of the CPI basket in Canada and so if 70% of it is rising by over 3% then it's not just food and energy. That's also true in terms of month-over-month seasonally adjusted price changes that saw broadly based accelerating pressures with prices ex-food-and-energy up 0.5% m/m SA non-annualized in April and 0.7% the month before. I guess some forms of bias are slow to fully change….
- As expected, there was no further guidance on balance sheet plans since the BoC implemented full roll-off of maturing GoC bond holdings and ended purchases in primary and secondary markets following the prior meeting.

Overall, it's refreshing to see the BoC pivot in this fashion as it is lightyears behind achievement of its 2% inflation target with inflation nearing 7% for the widest overshoot since before they adopted inflation-targeting three decades ago. Having denied inflation risk throughout almost all of 2020–21 and passing on opportunities to tighten into earlier this year, the BoC is now raising economic and market anxiety by the accelerated pace of out-sized moves. This should have never happened had the central bank been more circumspect, less stridently opposed to any talk of upside risk to inflation, more faithful to its two-tailed risk management framework of thinking and more open-minded to inflation risk amid growing distance from emergency conditions. That could have positioned the BoC to act in more gradual fashion along the lines of the central banks that more suitably led global tightening such as the RBNZ and Bank of Korea.

Please see the accompanying statement comparison.

RELEASE DATE: June 1, 2022

The Bank of Canada today increased its target for the overnight rate to 1½%, with the Bank Rate at 1¾% and the deposit rate at 1½%. The Bank is also continuing its policy of quantitative tightening (QT).

Inflation globally and in Canada continues to rise, largely driven by higher prices for energy and food. In Canada, CPI inflation reached 6.8% for the month of April—well above the Bank's forecast—and will likely move even higher in the near term before beginning to ease. As pervasive input price pressures feed through into consumer prices, inflation continues to broaden, with core measures of inflation ranging between 3.2% and 5.1%. Almost 70% of CPI categories now show inflation above 3%. The risk of elevated inflation becoming entrenched has risen. The Bank will use its monetary policy tools to return inflation to target and keep inflation expectations well anchored.

The increase in global inflation is occurring as the global economy slows. The Russian invasion of Ukraine, China's COVID-related lockdowns, and ongoing supply disruptions are all weighing on activity and boosting inflation. The war has increased uncertainty and is putting further upward pressure on prices for energy and agricultural commodities. This is dampening the outlook, particularly in Europe. In the United States, private domestic demand remains robust, despite the economy contracting in the first quarter of 2022. US labour market strength continues, with wage pressures intensifying. Global financial conditions have tightened and markets have been volatile.

Canadian economic activity is strong and the economy is clearly operating in excess demand. National accounts data for the first quarter of 2022 showed GDP growth of 3.1 percent, in line with the Bank's April *Monetary Policy Report* (MPR) projection. Job vacancies are elevated, companies are reporting widespread labour shortages, and wage growth has been picking up and broadening across sectors. Housing market activity is moderating from exceptionally high levels. With consumer spending in Canada remaining robust and exports anticipated to strengthen, growth in the second quarter is expected to be solid.

With the economy in excess demand, and inflation persisting well above target and expected to move higher in the near term, the Governing Council continues to judge that interest rates will need to rise further. The policy interest rate remains the Bank's primary monetary policy instrument, with quantitative tightening acting as a complementary tool. ***The pace*** of further increases in the policy rate will be guided by the Bank's ongoing assessment of the economy and inflation, and the Governing Council is prepared to act ***more forcefully*** if needed to meet its commitment to achieve the 2% inflation target.

RELEASE DATE: April 13, 2022

The Bank of Canada today increased its target for the overnight rate to 1%, with the Bank Rate at 1¼% and the deposit rate at 1%. The Bank is also ending reinvestment and will begin quantitative tightening (QT), effective April 25. Maturing Government of Canada bonds on the Bank's balance sheet will no longer be replaced and, as a result, the size of the balance sheet will decline over time.

Russia's ongoing invasion of Ukraine is causing unimaginable human suffering and new economic uncertainty. Price spikes in oil, natural gas and other commodities are adding to inflation around the world. Supply disruptions resulting from the war are also exacerbating ongoing supply constraints and weighing on activity. These factors are the primary drivers of a substantial upward revision to the Bank's outlook for inflation in Canada.

The war in Ukraine is disrupting the global recovery, just as most economies are emerging from the impact of the Omicron variant of COVID-19. European countries are more directly impacted by confidence effects and supply dislocations caused by the war. China's economy is facing new COVID outbreaks and an ongoing correction in its property market. In the United States, domestic demand remains very strong and the US Federal Reserve has clearly indicated its resolve to use its monetary policy tools to control inflation. As policy stimulus is withdrawn, US growth is expected to moderate to a pace more in line with potential growth. Global financial conditions have tightened and volatility has increased. The Bank now forecasts global growth of about 3½% this year, 2½% in 2023 and 3¼% in 2024.

In Canada, growth is strong and the economy is moving into excess demand. Labour markets are tight, and wage growth is back to its pre-pandemic pace and rising. Businesses increasingly report they are having difficulty meeting demand, and are able to pass on higher input costs by increasing prices. While the COVID-19 virus continues to mutate and circulate, high rates of vaccination have reduced its health and economic impacts. Growth looks to have been stronger in the first quarter than projected in January and is likely to pick up in the second quarter. Consumer spending is strengthening with the lifting of pandemic containment measures. Exports and business investment will continue to recover, supported by strong foreign demand and high commodity prices. Housing market activity, which has been exceptionally high, is expected to moderate.

The Bank forecasts that Canada's economy will grow by 4¼% this year before slowing to 3¼% in 2023 and 2¼% in 2024. Robust business investment, labour productivity growth and higher immigration will add to the economy's productive capacity, while higher interest rates should moderate growth in domestic demand.

CPI inflation in Canada is 5.7%, above the Bank's forecast in its January Monetary Policy Report (MPR). Inflation is being driven by rising energy and food prices and supply disruptions, in combination with strong global and domestic demand. Core measures of inflation have all moved higher as price pressures broaden. CPI inflation is now expected to average almost 6% in the first half of 2022 and remain well above the control range throughout this year. It is then expected to ease to about 2½% in the second half of 2023 and return to the 2% target in 2024. There is an increasing risk that expectations of elevated inflation could become entrenched. The Bank will use its monetary policy tools to return inflation to target and keep inflation expectations well-anchored.

With the economy moving into excess demand and inflation persisting well above target, the Governing Council judges that interest rates will need to rise further. The policy interest rate is the Bank's primary monetary policy instrument, and quantitative tightening will complement increases in the policy rate. ***The timing and pace*** of further increases in the policy rate will be guided by the Bank's ongoing assessment of the economy and its commitment to achieving the 2% inflation target.