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GLOBAL ECONOMICS

SCOTIA FLASH

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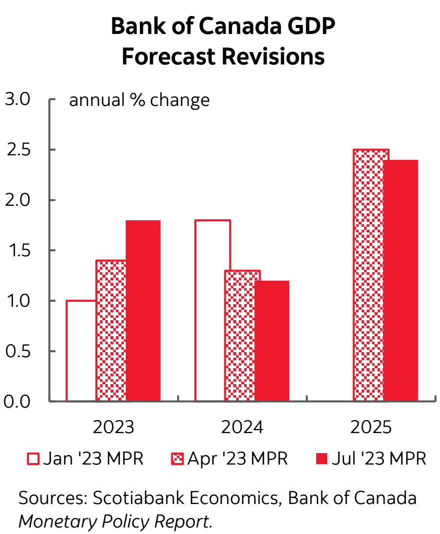
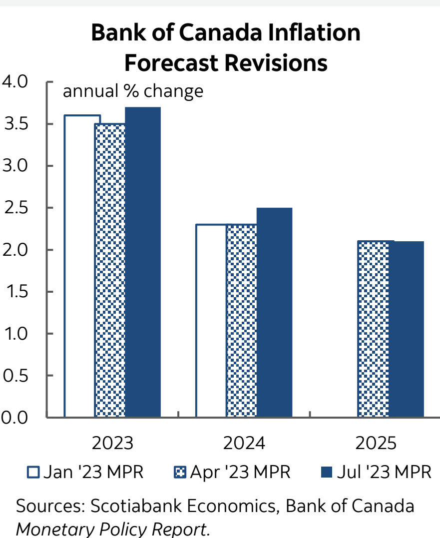
Chart 1



Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report*.

Chart 2



Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report*.

The BoC's Stealth Forward Guidance

- **The BoC hiked 25bps as widely expected**
- **Forecasts lean toward possible further tightening…**
- **…and against later easing…**
- **…as the Bank attempts to apply stealth forward guidance…**
- **…that should be treated with great skepticism**

The Bank of Canada hiked its overnight rate by 25bps as widely expected by domestic economists and mostly priced in advance by markets. The bias leaned toward the hawkish end of the spectrum.

The way they did so was to produce forecasts that suggest a continued bias toward further tightening in heavily data dependent fashion while suggesting little to no prospect for rate cuts along the way. After all, why cut rates when growth is resilient forever and inflation is zipping along years into the future. I will explain what I think is the motive to doing so and why you the reader shouldn't take it too seriously versus doing your own homework.

For now, I would tentatively pencil in a further hike at the September or October meeting especially if data surprises higher, but each decision is being communicated as data dependent and there is a lot of data over the next eight weeks until the September decision that could affect the call. That starts with next week's CPI that I've estimated to be up 0.3% m/m SA.

The market reaction was dominated by US CPI as market participants seemingly assumed that what applies to the US must be portable to Canada. I guess they'll never learn, given the idiosyncratic nature of many of the developments in Canada these days. The Canada two-year yield is down 14bps on the day in a mild 2s10s bull steepener while CAD appreciated primarily due to broad USD softness post-CPI but is underperforming other major crosses.

Please see the attached statement comparison. The Monetary Policy Report is available **here** and the Governor's opening statement to begin the press conference is **here**.

FADE THE LONGER-DATED GUIDANCE

The BoC issued a set of forecasts straight out through to 2025 that deserves a place on the fiction shelves at your favourite bookstore or the virtual equivalent. How so? Why?

They say there will be no recession. Maybe, but don't expect them to say anything but. Even during the press conference, Governor Macklem said "there is a path back to price stability with no recession" and that a soft landing remains possible.

Indeed, on a Q4/Q4 basis, growth is projected to run at 1.8% this year, 1.5% next year and to then accelerate to 2.5% in 2025. CPI is forecast to rise by 2.9%, 2.2% and 2.1% on the same Q4/Q4 basis. Annual GDP forecasts are shown in chart 1 relative to the prior round. Annual CPI inflation forecasts are shown in chart 2.

Growth is forecast at 1.5% q/q SAAR in each of 2023Q2 and Q3 implying sustained ok momentum through summer into the Fall this year. Chart 3 shows the soft landing.

Why did they do this? We can't reject the slim possibility that they may prove to be right, but I think the motives here go much further. One reality is that the political cost to forecasting recession is high in Canada and the cost to being a central bank forecasting a recession in Canada is even higher.

Before I get to what I really think is the motive, it's also feasible that this is truly what they believe will happen and in no small part based upon how growth and inflation have surpassed their expectations for some time now. If so, then err on the side of continued upside risk. Signals that growth will pick up by 2025 in response to possible future easing once they can implement less restrictive policy as inflation perhaps durably comes around toward target.

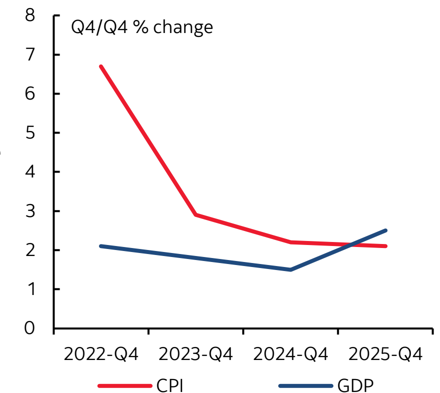
But I have a strong suspicion that what they are attempting to do goes much deeper here. Throughout this year they have been in a contest with markets that have been itching to price rate cuts and that was one contributing factor behind the Spring housing rebound and renewed hikes. In a desire to avoid a repeat, the BoC is trying to invoke stealth forward guidance through its forecast numbers. They can't use explicit forward that proved to be a disaster for the BoC when Macklem promised Canadians that they wouldn't even be thinking about rate hikes until about now, yet here we are with about 500bps into them. Nobody would believe such explicit forward guidance again in a fool me once shame on you, fool me twice shame on me sense.

So the BoC is trying to do so through their forecasts signed off by Governing Council. How so and why? The BoC knows that its direct influence upon the rates curve rapidly peters out beyond the near-dated measures. They have QT tools that can try to influence longer-dated bonds but that's a much, much less powerful alternative to the policy rate. Yet the BoC is frustrated that market participants have been pushing it toward pricing rate cuts earlier than the control freaks at 234 Wellington Street in Ottawa would like.

To understand why they don't want this requires acknowledging that the 5-year portion of the GoC rates curve is the most important benchmark for the Canadian housing market and with it much of the overall interest-sensitive landscape in Canada. So they're trying to exert their influence further up the curve by producing a set of forecasts that pushes back against any tendency to more dearly price those bonds because it would mean lower fixed mortgage rates given the ballpark 70% of outstanding mortgages that are fixed rate and overwhelmingly in fivers. It would mean more fuel thrown onto the housing fires in the country alongside stronger consumption. That, in turn, would make it more difficult to control inflation back to target.

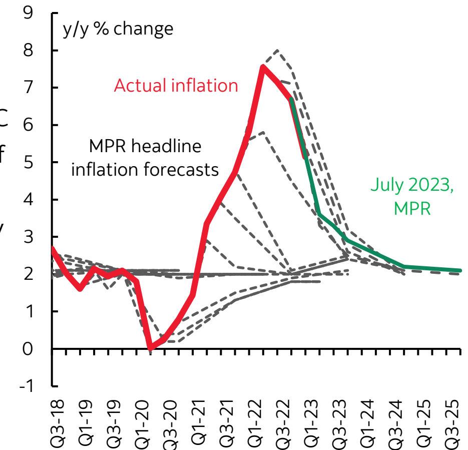
Fade it. Fade it in that one needs to do one's own homework without taking their forecasts as gospel. The reality is that the BoC can't really forecast and certainly not that far out. Not growth, not inflation, not the price of Skittles in Brandon, Manitoba.

Chart 3



Sources: Scotiabank Economics, Bank of Canada.

Chart 4



Sources: Scotiabank Economics, BoC, Haver.

Enter one of my favourite charts that I've been using for many years. I call it the Medusa chart (chart 4). You may not turn to stone if you look at it for too long, but you may very well lose your lunch. The thick red line plots actual y/y CPI inflation over the years and each of the dashed lines (aka Medusa's flailing locks) show inflation forecasts by the BoC in every Monetary Policy Report. They routinely miss the turns as well as undershoot and overshoot inflation forecasts.

If I'm right, then this stealth guidance tool means that should markets resume testing the BoC before it is ready, then markets may court the risk that the hammer gets pulled out again with another policy rate hike to prove the point. Right now they are not doing so, with markets pricing maybe a quarter-point of easing over the next year and maybe 100bps over the next two.

OTHER GUIDANCE

What follows is a gathering of key remarks during the press conference.

The Policy Rate Bias

Governor Macklem indicated that the BoC is prepared to raise its policy rate again if needed and that they will assess their policy stance meeting-by-meeting. They have to say this because the minute they signal confidence they are done is the minute they invite another pile-on into the front-end.

The Governor's opening remarks said they discussed whether to pause now and assess more data up to the next meeting but decided that the cost to delay exceeded the benefit. He didn't elaborate on this, but one possibility is that they feel the pressures are great enough to

require more action now. Another is the possibility they feared that markets would treat it as a sign of wavering and being done with the next step being to resurrect rate cut pricing they judge as premature.

The statement itself dropped the prior remark that they did not feel the policy stance was sufficiently restrictive, but Governor Macklem stated this in the press conference instead and so I don't think that was meaningful.

When asked during the press conference to comment on the terminal rate, Macklem said "We're going to be taking each decision one at a time. We see that monetary policy is working. It works with a lag. The full effects have not fed through. Those underlying inflationary pressures are stronger than we expected. With the increase, we see inflation hovering around 3% over the next year and then coming down toward 2% later in 2025. A number of things have to happen for inflation to come back to target. It's clearly too early to be talking about interest rate cuts."

Household Finances

There were a lot of questions about whether the BoC sympathizes with pressured households and I thought Macklem and Rogers handled them well with sensitivity while making it clear they are focused upon doing their job to control inflation. I think folks need to understand that while there are indeed many pressured households, the BoC is focused upon the broad macro evidence and that the entire point of the exercise of tightening monetary policy is to cause some damage to contain inflation and so far that really isn't happening enough.

Wages

The Governor was asked whether slower wage increases suggest they are closer to the goal of a cooler labour market. He replied saying that they are anticipating a slow down that should see the labour force better balanced and after some time wage growth will diminish and that it will take time. He could have also referenced unit labour costs that indicate compensation has been rising while productivity has been tumbling for some time.

Immigration's Effects

Macklem was asked whether he sees higher immigration as being more inflationary or disinflationary in the short run. He answered that on net it is roughly neutral but it affects different parts of the economy differently. He said immigration is adding to labour supply and easing some of the labour shortages and could ease the cost structures of companies. On the other hand, he said, these new entrants are new consumers and so they add to demand. It's hard to know exactly what the net effect is but the main message is that it is adding to both demand and supply but if you are already in excess demand then it is supporting persistence of excess demand. In my opinion, immigration is more of a demand impulse effect than a supply side effect on inflation but I can see the Governor's reticence to say as much even if absent any supporting evidence for his stance. US studies show that the immigrant wage elasticity effect after controlling for other influences upon wages is roughly zero, yet new arrivals immediately add to consumption and housing.

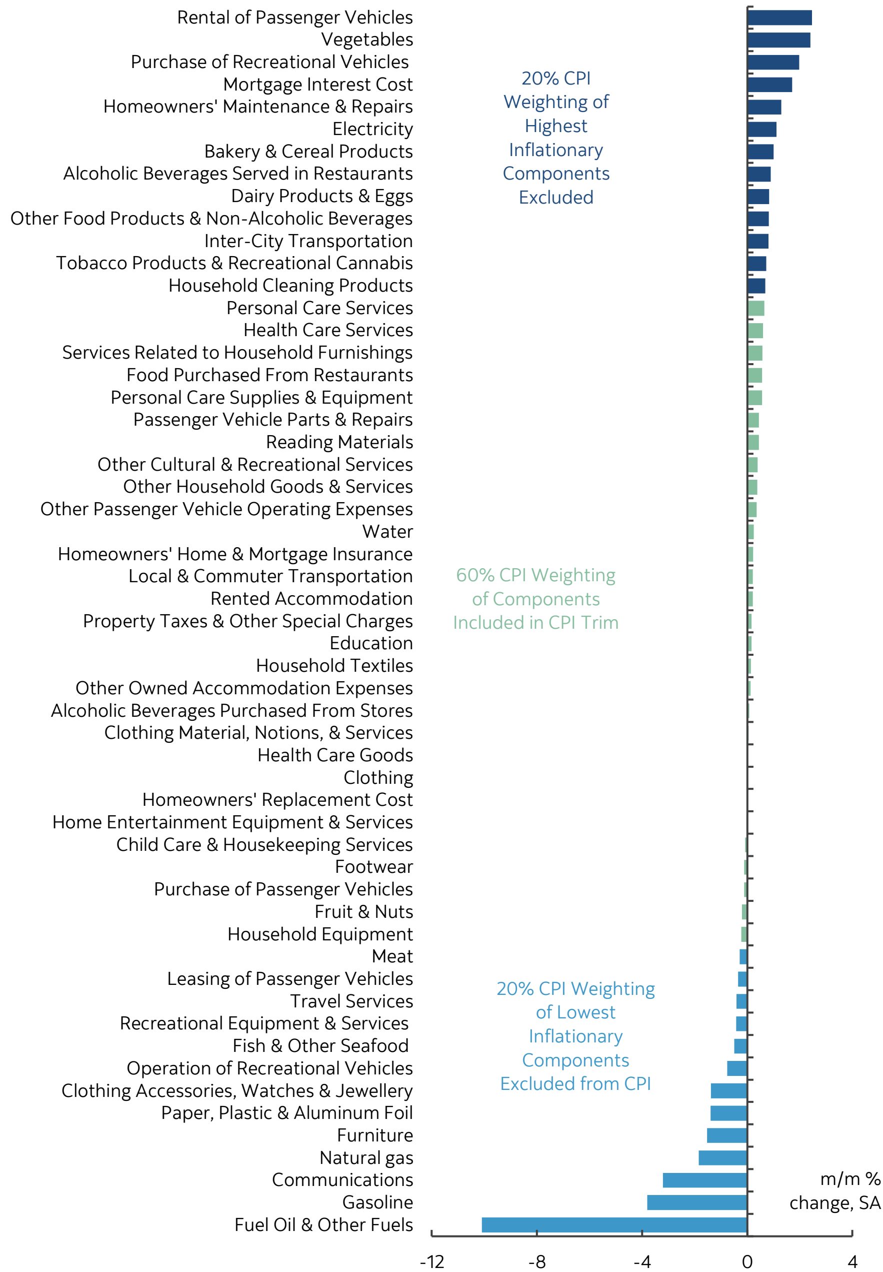
Nonsense About Mortgage Interest and CPI

At several points in the presser the Governor was asked whether he understood that raising the policy rate is putting upward pressure upon mortgage interest costs that are included in CPI and why he doesn't get that after removing this component they are on target. I've said it multiple times now, but this is just bad economics. Macklem's answer was correct but incomplete in that he said that about half the basket is up by over 5% y/y which indicates high breadth and that we can't cherry pick removal of some hot components like mortgage interest or some components that are a drag like year-over-year gasoline price changes and instead have to look at the breadth of the gains in totality. He could have also simply said mortgage interest is not even a factor in its central tendency measures of inflation. Trimmed mean excludes mortgage interest in the upper 20% of the distribution of prices (chart 5, next page) and weighted median uses the weighted 50th percentile price which is not mortgage interest.

Macklem was asked about the potential upside surprises to inflation that he seems to be so worried about. His answer was a good one in that he said "There are always going to be surprises but if you don't get inflation back to 2% and then you get an upside surprise then you are back to 4. The surprises should most of the time be within 1–3%. If inflation is fluctuating within that range then Canadians don't need to worry about fluctuations in their cost of living so they can invest and save and spend with confidence. It's not that there are some specific upside risks but the point is to get inflation back to 2% so you have to worry less about those."

Nobody asked—and the Governor didn't offer anything—about whether rate hikes continue to be needed because Canadian governments are overspending. Of course they are, with probably around a percentage point or more of the rate hikes to date being driven by fiscal stimulus. In the past, Macklem has avoided locking horns with the Feds but most BoC observers probably know the answer to the question.

Chart 5



Sources: Scotiabank Economics, Statistics Canada.

RELEASE DATE: July 12, 2023

The Bank of Canada today increased its target for the overnight rate to 5%, with the Bank Rate at 5¼% and the deposit rate at 5%. The Bank is also continuing its policy of quantitative tightening.

Global inflation is easing, with lower energy prices and a decline in goods price inflation. However, robust demand and tight labour markets are causing persistent inflationary pressures in services. Economic growth has been stronger than expected, especially in the United States, where consumer and business spending has been surprisingly resilient. After a surge in early 2023, China's economic growth is softening, with slowing exports and ongoing weakness in its property sector. Growth in the euro area is effectively stalled: while the service sector continues to grow, manufacturing is contracting. Global financial conditions have tightened, with bond yields up in North America and Europe as major central banks signal further interest rate increases may be needed to combat inflation.

The Bank's July *Monetary Policy Report* (MPR) projects the global economy will grow by around 2.8% this year and 2.4% in 2024, followed by 2.7% growth in 2025.

Canada's economy has been stronger than expected, with more momentum in demand. Consumption growth has been surprisingly strong at 5.8% in the first quarter. While the Bank expects consumer spending to slow in response to the cumulative increase in interest rates, recent retail trade and other data suggest more persistent excess demand in the economy. In addition, the housing market has seen some pickup. New construction and real estate listings are lagging demand, which is adding pressure to prices. In the labour market, there are signs of more availability of workers, but conditions remain tight, and wage growth has been around 4-5%. Strong population growth from immigration is adding both demand and supply to the economy: newcomers are helping to ease the shortage of workers while also boosting consumer spending and adding to demand for housing.

As higher interest rates continue to work their way through the economy, the Bank expects economic growth to slow, averaging around 1% through the second half of this year and the first half of next year. This implies real GDP growth of 1.8% in 2023 and 1.2% in 2024. The economy will move into modest excess supply early next year before growth picks up to 2.4% in 2025.

Inflation in Canada eased to 3.4% in May, a substantial and welcome drop from its peak of 8.1% last summer. While CPI inflation has come down largely as expected so far this year, the downward momentum has come more from lower energy prices, and less from easing underlying inflation. With the large price increases of last year out of the annual data, there will be less near-term downward momentum in CPI inflation. Moreover, with three-month rates of core inflation running around 3½-4% since last September, underlying price pressures appear to be more persistent than anticipated. This is reinforced by the Bank's business surveys, which find businesses are still increasing their prices more frequently than normal.

In the July MPR projection, CPI inflation is forecast to hover around 3% for the next year before gradually declining to 2% in the middle of 2025. This is a slower return to target than was forecast in the January and April projections. Governing Council remains concerned that progress towards the 2% target could stall, jeopardizing the return to price stability.

In light of the accumulation of evidence that excess demand and elevated core inflation are both proving more persistent, and taking into account its revised outlook for economic activity and inflation, Governing Council decided to increase the policy interest rate to 5%. Quantitative tightening is complementing the restrictive stance of monetary policy and normalizing the Bank's balance sheet. ***Governing Council will continue to assess the dynamics of core inflation and the outlook for CPI inflation. In particular, we will be evaluating whether the evolution of excess demand, inflation expectations, wage growth and corporate pricing behaviour are consistent with achieving the 2% inflation target.*** The Bank remains resolute in its commitment to restoring price stability for Canadians.

RELEASE DATE: June 7, 2023

The Bank of Canada today increased its target for the overnight rate to 4¾%, with the Bank Rate at 5% and the deposit rate at 4¾%. The Bank is also continuing its policy of quantitative tightening.

Globally, consumer price inflation is coming down, largely reflecting lower energy prices compared to a year ago, but ***underlying inflation remains stubbornly high.*** While economic growth around the world is softening in the face of higher interest rates, major central banks are signalling that interest rates may have to rise further to restore price stability. In the United States, the economy is slowing, although ***consumer spending remains surprisingly resilient*** and the labour market is still tight. Economic growth has essentially stalled in Europe but upward pressure on core prices is persisting. Growth in China is expected to slow after surging in the first quarter. Financial conditions have tightened back to those seen before the bank failures in the United States and Switzerland.

Canada's economy was stronger than expected in the first quarter of 2023, with GDP growth of 3.1%. ***Consumption growth was surprisingly strong and broad-based***, even after accounting for the boost from population gains. Demand for services continued to rebound. In addition, spending on interest-sensitive goods increased and, more recently, housing market activity has picked up. The labour market remains tight: higher immigration and participation rates are expanding the supply of workers but new workers have been quickly hired, reflecting continued strong demand for labour. Overall, excess demand in the economy looks to be more persistent than anticipated.

CPI inflation ticked up in April to 4.4%, the first increase in 10 months, with prices for a broad range of goods and services coming in higher than expected. Goods price inflation increased, despite lower energy costs. Services price inflation remained elevated, reflecting strong demand and a tight labour market. The Bank continues to expect CPI inflation to ease to around 3% in the summer, as lower energy prices feed through and last year's large price gains fall out of the yearly data. ***However, with three-month measures of core inflation running in the 3½-4% range for several months and excess demand persisting, concerns have increased that CPI inflation could get stuck materially above the 2% target.***

Based on the accumulation of evidence, Governing Council decided to increase the policy interest rate, ***reflecting our view that monetary policy was not sufficiently restrictive*** to bring supply and demand back into balance and return inflation sustainably to the 2% target. Quantitative tightening is complementing the restrictive stance of monetary policy and normalizing the Bank's balance sheet. ***Governing Council will continue to assess the dynamics of core inflation and the outlook for CPI inflation. In particular, we will be evaluating whether the evolution of excess demand, inflation expectations, wage growth and corporate pricing behaviour are consistent with achieving the inflation target.*** The Bank remains resolute in its commitment to restoring price stability for Canadians.

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