Scotiabank.

GLOBAL ECONOMICS

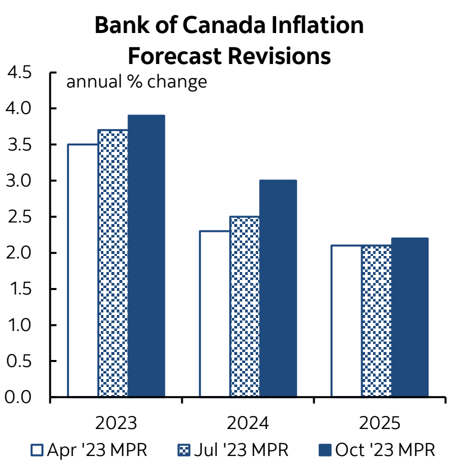
SCOTIA FLASH

October 25, 2023

Contributors

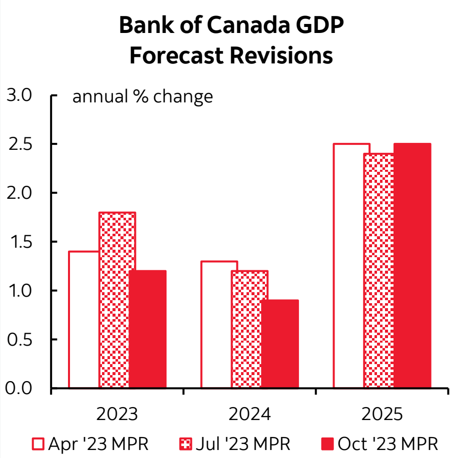
Derek Holt
VP & Head of Capital Markets Economics
Scotiabank Economics
416.863.7707
derek.holt@scotiabank.com

Chart 1



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

Chart 2



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

The BoC Delivered a (More) Hawkish Hold

- **The BoC stayed on hold and described itself as "patient"…**
- **…while nevertheless committing to a hawkish bias…**
- **…encouragingly avoiding a prematurely dovish pivot…**
- **…that leaves them monitoring conditions like the rest of us**

The Bank of Canada delivered a hawkish hold as expected, but it was slightly more hawkish than I had expected going into it. The overnight rate was left at 5% as universally anticipated and so was ongoing quantitative tightening, while the verbiage retained a tightening bias that was anticipated. A statement comparison is offered in the appendix. The Monetary Policy Report including fresh forecasts is available **here** and the Governor's opening remarks during his press conference are available **here**.

On net, Canada's front-end is somewhat volatile today but is unchanged on the day compared to where things left off yesterday while outperforming the US front-end that saw yields drift a little higher after US new home sales data hit. USDCAD is unchanged, perhaps also influenced by the simultaneous release of strong US data.

I like the overall blend of communications that the BoC delivered here today. They struck a reasonable balance in their assessments while leaning cautiously against prematurely declaring victory over inflation while avoiding a promise to end rate hikes. Their view on how inflation risk has moved higher is the same view that I have been marketing with clients.

What can we point to in order to say that their communications were slightly more hawkish on balance than before?

- One obvious starting point is that they raised their inflation forecasts and now see inflation at 3.3% y/y in 2023Q4 (previously 2.9%) and 2.5% in 2024Q4 (previously 2.2%). See chart 1. This is despite revising 2023 and 2024 GDP growth downward while leaving 2025 unchanged (chart 2).
- They delayed the forecast achievement of 2% inflation until 2025H2 instead of mid-2025. Working backwards, that would imply a later start to their thinking on implied easing in advance of achieving this target.
- They statement-codified reference to how "inflationary risks have increased"
- Potential output has been revised down slightly over the projection horizon, reflecting ongoing weakness in productivity against their prior expectation for productivity to improve and as an offset to unexpected strength in population growth. A lower speed limit for growth in future implies that a weakened economy would not create as much disinflationary slack.

The BoC elaborated upon these points by stating that "Overall, inflationary risks have increased since July. Today's forecast has inflation on a higher path than we expected. In addition, rising global tensions are increasing risks. In a more hostile world, energy prices could move sharply higher and supply chains could be disrupted again, pushing inflation up around the world."

The reasons for saying that inflation risks are higher and for revising up inflation forecasts included:

- energy price pressures partly related to geopolitical tensions;
- structural housing shortfalls;

- Potential further shocks to global supply chains partly related to wars;
- stickiness in underlying prices.

Those are really the main takeaways. There are other points to quibble about, but they don't change the bottom line which is that the BoC is on hold and monitoring conditions with a hawkish bias before deciding next steps.

One point to quibble over is that in my view they continue to inappropriately ignore the effects of multiple transitory shocks on the economy from wildfires to multiple strikes and shaky weather and pin the summertime slowdown entirely on their view that rate hikes are working to cool demand. That's obviously an exaggeration to anyone who saw with their own eyes what was happening.

Another one to quibble about is that, in my opinion, the Bank of Canada is making the same mistake that some others are making in stating that real consumption growth has stalled in per capita terms and that labour force growth is exceeding job gains which are signs—in their view—that tighter policy is working. They are using aggregate population growth to arrive at these conclusions, but it's silly to take the total population change when so much of the surge in immigration that has driven rapid population growth is made up of students and temps.

ADDED INSIGHTS FROM THE PRESS CONFERENCE

The press conference Q&A offered added insights compared to the formal communications with my attempt at a transcript offered below.

Q1. CAD is at a seven month low to the USD today. How concerned are you about the implications for inflation especially since the US economy is doing better than expected?

A1. We don't target the currency. Normally when we raise interest rates a lot, the currency appreciates and that slows the economy. Because other central banks have also been raising, CAD is reasonably stable versus the US, up against others. We're not getting the direct effect through lower imported inflation due to C$ weakness which means that we have to rely more upon interest rates and that is something we have to take into account.

Q2. What do you need to see happen in the near term to prompt another hike?

A2. We decided to hold the policy rate because we are seeing clearer evidence that higher rates are cooling the economy but we did leave the door open to higher rates if needed. We need to see downward momentum in our measures of core inflation. Over the past 8 months or so, there has really been very little downward momentum. We need to see downward momentum. We are watching the balance between demand and supply, wage growth, corporate pricing behaviour and inflation expectations. We will take our decisions one at a time. We are prepared to raise our policy rate further if that's what needed.

Q3. One of the upside risks is the war and the effect on energy prices. The MPR notes this may play out differently today because of other factors driving inflation. How would the BoC handle this now?

A3. We've already built in a higher path for oil prices. We have raised that by about US$10 since our projections in July. It's clear there are risks that tensions in the Middle East could intensify. Typically we would look through higher oil prices, but it's not the same set of circumstances today. Expectations are already high, corporate pricing behaviour has changed. In that environment we need to be more focused upon higher oil prices than normal and through the effects on core inflation by way of evidence they are feeding through the rest of the economy.

Q4. Are expecting recession in the coming quarters?

A4. We can't rule out the possibility of small negative numbers for growth. When people say 'recession' they have a steep decline in output and a sharp rise in unemployment but that's not what we are forecasting. The path to a soft landing was narrow and has gotten narrower.

Q5. What explains the difference between growth in the US and Canada and is it persistent?

A5. The structure of the mortgage market in Canada is different. Mortgages reset faster in Canada. Monetary policy would be expected to have more traction in Canada. Also, the buffer of extra savings is still being horded in Canada and not spent in part like in the US and so Canadian consumption has been weaker as people save for higher mortgage payments. A longer-term issue is productivity growth in the two countries.

Q6. Why have house prices not come down more in this hike cycle as in past cycles?

A6. The answer comes down to a structural lack of supply in the Canadian housing market.

Q7. Can you comment on mortgage resets?

A7. We are paying really close attention to the mortgage renewal cycle. We will comment more on this in the financial system review in November which is where we would normally do this.

Q8. To what extent is fiscal policy contributing to inflation? Are there other things that governments can do to bring inflation down?

A8. We don't set fiscal policy. If current spending plans are delivered then spending growth of about 2.5% will exceed potential GDP growth of about 2% and this will add to inflation. It would be helpful if governments considered the impact of their decisions on inflation.

Q9. When can we expect lower rates?

A9. We can reduce our policy rate before achieving 2% inflation when we see where it is going. Now is not the time to assess this. For now, we are evaluating whether the policy rate has tightened sufficiently. We need to see clear signs that inflation is going back down to 2% and right now it is too early.

Q10. Has Canada entered a period of stagflation?

A10. It's not a word I would use. Stagflation is a period of high inflation and high unemployment. Inflation is lower than the 1970s and the UR is quite low.

Q11. How confident are you that inflation returns to target around 2025H2? Has your confidence changed in the past couple of months?

A11. What has changed is that inflationary risks have increased for two reasons. One is that the trend has moved up so we are further from our target and we are starting from a worse place. The other is that we have raised our oil price forecast. There is also the potential for renewed supply chain shocks along with geopolitical shocks. At the same time, we are seeing supply and demand coming back into balance and that's the reason we held at 5% today. We will need to monitor the risks carefully.

Q12. If US Treasury yields continued to run higher because of deficits and Treasury supply and not inflation, could that be inflationary or disinflationary to Canada and what risks would that pose to Canadian monetary policy?

A12. To the degree that higher bond yields reflect central bank guidance it's not a substitute. To a degree to which it does not then it could be a substitute. It is unclear and remains to be seen.

RELEASE DATE: October 25, 2023

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

The global economy is slowing and growth is forecast to moderate further as past increases in policy rates and the recent surge in global bond yields weigh on demand. The Bank projects global GDP growth of 2.9% this year, 2.3% in 2024 and 2.6% in 2025. ***While this global growth outlook is little changed from the July Monetary Policy Report (MPR), the composition has shifted, with the US economy proving stronger and economic activity in China weaker than expected.*** Growth in the euro area has slowed further. Inflation has been easing in most economies, as supply bottlenecks resolve and weaker demand relieves price pressures. However, with underlying inflation persisting, central banks continue to be vigilant. Oil prices are higher than was assumed in July, and the war in Israel and Gaza is a new source of geopolitical uncertainty.

In Canada, there is growing evidence that past interest rate increases are dampening economic activity and relieving price pressures. Consumption has been subdued, with softer demand for housing, durable goods and many services. Weaker demand and higher borrowing costs are weighing on business investment. The surge in Canada's population is easing labour market pressures in some sectors while adding to housing demand and consumption. In the labour market, recent job gains have been below labour force growth and job vacancies have continued to ease. However, the labour market remains on the tight side and wage pressures persist. ***Overall, a range of indicators suggest that supply and demand in the economy are now approaching balance.***

After averaging 1% over the past year, economic growth is expected to continue to be weak for the next year before increasing in late 2024 and through 2025. The near-term weakness in growth reflects both the broadening impact of past increases in interest rates and slower foreign demand. The subsequent pickup is driven by household spending as well as stronger exports and business investment in response to improving foreign demand. Spending by governments contributes materially to growth over the forecast horizon. ***Overall, the Bank expects the Canadian economy to grow by 1.2% this year, 0.9% in 2024 and 2.5% in 2025.***

CPI inflation has been volatile in recent months—2.8% in June, 4.0% in August, and 3.8% in September. ***Higher interest rates are moderating inflation in many goods that people buy on credit, and this is spreading to services.*** Food inflation is easing from very high rates. However, in addition to elevated mortgage interest costs, inflation in rent and other housing costs remains high. Near-term inflation expectations and corporate pricing behaviour are normalizing only gradually, and wages are still growing around 4% to 5%. The Bank's preferred measures of core inflation show little downward momentum.

In the Bank's October projection, CPI inflation is expected to average about 3½% through the middle of next year before gradually easing to 2% in 2025. Inflation returns to target about the same time as in the July projection, but the near-term path is higher because of energy prices and ongoing persistence in core inflation.

With clearer signs that monetary policy is moderating spending and relieving price pressures, Governing Council decided to hold the policy rate at 5% and to continue to normalize the Bank's balance sheet. However, ***Governing Council is concerned that progress towards price stability is slow and inflationary risks have increased, and is prepared to raise the policy rate further if needed. Governing Council wants to see downward momentum in core inflation,*** and continues to be focused on the balance between demand and supply in the economy, inflation expectations, wage growth and corporate pricing behaviour. The Bank remains resolute in its commitment to restoring price stability for Canadians.

RELEASE DATE: September 6, 2023

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

Inflation in advanced economies has continued to come down, but with measures of core inflation still elevated, major central banks remain focused on restoring price stability. Global growth slowed in the second quarter of 2023, largely reflecting a significant deceleration in China. With ongoing weakness in the property sector undermining confidence, growth prospects in China have diminished. In the United States, growth was stronger than expected, led by robust consumer spending. In Europe, strength in the service sector supported growth, offsetting an ongoing contraction in manufacturing. Global bond yields have risen, reflecting higher real interest rates, and international oil prices are higher than was assumed in the July *Monetary Policy Report* (MPR).

The Canadian economy has entered a period of weaker growth, which is needed to relieve price pressures. Economic growth slowed sharply in the second quarter of 2023, with output contracting by 0.2% at an annualized rate. This reflected a marked weakening in consumption growth and a decline in housing activity, as well as the impact of wildfires in many regions of the country. Household credit growth slowed as the impact of higher rates restrained spending among a wider range of borrowers. Final domestic demand grew by 1% in the second quarter, supported by government spending and a boost to business investment. The tightness in the labour market has continued to ease gradually. However, wage growth has remained around 4% to 5%.

Recent CPI data indicate that inflationary pressures remain broad-based. After easing to 2.8% in June, CPI inflation moved up to 3.3% in July, averaging close to 3% in line with the Bank's projection. With the recent increase in gasoline prices, CPI inflation is expected to be higher in the near term before easing again. Year-over-year and three-month measures of core inflation are now both running at about 3.5%, indicating there has been little recent downward momentum in underlying inflation. The longer high inflation persists, the greater the risk that elevated inflation becomes entrenched, making it more difficult to restore price stability.

With recent evidence that excess demand in the economy is easing, and given the lagged effects of monetary policy, Governing Council decided to hold the policy interest rate at 5% and continue to normalize the Bank's balance sheet. However, ***Governing Council remains concerned about the persistence of underlying inflationary pressures, and is prepared to increase the policy interest rate further if needed. 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 behavior are consistent with achieving the 2% inflation target. The Bank remains resolute in its commitment to restoring price stability for Canadians.