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SCOTIA FLASH

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The Likes and Dislikes of the BoC's Yawner

- **The Bank of Canada left all policies unchanged as expected.**
- **BoC guidance pushed back on nearer term cuts again, wiping out March.**
- **The BoC's confusing two-faced approach to hike risk.**
- **How a boring, unchanged set of communications could soon go wrong.**

The Bank of Canada broadly delivered upon expectations. It's easy to do when they are set rather low to begin with. Nothing was changed. Nothing at all. Policy measures were left intact as expected. No material changes to their prior round of forecasts in October were offered. It's as if time stood completely still since the last forecasts on October 25th when in reality so much change is afoot. I don't find that satisfying when you've got a few hundred folks involved in the process.

The overall set of communications left us with the exact same understanding of the BoC perspective that we've had for months. Their growth and inflation forecasts were hardly changed at all (charts 1–2). Their models continue to forecast a nice, neat, perfect landing on 2% next year in strict adherence to the general equilibrium properties that guide them.

If you buy their ongoing view that inflation will durably land on 2% into next year as they basically always forecast and simply have to forecast, then a forward-looking central bank will be cutting probably around the middle of this year, give or take. That's what everyone is hanging their view upon and what is roughly priced. In reality, they can't forecast inflation (chart 3), which makes it totally fair game to apply some heat on the BoC in terms of where they could be wrong and when. That's the job of a street economist.

On that note, and given the absence of any changes from the BoC, I'll go through what I like about what they did on balance, what I didn't like, and where I think the risks lie over coming months. For now, this set of communications was mostly a dull placeholder on the path toward evaluating more needed evidence that will soon begin to arrive.

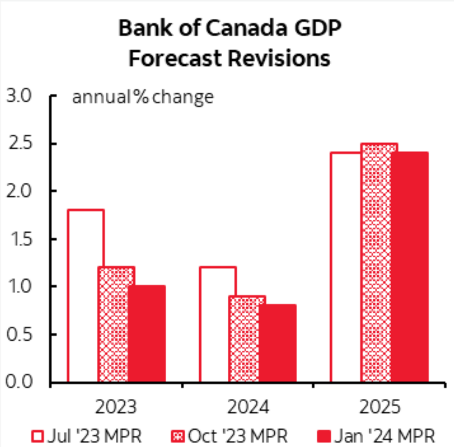
LIKE—PUSHED BACK AGAINST NEARER-TERM CUT PRICING

I liked that they pushed back against nearer-term prospects for rate cuts.

A key way in which they did so shone through in the sentence in the statement that said "core measures of inflation are not showing sustained declines."

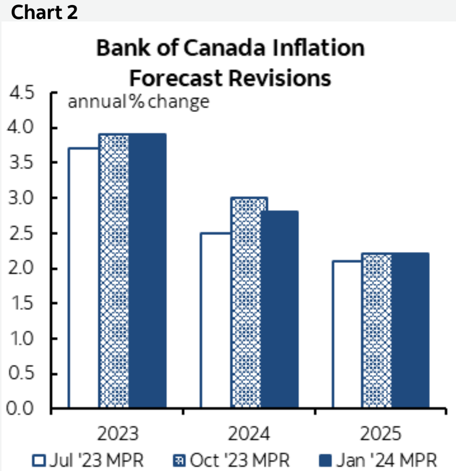
That is perhaps the most impactful thing of all. They've been very explicit in saying they require sustained declines and confidence that the measures will remain low before

Chart 1



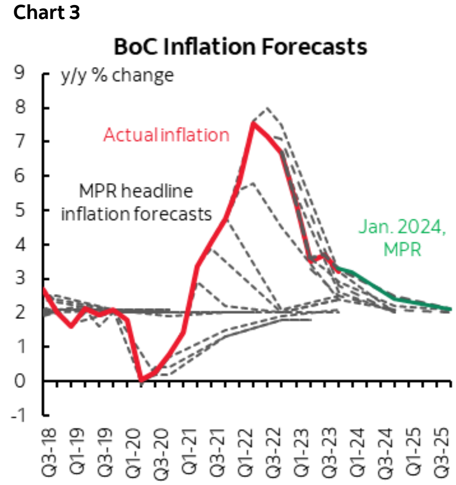
Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report*.

Chart 2



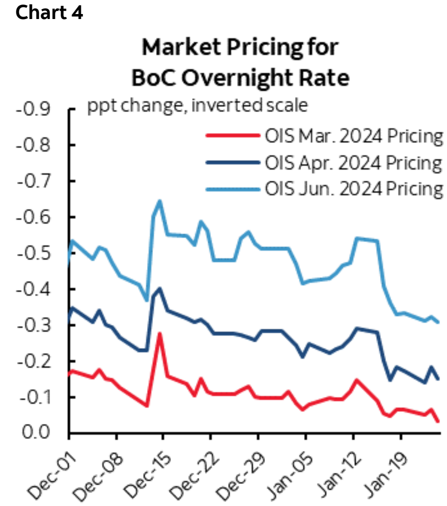
Sources: Scotiabank Economics, Bank of Canada *Monetary Policy Report*.

Chart 3



Sources: Scotiabank Economics, BoC, Haver.

Chart 4



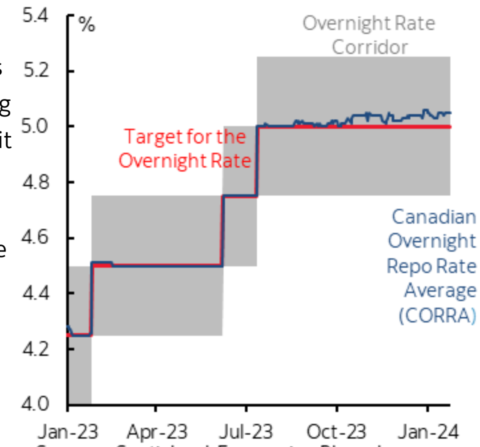
Sources: Scotiabank Economics, Bloomberg.

embarking upon a discussion of when to ease. They are not even ticking the first box which means that at a minimum they are several meetings away from contemplating easing.

Longstanding advice to pay the nearer term contracts has paid off. The part of consensus that guided cutting by March is licking their wounds. As chart 4 shows, pricing for a March rate cut has basically been wiped out now and with a further 3–4bps trimming of market pricing. April meeting pricing was reduced by a few basis points to a still material two-thirds chance at a 25bps cut but it wasn't long ago that almost a full half-point cut had been priced by that meeting. June contract pricing was also slightly reduced but cumulative cut pricing by that meeting has been cut in half from its December peak. CAD softened post-BoC but mostly because of the simultaneous release of strong US PMIs that drove a stronger dollar.

Chart 5

Bank of Canada Overnight Rates



Sources: Scotiabank Economics, Bloomberg.

LIKE—OPEN MINDED GUIDANCE ON REVISITING QT PLANS

I partly liked the way the Governor handled QT. No changes were expected to be announced and none were delivered. There was zero reference to funding market strains or the use or other balance sheet tools and QT plans in any of the published communications.

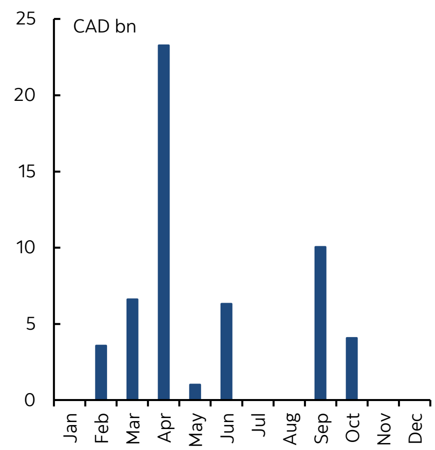
The Governor was asked about it in the press conference and came prepared as it was widely expected. Macklem didn't dismiss changes. He said:

> "Our primary instrument is the policy interest rate. With respect to QT we'll take it one decision at a time. Our balance sheet is gradually declining and at a certain point it will reach a more normal level and we will start to purchase again. We put out estimates of where we think we need to be. They are estimates. As we get closer, we will engage with market participants and evaluate. When we decide to change anything, we will communicate ahead of time, but we are not there yet."

He could have been more direct in saying that funding markets are sending them a signal they are evaluating as evidence by funding market pressures over the policy rate (chart 5), but they have time to do so. I expect rising pressure on the BoC to address this potentially in a standalone speech and it could come before a large C$23.3B bond holding drops off the balance sheet in April with a total of about $34B of holdings maturing between now and then (chart 6). That will further pressure settlement balances and funding markets. Pass today, but as settlement balances drop much further by Spring, the pressure on the BoC to update its thinking on QT plans will rise.

Chart 6

BoC Bond Maturity Profile for 2024



Sources: Scotiabank Economics, Bank of Canada.

DISLIKE—PASSED ON BOLDER NEAR-TERM CUT SPECULATION

I didn't like that Macklem passed on a chance to be more direct on easing prospects over the next several meetings. He sort of did when he said "months" in the plural sense by way of monitoring inflation data going forward, but he could have been more direct. Here is the passage in reference to 'months':

> "I think it's important that we don't give Canadians a false sense of precision. We are being clear on the conditions around when we can begin to discuss when to cut interest rates. Putting it on a calendar is a false sense of precision. We are going to have to see how inflation evolves as we've seen inflation push and pull. In the months ahead we expect to continue to see this push and pull."

When asked point blank "would Canadians be wrong to think that rate cuts are imminent" with a reference to cutting by Spring, Macklem responded by saying:

> "We want to see inflationary pressures ease further. When we have more assurances that we are on that path we can begin discussing when to ease but we're not there yet. We are concerned about persistence in underlying inflation. We need to give monetary policy a bit more time to let it do its work."

DISLIKE—TWO-FACED HIKE GUIDANCE THAT CHANGED NOTHING IN THE END

I don't like the way they handled communications around the Governing Council's appetite for rate hikes. What they took away they gave back and without affecting our prior understanding that hike risk remains contingent upon risks to their base case scenario.

On the one hand, they struck out the sentence in the statement that said they remain "prepared to raise the policy rate further if needed."

But then they put it in the Governor's opening remarks where he said:

> "That doesn't mean we have ruled out further policy rate increases. If new developments push inflation higher, we may still need to raise rates. But what it does mean is that if the economy evolves broadly in line with the projection we published today, I expect future discussions will be about how long we maintain the policy rate at 5%."

Ok so now we basically have two statements being issued on the same day and that appear to mischievously play good-cop, bad-cop with one another? Keep going and soon you'll sound like the 3–4 conflicting messages we heard on some of former Governor Poloz's delivery days from the statement to the MPR to the presser and subsequent media interviews.

Retaining the prior statement-codified reference would've achieved the same thing as they delivered today by saying they are prepared to hike again if they need to but don't think they do. They said that before, and now they're just saying it in the Governor's remarks instead?

Further, when asked if anyone on Council advocated a cut and to opine on timing a first cut, Macklem said:

> "The focus across the Council was very much on holding. Going forward, our forecast has increased our confidence we have raised enough to get back to the 2% inflation target. Progress has been uneven and we're concerned about the persistence of underlying inflation. That means it's premature to discuss cutting our policy rate. We need to see more progress before we have that discussion."

Macklem was then asked if the risk of a rate hike is now zero and said this:

> "The risk of a rate hike is not zero. I was clear in the opening statement. If we saw renewed upward pressure upon inflation and thought this was going to be durable, then yes we probably would have to raise rates further. The message today though is that's not our base case. With the progress we are seeing, we think pressures on inflation are coming down and that has made us more confident that we have raised the policy rate enough but that doesn't mean there are no scenarios in which we have to raise rates further.

Again, they took mention of a risk of hiking out of the statement and merely put it in the Governor's opening statement and backed it up with comments in the press conference that keep the option alive.

SDG Rogers took her turn at answering when to cut and hike risk by saying:

> "We can't be precise. We see a hike as a response to something that knocks us off our base case. Where we focused our discussion was upon how long we think we need to stay where we are. Right now, we think we need to stay the course."

DISLIKE—LARGELY IGNORED GLOBAL SUPPLY CHAIN PRESSURES

Have you heard of the Red Sea? Panama Canal? The island of Taiwan? US election risks? Good. Tell the BoC.

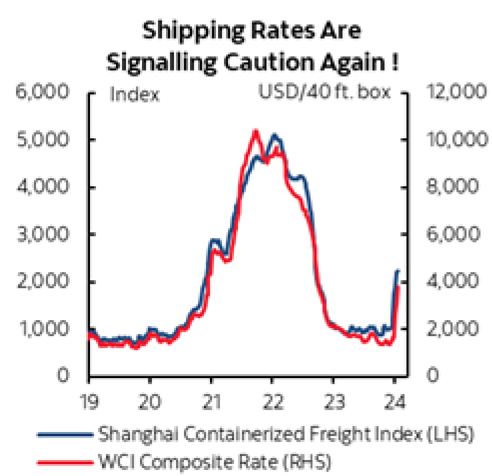
Nowhere in any of the published communications did the BoC even remotely hint at its awareness of renewed supply chain pressures. Whether they are of concern, or whether they think it's nothing to worry about, we were left scratching our heads wondering why there was absolutely no mention of this. Chart 7 vividly depicts the 175% jump in container prices since November.

In fact, during Macklem's presser, he started by referencing "improvements in global supply chains." Technically if your starting point is the depths of the pandemic then he's correct, but it's not indicating sensitivity toward incremental evidence since he last spoke.

It took a clever reporter indirectly call them to task on this in the press conference by asking about the impact of the war in the Middle East and effects. Macklem said:

> "Oil prices could rise. Transportation costs are rising. So far we haven't seen a big effect but the longer they last and the more severe they become they could impact inflation as a risk. We think the risks to our inflation projection are reasonably well balanced. We'll have to see how things evolve. With inflation having been above 2% for two years now we are more concerned about upside risk."

Chart 7



Sources: Scotiabank Economics, Drewry World Container Index, Shanghai Shipping Exchange.

In my opinion, they should not have said that the risks to their inflation forecast remain as balanced as they were in October. Financial conditions have ease. Container prices are skyrocketing. There is empirical evidence that rising shipping costs can materially impact inflation over the coming year as reviewed in my Global Week Ahead.

So why not signal more concern—any concern—now? That could be because the BoC is typically slow to respond to incremental shocks. Part of that is because they want to be careful not to overreact. Part of it is because their forecasts and MPR started weeks ago and there may be forecast inertia.

If geopolitical risks continue to pressure supply chains, then I would expect them to reference this in their March/April communications. If they continue to apply pressure but the BoC does not address this, then they'll have to have a good explanation of why not. #homework.

LIKE—A WARNING TO GOVERNMENTS AHEAD OF BUDGETS

When Macklem was asked in his press conference about how governing spending could impact their inflation goals particularly with elections coming up he had this to say:

> "Our forecast for gov't spending simply reflects announced spending plans of all level of government. We expect real government spending to grow by about 2.25–2.5% this year. Potential output growth is growing around 2%. So government spending is on the upper end of that which suggests if governments do spend all that, it won't help relieve inflation pressures but is not seriously getting in the way. If governments announce more spending then it could certainly get in the way of that inflation goal which would not be helpful."

As argued in my morning note, one should probably expect new information about expanded spending in the upcoming round of Federal and provincial government budgets from February through Spring. Housing and pharmacare are among the top items with the NDP's support for the Liberals' minority government hanging in the balance and the Trudeau government's polling in the dumps.

LIKE—SETTING A HIGH BAR AGAINST WORRYING ABOUT GROWTH

When Macklem was asked whether he still believes in a soft landing, he basically said yes but that he won't be fussed by softness over 2024H1. He's expecting it, and it would probably have to be much worse—or better—than expected in order to impact his views:

> "Our projection hasn't changed much since October. We expect weakness to start the year and strength later in the year. There could be small positives or small negatives along the way. We are not expecting a deep recession and are not trying to have one. We do need this period of weak growth to achieve our 2%."

Any material upside or downside risk to H1 GDP may be material to how the BoC views the future evolution of underlying inflation.

LIKE—MONITORING THE SPRING HOUSING MARKET

Macklem was asked whether there was any concern that a rebound in the housing market could cause a rebound in inflation. Rogers responded by saying:

> "We flagged an unexpected rise in house prices lifting inflation as a risk but it's not in our base case."

Ergo, watch the mortgage pre-approvals and Spring housing market closely for signs that it could be impactful to the BoC. When last Spring's housing market ripped, it brought them back to hike again in June and July among other considerations.

DISLIKE—DOWNPLAYED THE IMPORTANCE OF THE US ECONOMY TO CANADA

A reporter remarked that Q4 US GDP is expected to be solid and asked how much will a resilient US economy and ongoing US fiscal stimulus effects impact Canada and the chances of a Canadian rate cut this year?

Macklem responded by saying:

> "We look at GDP growth in Canada. The US economy is a very important economy for us, but the biggest element of demand in the economy is Canadian consumers and the impact of higher prices and interest rates has reduced spending by consumers."

That's true to an extent, but Canadian consumers are impacted by the US economy's pull effect on Canadian exports and jobs. Further, how the Fed responds to US economic resilience could well matter to the currency and by extension to the BoC. There are limits to BoC policy independence even if the BoC never admits it publicly.

Ergo, watch US economic growth and how the Fed responds particularly given six consecutive quarters in which consensus forecasts for US GDP growth have been blown away.

LIKE—CONCERN ABOUT NEARER-TERM INFLATION EXPECTATIONS

Macklem was asked why the BoC's message on inflation forecasts isn't getting through in terms of still elevated measures of inflation expectations and he had this to say:

> "Longer term expectations have remained anchored on the target. That reflects our experience and track record on bringing inflation back to target. Inflation expectations in the nearer term are not coming down as quickly as inflation and as quickly as our forecasts and that is one thing we are concerned about because it could slow the progress."

Flash forward to the next batch of the BoC's consumer and business surveys aptly timed for April Fool's Day. If they continue to show elevated nearer term expectations over the next 1–2 years and even still above 2% longer-term expectations, then the BoC may sound more frustrated than it does at present.

LIKE—STILL MONITORING THE SAME RISKS

Overall, there was no change to guidance about what the BoC says it is worried about and monitoring and the best way to depict this is to use their own words.

> "The Council is still concerned about risks to the outlook for inflation, particularly the persistence in underlying inflation. Governing Council wants to see further and sustained easing in core inflation and continues to focus on the balance between demand and supply in the economy, inflation expectations, wage growth, and corporate pricing behaviour. "

> "Growth is expected to remain flat in the near term. With weak demand in the economy, upward pressure on prices should continue to moderate, and inflation is expected to ease further. The share of consumer price index (CPI) components that are rising faster than 3% has declined substantially and should continue to normalize."

> "But tightness in some parts of the economy is continuing to hold inflation up. The most prominent of these is housing. Inflation in shelter services remains high—close to 7%—because of rising mortgage interest costs, higher rents and other housing costs. And while food prices are not increasing as fast as they were, food inflation is still about 5%. Finally, inflation in services excluding shelter has improved, but there are signs that price pressures remain.

> All this push and pull on inflation means that further declines in inflation are likely to be gradual and uneven. That suggests the path back to our 2% target will be slow, and risks remain."

Please also the attached statement comparison. The BoC's full MPR is available **here**. Macklem's opening remarks are **here**.

RELEASE DATE: January 24, 2024

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.

Global economic growth continues to slow, with inflation easing gradually across most economies. While growth in the United States has been stronger than expected, it is anticipated to slow in 2024, with weakening consumer spending and business investment. In the euro area, the economy looks to be in a mild contraction. In China, low consumer confidence and policy uncertainty will likely restrain activity. Meanwhile, oil prices are about $10 per barrel lower than was assumed in the October *Monetary Policy Report* (MPR). Financial conditions have eased, largely reversing the tightening that occurred last autumn.

The Bank now forecasts global GDP growth of 2½% in 2024 and 2¾% in 2025, following 2023's 3% pace. With softer growth this year, inflation rates in most advanced economies are expected to come down slowly, reaching central bank targets in 2025.

In Canada, the economy has stalled since the middle of 2023 and ***growth will likely remain close to zero through the first quarter of 2024.*** Consumers have pulled back their spending in response to higher prices and interest rates, and business investment has contracted. With weak growth, supply has caught up with demand and ***the economy now looks to be operating in modest excess supply.*** Labour market conditions have eased, with job vacancies returning to near pre-pandemic levels and new jobs being created at a slower rate than population growth. However, wages are still rising around 4% to 5%.

Economic growth is expected to strengthen gradually around the middle of 2024. In the second half of 2024, household spending will likely pick up and exports and business investment should get a boost from recovering foreign demand. Spending by governments contributes materially to growth through the year. Overall, ***the Bank forecasts GDP growth of 0.8% in 2024 and 2.4% in 2025, roughly unchanged from its October projection.***

CPI inflation ended the year at 3.4%. ***Shelter costs remain the biggest contributor to above-target inflation. The Bank expects inflation to remain close to 3% during the first half of this year before gradually easing, returning to the 2% target in 2025.*** While the slowdown in demand is reducing price pressures in a broader number of CPI components and corporate pricing behaviour continues to normalize, ***core measures of inflation are not showing sustained declines.***

Given the outlook, Governing Council decided to hold the policy rate at 5% and to continue to normalize the Bank's balance sheet. ***The Council is still concerned about risks to the outlook for inflation, particularly the persistence in underlying inflation.*** Governing Council wants to see further and sustained easing in core inflation and continues to focus 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: December 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 continuing its policy of quantitative tightening.

The global economy continues to slow and inflation has eased further. In the United States, growth has been stronger than expected, led by robust consumer spending, but is likely to weaken in the months ahead as past policy rate increases work their way through the economy. Growth in the euro area has weakened and, combined with lower energy prices, this has reduced inflationary pressures. Oil prices are about $10-per-barrel lower than was assumed in the October Monetary Policy Report (MPR). Financial conditions have also eased, with long-term interest rates unwinding some of the sharp increases seen earlier in the autumn. The US dollar has weakened against most currencies, including Canada's.

In Canada, economic growth stalled through the middle quarters of 2023. Real GDP contracted at a rate of 1.1% in the third quarter, following growth of 1.4% in the second quarter. Higher interest rates are clearly restraining spending: consumption growth in the last two quarters was close to zero, and business investment has been volatile but essentially flat over the past year. Exports and inventory adjustment subtracted from GDP growth in the third quarter, while government spending and new home construction provided a boost. The labour market continues to ease: job creation has been slower than labour force growth, job vacancies have declined further, and the unemployment rate has risen modestly. Even so, wages are still rising by 4-5%. Overall, these data and indicators for the fourth quarter suggest the economy is no longer in excess demand.

The slowdown in the economy is reducing inflationary pressures in a broadening range of goods and services prices. Combined with the drop in gasoline prices, this contributed to the easing of CPI inflation to 3.1% in October. However, shelter price inflation has picked up, reflecting faster growth in rent and other housing costs along with the continued contribution from elevated mortgage interest costs. In recent months, the Bank's preferred measures of core inflation have been around 3½-4%, with the October data coming in towards the lower end of this range.

With further 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. Governing Council is still concerned about risks to the outlook for inflation and ***remains prepared to raise the policy rate further if needed.*** Governing Council wants to see further and sustained easing in core inflation, and continues to focus 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.