Bank of Canada Preview — Better Data, Still Uncertain

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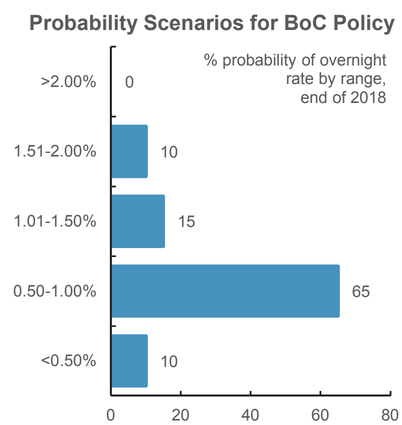
Macroeconomic data may have improved and headline inflation is on the rise, but these necessary but not sufficient conditions for a more hawkish bias shift at the Bank of Canada will instead probably encounter a patient stance. The rate statement hits the tapes at 10amET on Wednesday along with the Monetary Policy Report and its full set of forecast updates. Governor Poloz and Senior Deputy Governor Wilkins hold a joint press conference 75 minutes later. Because Fed Chair Yellen speaks twice after the BoC announcements this week, it's possible that a hawkish sounding Fed will do any of the Bank of Canada's residual policy work for it on the C$ should the BoC feel the need to retain a cautious but more balanced stance than previously.

OIS markets are convinced there will be no policy change with the overnight rate holding at 0.5% and are pricing about a 30% probability of a hike by year's end.

There are **three main risks** to be mindful of going into the statement before going into the pros and cons of a more hawkish or more dovish stance and where things are likely to net out.

- **Forecast revisions:** the BoC likely has to upgrade its assessment of growth over the back half of last year compared to its last forecasts in October and that could imply less spare capacity than previously judged at this point.
- **Will it re-insert an assessment of the balance of risks?** That was omitted the last time around in the December statement. It's possible this was a simple omission, but I doubt it. Instead, the fact that the statement was peppered with references to uncertainty probably made it a conscious decision to omit an assessment of the balance of risks. Go here for a reminder of that last statement and I'll come back to the possibilities in a moment.
- **If the MPR doesn't, then I would expect the press conference to have a focus upon potential contingency options in the event that US trade policy turns more protectionist**. If not offered by the BoC beforehand, then it's likely the press will ask. A softwood lumber agreement remains unsigned, a US border tax may be imposed to some degree, and the NAFTA agreement may be revisited. If he chooses to entertain the question, then at the end of this note I summarize a suggested ways of considering the issue of a border tax.

Chart 1



Source: Scotiabank Economics.

A CASE FOR A MORE DOVISH BIAS

Beyond these three risk factors into the meeting, a case for a more dovish bias and/or a cut that markets are not expecting could be based upon the following. I'll then review the case for a more hawkish stance, and conclude with how things might net out.

1. Insurance against Trump-related trade risks

An easing bias to counter potentially adverse turns in US trade policy is possible but unlikely at this juncture in my opinion. Recall that Poloz stated in November: "We only incorporate actually announced policy changes, and there haven't been any of those." A similar approach was taken ahead of last year's Federal Budget and stimulus contained within. Both on trade and fiscal policy, the BoC is likely to wait until it sees what—if anything—transpires.

2. Fight CAD

The C$ has appreciated versus the USD by about 4 cents since just after Christmas; will the BoC lean against it in order to further stimulate export growth? A counter-argument is that the C$ is only about two pennies stronger than it was before the last BoC statement and so little new information is revealed in the currency's net movements since. Further, I wouldn't dredge up the monetary conditions index or type 1 and type 2 factors again, but some or perhaps all of the currency's moves have been driven by stronger-than-expected data.

3. Counter bond markets

Recall that in its last statement, the BoC noted that "There has been a rapid back-up in global bond yields" and thus signaled to markets it was mindful of said risks. If the BoC wasn't concerned enough to pull the trigger in December then the added 6bps in 2 and 5 year Government of Canada bond yields since then wouldn't have materially changed its mind. If Canada imports much more of a US-led bond shock that is deemed unsuitable to Canadian fundamentals then this risk may be revisited in future, but the BoC's capacity to lean against such developments is more limited the further up the curve one goes.

4. Inflation under-target

The evidence is rather mixed on this front. Headline CPI inflation was 1.2% y/y in November but is likely to pop higher toward 2% in Wednesday's CPI report on higher commodity moves and base effects that are shaking out of the data. Further, the BoC's three new core inflation measures range from 1.3% (common component) to 1.6% (trimmed) and 1.9% (median). BoC research has emphasized that the preferred measure is the common component gauge but it is the most difficult to communicate.

A CASE FOR A MORE HAWKISH STANCE

A case for a more hawkish stance by the BoC could be based on the following.

1. Confidence Has Not Waned—At Least Not Yet

The BoC had stated in December that "uncertainty, which has been undermining business confidence and dampening investment in Canada's major trading partners, remains undiminished." However, since then, the Bank of Canada's Business Outlook Survey reflected more buoyant business attitudes in Canada while confidence gauges and purchasing managers' indices abroad have improved—not deteriorated as feared. This has translated into survey evidence—as in the Business Outlook Survey—indicating stronger expected growth in sales, investment and jobs with upside risk to inflation expectations *after* the US election results were known.

2. The Fundamentals Have Been Strong

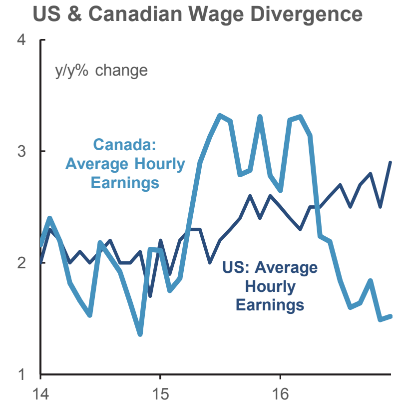
Canada's economy has hardly performed like one in need of an adrenaline shot. Any particular month's job numbers are at least partly a crap shoot, but it's hard to ignore the trend. Canada has created 202,000 jobs just since August, exceeding overly pessimistic consensus expectations by a whopping 213,000 over this period including over 80,000 full-time jobs in December alone. Export volumes have surged by about 9% q/q in Q3 and we're tracking a further nearly 3% gain in Q4 based upon current evidence which suggests that export growth has legs to it. Also note that the BoC probably has to revise its growth forecasts higher with Q3 growth of 3.5% slightly exceeding the October MPR's assumption of 3.2%, and Q4 growth likely tracking around a percentage point faster than the October MPR estimated. That means a smaller output gap at present than previously judged, and with momentum arguments into 2017 in Canada's favour.

ON NET: A LITTLE LESS CAUTIOUS

Conditions have improved since the last policy meeting in December and that likely has to be acknowledged by the BoC. Nevertheless, trade policy uncertainty matters an awful lot to Canada. One-third of GDP is derived from exports, and the BoC needs to see a sustained trend of export growth that rotates the economy away from excess reliance upon household sector activity. Until it does—and conditioned by US trade policy—it would be more than a tad unwise to shift toward sounding more hawkish at this juncture. Ditto for bond market uncertainty that rests upon US fiscal management.

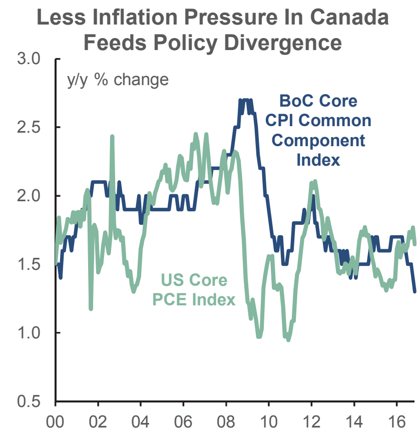
Nevertheless, wage growth is running at half that of the US (chart 2), and even though headline inflation will likely spike to around 2% y/y this week, the BoC's preferred common-component measure of core CPI is only sitting at 1.3% y/y (chart 3). The criteria for policy divergence from the Fed are thus focused upon less traction on inflation risks.

Chart 2



Sources: Scotiabank Economics, Bureau of Labor Statistics, Statistics Canada.

Chart 3



Sources: Scotiabank Economics, Statistics Canada, Bureau of Economic Analysis.

MITIGATING FACTORS IN THE 'BORDER TAX' DEBATE

Should the incoming Trump administration impose a protectionist border tax (aka import duty) on Canada, the effects would obviously be bad but there are mitigating considerations that could at least partly insulate real variables like jobs, the unemployment rate and GDP growth. There are several points to bear in mind in this regard.

- it was only a spokesman for Trump who mentioned Canada in response to a question about whether the border tax would apply to it. We haven't heard from Trump about applying a tax to Canada. Then we'll need to see if Trump's rhetoric carries the day in Congress, and bear in mind that lobbying efforts are rather intense these days. We are treating it as a risk to our base case forecast but one that cannot be incorporated until it becomes fact and it isn't clear that will happen.

- a border tax is a form of an external terms of trade shock, measured as a change in the ratio of export to import prices.

- the effects of a terms of trade shock partly depend upon what kind of exchange rate regime the country has. **Canada's flexible exchange rate would serve as a partial shock absorber** and a first line of defence. A recent example was the plunge in commodity prices and the partially insulating offset of CAD depreciation. When it comes to trade policy risks and recent experiences, think sterling or peso.

- **tax incidence effects** could also serve as a partial shock absorber or second line of defence for real variables like jobs, the unemployment rate, GDP, etc. Margins might compress, and some or all of a border tax might be passed on through the value chain and ultimately to consumers including, by the way, mostly US consumers.

- Canada's economy is in better shape to deal with a border tax adjustment as the negative effects of the prior commodity price shock dissipate and the positive effects take over.

- **How would the Bank of Canada respond?** That's not fully clear, but expect either a focus box in tomorrow's MPR, or at a minimum a question in the press conference. The BoC's job is inflation targeting, and a border tax creates uncertain effects on the inflation mandate. It could create more disinflationary slack with an offset being C$ depreciation. The effects of a one-off tax and C$ shock would likely be transitory. It's also unclear how sector-specific US policies evolve. Autos, for instance, would be hit but energy could be lifted if the tax doesn't apply to it, and buoyed by Canadian pipeline approvals plus likely Keystone approval by the US, and the effects of a partial recovery in oil prices over the past year. The point is to consider the policy effects in their totality including potential spillover effects of US stimulus measures into Canada. The BoC would ease and take out insurance if it felt its broad inflation mandate was sustainably faced with net downside risk. In my opinion, the BoC is likely to wait until it sees what policy transpires and the details before doing anything, in the event that cooler heads prevailed with Trump's team reining in his tendencies and Congress doing likewise.

- **that turns the attention to fiscal policy levers at the Federal and provincial levels of government** and especially if a border tax is a sector-specific shock that blunt monetary policy instruments cannot accommodate with the same efficacy. A possibility is either across the board corporate tax reductions or the equivalent through credits and not least of which because the US will likely be doing so very soon. The point here is that a border tax isn't the only policy lever that can change.

- also note that Canada's auto industry is mostly based on legacy assets. Nobody has built a new assembly plant in Canada since Toyota and Honda in the '90s. Incremental investments of a more targeted nature are occurring and the parts sector is large and dynamic, but I doubt Canada would get caught up in quite the same headlines as Mexico where new assembly plants are going in frequently. Canada's sector is also higher cost than Mexico and more like the US, and more focused on higher margin trucks/SUVs.

So on net, a border tax would be unwelcomed and would impose bad effects on the economy or at least some important sectors and regions, but there are mitigating factors to consider. The US needs friends in the world to achieve multiple policy goals and yet the incoming President-elect is rapidly alienating the country's most trusted partners in commerce and global security. With this in mind, Trump needs to bear in mind that other countries have what America wants and needs and a spirit of collaboration will be needed that if not provided by America will be sought through tightened ties elsewhere. Until we know what policy is applied—if any—and the details, we can only loosely speculate on its effects and the possible offsets.