BoC to Hike in July, Total of 75bps by 2018Q1

- The BoC will raise its overnight rate by 25bps in July, October and ‘18Q1;
- An abrupt shift in BoC guidance has been led by Governor Poloz;
- Hike enablers include the inflation outlook and a reduction in several risks once viewed as impediments.

We now believe that the Bank of Canada’s 12 July policy rate meeting is not just live, but tipped toward marking the Bank’s first policy rate increase in seven years. Over the course of June, the BoC’s senior leadership has provided a cascade of statements that represent a radical shift in tone from earlier this year. In response, on 14 June we moved our expectation of a first hike from 2018Q1 to October of this year on the basis of statements by Senior Deputy Governor Wilkins on 12 June and Governor Poloz on 13 June that Canada’s adjustment to the last major oil price shock was complete and that the two 25bps cuts the Bank enacted in 2015 had “largely done their work”. Governor Poloz reiterated in yesterday’s interview at the ECB Forum that “those cuts have done their job” while at the same time dismissing some of his previous concerns about trade policy uncertainty and oil prices. With three opportunities to do so, it is noteworthy that Poloz did not attempt to rein in the market reaction to Wilkins’ speech—indeed he reinforced it. Today, Deputy Governor Lynn Patterson joined the chorus, noting that the “economic drag from lower (oil) prices is largely behind us.”

On this basis, we now anticipate that the BoC will raise its overnight rate by 25bps in July, 25 bps in October, and a further 25bps in 2018Q1—thereby removing the 50bps of “insurance” that Governor Poloz implemented in 2015 and adding some insurance against upside risks as Canada’s output gap closes.

WHAT THE BOC HAS SAID

The BoC’s senior leadership appears to be signalling that their reaction function has shifted meaningfully in recent weeks. Their models anticipate closure of Canada’s output gap late this year or early next year, which would imply a need to act pre-emptively to dampen price pressures even as core inflation continues to fall. Governor Poloz and his colleagues, just like Fed Chair Janet Yellen, are undoubtedly anxious to avoid past monetary policy mistakes where central banks have been late to raise rates in response to strengthening economies—and then were forced to hike so much that they stifled growth. But we’re mystified as to why the BoC’s leadership has changed its tune so suddenly: their staff models have likely been pointing to a closing output gap for some time.

At the ECB Forum, Governor Poloz additionally swept aside concerns that he has previously indicated could keep the Bank on hold. He noted that the Bank has assumed for the last couple of years that oil prices would remain in a range between US$40 and US$50/bbl, thereby neutering any worries about the recent decline in oil prices. Governor Poloz also took off the table his previous argument that uncertainty over US trade policy merits caution. Instead, he emphasized that risks surrounding NAFTA are a hypothetical “unknown thing” and that “we have to deal with that we have”. And what we have is a 3.8% growth rate in Q1 as growth “broadens” in Canada in sync with “gathering momentum” in “virtually every major area of the world,” including the US where “the Fed has confidence that the

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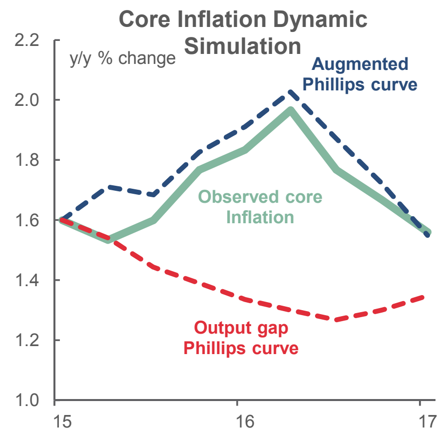
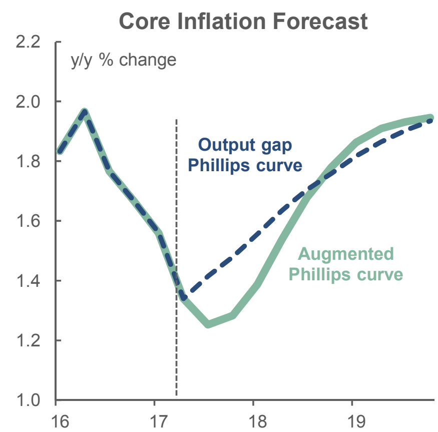
Chart 1



Sources: Scotiabank Economics, Statistics Canada.

Chart 2



Sources: Scotiabank Economics, Statistics Canada.

economy is strengthening further". In one interview, Governor Poloz demolished all of his previously articulated reasons for keeping the BoC's overnight rate on hold.

CORE INFLATION'S SLOW FORECAST ASCENT

Fundamentally, the case for raising rates, but going slowly, comes back to the question of why core inflation is still tracking lower. Closing spare capacity is expected to lift inflation over our forecast horizon, but this view must be buttressed by additional perspectives. Output gaps don't explain it all in terms of inflation modelling. This is illustrated by the fact that only now is Canada registering a 22 year low in core inflation despite much greater spare capacity in the depths of the recession.

We therefore broaden our explanatory modelling tools. An augmented Phillips curve was introduced in the Scotiabank Global Macroeconomic Model to produce a forecast for core inflation. It outperforms a standard Phillips curve estimation of the output gap-inflation relationship with the comparison shown in chart 1. The model adds unit labour costs, oil prices and food prices to the estimation that includes an output gap variable and the real effective exchange rate in order to account for more influences upon inflation than just spare capacity and exchange rate arguments. Core inflation is forecast to stabilize around 1.2–1.3% before gradually rising to about 1.8% by the end of 2018 and tracking very close to 2% by the end of 2019 (chart 2). This would be progress toward the BoC's inflation mandate, but would continue to fall short of it over much or all of our forecast horizon.

OTHER RATIONALES FOR HIKING

Additional arguments for a shift in policy bias may include that trade policy risks emanating from the US such as a border tax or sharp NAFTA shock are judged to be much less material than was the case at the start of the year. Further, job growth has been very strong over the past year, GDP growth has surpassed expectations compared to last autumn in no small part due to ongoing consumer strengths and investment is rebounding. Also key is that fear of an imported bond market shock through deficit-financed US stimulus has been reduced as financial market conditions have proven easier than feared. In the meantime, CAD's appreciation has arguably been for sound reasons versus tightening financial conditions.

COUNSELLING CAUTION

Of course, monetary policy transition points always involve risks and this time is no exception. It is possible that the BoC feels it is righting market pricing that had gone too far in favour of carefully delaying a hike until autumn instead of anticipating a move in July. We believe that the sudden urgency associated with BoC communications well ahead of the July meeting implies that a rate increase is imminent. If the BoC were simply setting up July for a rate hike later in the year then the shift in communications would not be so sudden.

Further, with core inflation not yet finding a clear bottom, wage growth still soft and following six years in which inflation has fallen short of the 2% inflation target, the BoC should likely proceed very cautiously. The durability of domestic growth, continued frustration with export growth, a strained household sector and the risks posed by the delicate balance between markets and expectations for US fiscal stimulus all counsel additional caution. We express this caution in terms of capping the sum total of expected rate hikes during 2017–18 at 75bps; we allow for the removal of emergency levels of stimulus re-introduced in 2015 and add one more hike to take out tentative insurance against upside risks given the economy's outperformance over 2016H2–2017H1.