More BoC Hikes Coming, Perhaps Sooner Than You Think

- **The BoC left its policy rate at 1.25% as expected alongside a moderately hawkish bias**. The broad set of BoC communications remains consistent with projecting additional monetary tightening in keeping with our forecasts for two hikes this year. CAD depreciated and two year yields rallied partly as a reversal of more hawkish betting over the past couple of days on the remote chance that either the BoC might have hiked or misplaced expectations that it might have sounded more constructive on NAFTA risks at this juncture. Such market reactions may have also occurred because the BoC's messaging was muddled at times, yet the main framework guidance still points to significant policy tightening to come.
- If, however, that market reaction was also because markets took the communications as incrementally more dovish then I disagree with that assessment for several reasons that **keep us on track for a July hike. There is the non-negligible risk of a May hike** that would require further upsides to wage and inflation figures and the hint to this effect may have been in the opening statement to the press conference that said **"We will be monitoring the data for the second quarter very closely in the weeks ahead."** To have attached such a firm and relatively short timeline measured in weeks to data dependency suggests that the risk of a May hike should not be ignored.
- One is that the BoC clearly signalled that it has **more confidence in a firmer wage and inflation outlook**. The final paragraph's revision now flags "some progress" that "reinforces" a tightening bias by my read:
    - "Some progress has been made on the key issues being watched closely by Governing Council, particularly the dynamics of inflation and wage growth. This progress reinforces Governing Council's view that higher interest rates will be warranted over time…"
- Indeed, the opening statement to the press conference (here) cited how "recent data have been very reassuring." While upgrading this confidence, the BoC still says it will be 'cautious' going forward and retained reference to 'continued monetary policy accommodation' being needed. **Having more confidence in its assessment of progress on its inflation mandate but still being cautious is incrementally more supportive of a tightening bias.**
- Second, the opening statement to the press conference was balanced in many respects but netted out to say "It is the view of Governing Council that **the need for a negative real policy rate continues to diminish steadily, albeit gradually**." This remains supportive of further rate increases especially in light of the forecast for inflation to be reasonably anchored at just over 2% over time. If inflation is already there and real rates are expected to rise then the nominal rate policy tightening guidance is intact if not strengthened.
- **Third, the neutral nominal policy rate was left unchanged at 3%** as the mid-point of a 2.5–3.5% target range. That keeps it essentially on top of the FOMC's median estimate of the US nominal neutral policy rate. Play around with actual and potential growth forecasts all one wants but if the ultimate rates guidepost is left unchanged then this is what ultimately matters to the rates complex in netting out all the components to the broad forecasting

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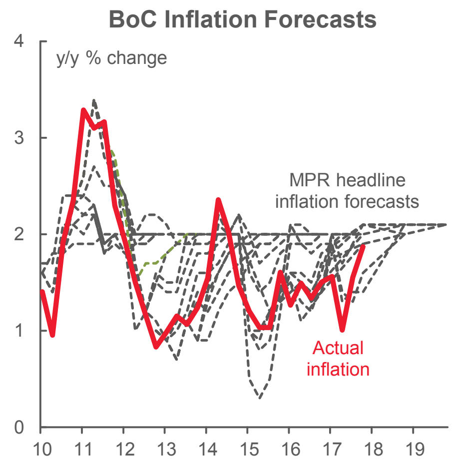

Sources: Scotiabank Economics, Bank of Canada, Haver Analytics.

framework. The fact it remains unchanged at 3% continues to signal that the BoC views present monetary conditions as highly stimulative at the present 1.25% policy rate and that counsels rate hikes over the forecast horizon.

- **Fourth, I fear that markets are forgetting a basic lesson about interpreting BoC communications** especially given this central bank doesn't provide formal rate guidance. **Those forecasts embed the BoC's assumed rate trajectory.** That assumed trajectory is among the factors that almost always result in the BoC saying that the output gap will remain roughly balanced over the forecast horizon and inflation will stay around target. If the markets are taking such guidance differently (ie: no further pressure on spare capacity or inflation than previously) then they are implicitly ignoring the BoC's internalized policy path.

- **Fifth, the forecast details support a policy path that points to further rate hikes.**

    - Global growth was revised up to 3.8% this year (3.6% previously), 3.6% in 2019 (3.5% previously) and 3.4% in 2020 and hence a sustained global expansion is forecast.

    - US growth was revised up to 2.7% this year (2.6% previously), 2.7% next (2.3% previously) and 2% in 2020.

    - Canadian growth was revised more up than down over the years. 2018 growth was revised down two-tenths to 2% because of the weak starting point, but next year was revised up by ½% to 2.1% and 2020 is projected to grow by 1.8% given model convergence toward potential over the longer run. The BoC is looking through a downwardly revised soft patch in 2018Q1 due to tightened mortgage rules and transportation bottlenecks with 1.3% growth now forecast (2.5% previously) on the path to 2.5% growth in Q2 and firm growth over the forecast horizon. Looking through a soft patch on growth and upgrading growth projections on balance and just about everywhere is not dovish.

    - Somewhat offsetting this was an upward revision to potential GDP growth with the mid-point estimate within ranges moving to 1.8% this year (1.4% previously), from 1.5% to 1.8% next year and 1.8% in 2020. That's enough to swing the output gap from mildly negative to slightly positive starting next year and through 2020 but with net excess aggregate demand expected to be very small. Always bear in mind that this forecast embeds the BoC's assumed policy trajectory in order to keep balanced aggregate demand and supply conditions which they always say they'll achieve. The same applies to what it says about the inflation target being achieved in light of the BoC's record on forecasting inflation. The BoC's recent inflation expectations have been on the mark. The chart below shows the track record with each dashed line being an MPR forecast which speaks to Poloz's point about inflation averaging beneath the BoC's 2% target over recent years.

    - Canadian inflation is forecast to be 2.3% in 2018 (2% previously) and 2.1% in each of 2019 (unchanged) and 2020. The implication is that **the BoC sees the balance of risks being marginally skewed toward being slightly above the 2% policy target throughout the forecast horizon while nevertheless correctly emphasizing that it is a policy range of 1–3%**. A lot of statement emphasis was placed upon transitory factors influencing inflation both to the downside previously and the upside more recently, but after shaking out all of these considerations the BoC still anticipates inflation to be at or slightly above target throughout the forecast horizon.

- On NAFTA, it only received one single reference in the MPR and nothing directly in the statement. Instead, more general references to trade and geopolitical policy risks were flagged as factors that "risk undermining the global expansion." The MPR flags "a wide range of outcomes are still possible for the renegotiation of" the NAFTA agreement.

- On how to treat NAFTA risks should an agreement be reached, Poloz basically said during the press conference that forecasts would adjust more positively but policy would remain data dependent and wait to see data converging upon an improved outlook through a reduction of forecast risks. **Policy would not necessarily pre-empt an expected improvement in the outlook should a NAFTA agreement be reached**. That means that even if an agreement is reached into the next BoC meeting on May 30th, the BoC would be unlikely to tighten at that point and instead the decision would be more informed by any stronger-than-expected data and particularly in terms of inflation and wage developments. As alluded to above, the main catalyst for such expectations would be whether the expected Q2 rebound is unfolding and so markets should be on heightened data watch over the next six weeks.

- The BoC's MPR is available here.

- Scotiabank Economics forecasts are here.

RELEASE DATE: APRIL 18, 2018

The Bank of Canada today maintained its target for the overnight rate at 1 ¼ per cent. The Bank Rate is correspondingly 1 ½ per cent and the deposit rate is 1 per cent.

Inflation in Canada is close to 2 per cent as temporary factors that have been weighing on inflation have largely dissipated, as expected. Consistent with an economy operating with little slack, core measures of inflation have continued to edge up and are all now close to 2 per cent. The transitory impact of higher gasoline prices and recent minimum wage increases will likely cause inflation in 2018 to be modestly higher than the Bank expected in its January *Monetary Policy Report* (MPR), returning to the 2 per cent target for the rest of the projection horizon.

The global economy is on a modestly stronger track than forecast in January, with upward revisions to growth and potential output in a number of major advanced economies. The outlook for the U.S. economy has been further boosted by new government spending plans. **However, escalating geopolitical and trade conflicts risk undermining the global expansion**.

In Canada, GDP growth in the first quarter was weaker than the Bank had expected, but **should rebound in the second quarter**, resulting in 2 per cent average growth in the first half of 2018. **The economy is projected to operate slightly above its potential over the next three years**, with real GDP growth of about 2 per cent in both 2018 and 2019, and 1.8 per cent in 2020. **This stronger profile for GDP incorporates new provincial and federal fiscal measures announced since January.** It also reflects upward revisions to estimates of potential output growth, which suggest the Canadian economy **has made some progress in building capacity**.

Slower economic growth in the first quarter primarily reflects weakness in two areas. Housing markets responded to new mortgage guidelines and other policy measures by pulling forward transactions to late 2017. Exports also faltered, partly owing to transportation bottlenecks. Some of the weakness in housing and exports is expected to be unwound as 2018 progresses.

The Bank anticipates that Canadian exports will strengthen as foreign demand increases, but not sufficiently to recover the ground lost during recent quarters. Export growth is being increasingly limited by capacity constraints in some sectors. Continued gains in business investment should build additional capacity in those sectors and in the economy more generally. However, both exports and investment are being held back by ongoing competitiveness challenges and uncertainty about trade policies.

Growth in consumption remains robust, supported by strong labour income growth. Wages have continued to pick up as expected, even after factoring out recent minimum wage increases in Ontario and Alberta. The Bank will continue to assess labour market data for signs of remaining slack.

Some progress has been made on the key issues being watched closely by Governing Council, particularly the dynamics of inflation and wage growth. This progress reinforces Governing Council's view that higher interest rates will be warranted over time, although some monetary policy accommodation will still be needed to keep inflation on target. The Bank will also continue to monitor the economy's sensitivity to interest rate movements and the evolution of economic capacity. In this context, Governing Council will remain cautious with respect to future policy adjustments, guided by incoming data.

RELEASE DATE: MARCH 7, 2018

The Bank of Canada today maintained its target for the overnight rate at 1 1/4 per cent. The Bank Rate is correspondingly 1 1/2 per cent and the deposit rate is 1 per cent.

Global growth remains solid and broad-based. In the United States, new government spending and previously-announced tax cuts are anticipated to boost growth in 2018 and 2019. However, trade policy developments are an important and growing source of uncertainty for the global and Canadian outlooks.

In Canada, the national accounts data show that the economy grew by 3 per cent in 2017, bringing the level of real GDP in line with the projection in the Bank's January *Monetary Policy Report* (MPR). In the fourth quarter, GDP growth was slower than expected, largely due to higher imports, while exports made only a partial recovery from their third-quarter decline. The gain in imports mainly reflected stronger business investment, which adds to the economy's capacity.

Strong housing data in late 2017, and softer data at the beginning of this year, indicate some pulling forward of demand ahead of new mortgage guidelines and other policy measures. It will take some time to fully assess the impact of these, as well as recently announced provincial measures, on housing demand and prices. More broadly, the Bank continues to monitor the economy's sensitivity to higher interest rates. Notably, household credit growth has decelerated for three consecutive months. The implications of the recent federal budget for the outlook for growth and inflation will be incorporated in the Bank's April projection.

Inflation is running close to the 2 per cent target and the Bank's core measures of inflation have edged up, consistent with an economy operating near capacity. Wage growth has firmed, but remains lower than would be typical in an economy with no labour market slack. Inflation is fluctuating because of temporary factors related to gasoline, electricity, and minimum wages.

In this context, Governing Council maintained the target for the overnight rate at 1 1/4 per cent. While the economic outlook is expected to warrant higher interest rates over time, some continued monetary policy accommodation will likely be needed to keep the economy operating close to potential and inflation on target. Governing Council will remain cautious in considering future policy adjustments, guided by incoming data in assessing the economy's sensitivity to interest rates, the evolution of economic capacity, and the dynamics of both wage growth and inflation.