The BoC's Hike Criteria Risk Lagging The Cycle

CONTACTS

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

- **On top of leaving its policy rate unchanged at 1.5% the BoC was noticeably more cautious sounding in this statement.** The Canada two year yield dipped about 2bps post-statement which just unwinds today's rise leading up to the statement, while the C$ depreciated by less than a quarter cent versus the USD. Kudos go to more dovish forecasters than our low conviction call for a hike that at least made it a fair debate. Maybe the BoC did the right thing here.

- **I'll review how the statement sounded more cautious while sharing personal views that suggest the BoC may be putting itself further behind building capacity pressures.** Indeed, the criteria laid down for raising rates in future appears to be based upon a number of lagging metrics which raises some concern about falling behind capacity and inflation risks. **Whether this shift is oriented toward buying time and faces the risk of expediting rate hikes later, or whether it increases the risk of monetary policy falling behind cyclical developments remains to be seen but I'm more worried about the latter than I was previously.** I'm also concerned about the discontinuity relative to prior communications including zero indication that the BoC is still concerned about operating at negative real rates for an economy with Canada's capacity pressures. Ditto regarding the increased emphasis upon following trade policy headlines when all along the Governor has tended to take a more balanced approach and one firmly anchored in monitoring the data and sounding cautiously optimistic on trade negotiations. Uncertainty is indeed everywhere, but the underlying narrative is volatile.

- On inflation, the BoC rightly reinforces expectations for headline inflation to "move back towards 2 per cent in early 2019" and flagged that "core measures of inflation remain firmly around 2 per cent, consistent with an economy that has been operating near capacity for some time" with "growth to average near potential**."** **The risk here is that the BoC may be lagging developments in capacity pressures with such a remark.** Q2 growth of 2.9% and the very real prospect that strong US growth will back into Canada more aggressively than the BoC's July forecast for Q3 growth of just 1.5% and would mean back-to-back quarters of rising capacity pressures. The 6%+ advance in industrial output during Q2 may also drive the highest capacity utilization rate since the late 1980s when the estimate arrives next week.

- The issue is therefore that because inflation reacts with a lag to capacity pressures that the BoC has previously estimated to be about a 5 quarter connection between the output gap and future turns on core inflation, the BoC may not be front-running future inflation pressures that may emerge in lagging response to capacity pressures. Monetary policy needs to be forward looking and operates with long and variable lags on the economy and inflation, and so **to emphasize current core inflation and the connection with trailing capacity measures is at risk of missing a future turn higher.** Emphasizing data that basically showed one-handled GDP growth over 2017H2 and into Q1 this year is vulnerable to **taking a backward look at where monetary policy should go in future**. **It clearly states that the BoC will largely wait to see inflation before adjusting policy and the obvious risk to doing so is that by that point it may be too late. This has always been among the concerns with data dependency that relies upon what happened yesterday to shape what policy may be suited to future needs.**

- The statement dovishly flags "As past interest rate increases work their way through the economy, credit growth has moderated and the household debt-to-income ratio is beginning to edge down." **That's a stronger reference to debt growth than the July statement that simply flagged the BoC was monitoring the adjustment to higher rates.** While factually correct, the risk here is that **the BoC is emphasizing lagging credit metrics** by pointing to growth in credit outstandings and the stock of debt to the flow of income that reflect decisions made months or quarters ago before showing up in the stock of credit. We already know that housing may well be turning more positively with recent sales gains after the H1 response to B20. If the BoC is basing policy decisions on lagging growth in outstandings that get booked ages after the driving decisions have been made then it could well lag the cycle pressures accordingly. Furthermore, the debt-to-income ratio is an awful one; it is the classic stock to flow measure, when the BoC could have alternatively emphasized how debt payments to incomes are stable given income growth as an offset to rates, or the equally stable debt-to-assets ratio.

- In three separate areas, trade tensions are cited. That's actually half the number of times as in the July statement, so one might think that concerns have been downplayed, but the emphasis has changed in a more dovish sense. One example is where the BoC states "Elevated trade tensions remain a key risk to the global outlook and are pulling some commodity prices lower." Two is "The Bank is also monitoring closely the course of NAFTA negotiations and other trade policy developments." Three is where the BoC states "uncertainty about trade policies continues to weigh on businesses." Combined, these references **raise the question of whether a possible NAFTA deal would suddenly wipe out such references in hawkish fashion given how reactive the BoC has become to current negotiations, or whether Poloz stands by his earlier bias to remove negative forecast judgement that is related to trade only in lagging fashion to policy developments and when they show up in the data**. More fundamentally, I'm not terribly convinced that we're seeing evidence that trade policy uncertainty is weighing on businesses in a way that is depressing the data. Investment growth has been solid this year. Intentions surveys are robust. **The BoC is playing down its prior communications that emphasized data over volatile trade negotiations.**

- **The BoC flags expectations for GDP growth to "slow temporarily in the third quarter" but doesn't say if it still thinks it will slow to 1.5% as it forecast in the July MPR or something that gets revised up in keeping with evidence of stronger US growth tracking so far in Q3.** The BoC is indicating no pressure to materially alter forecasts for the global economy: "Recent data on the global economy have been consistent with the Bank's July *Monetary Policy Report* (MPR) projections. The US economy is particularly robust…." I'm not so convinced they won't face pressure to sound more optimistic about Canada in Q3 and H2 given how Q3 US growth is tracking and by the time the October MPR rolls around. Would the BoC still feel the way it does today if after 2.9% growth in Q2 we get another above-potential quarter of growth in Q3?

- Also note the increased emphasis upon how "financial stresses have intensified in certain emerging market economies, but with limited spillovers to other countries." The BoC is clearly intensifying its monitoring of emerging markets and time will tell if that's the correct focus or whether it is reacting too much to volatile EMs when we've seen this movie many times over the years. The evidence that EM challenges are systemic as opposed to being driven by idiosyncratic developments that raise opportunity to investors who do their homework and differentiate among the EM markets is not compelling at this stage.

- More encouraging words crept into the second last paragraph with greater conviction that the rotation of demand toward investment and exports is proceeding, the housing market is stabilizing, and jobs and income growth are supportive.

- **In summation, there are legitimate areas of debate throughout this statement but it's not clear to what extent it reflects what the BoC really thinks or whether the shift in tone is due to the fact the BoC was uncomfortable toward current market pricing and wishes to avoid the political headlines surrounding NAFTA negotiations. If it is current pricing and peak negotiations that are hitting pause, then the story may be vulnerable to a future sudden re-write that would continue to portray the BoC's narrative as volatile over time.**

- Please see the attached statement comparison. Because this is a non-MPR statement compared to the prior MPR statement that usually emphasizes forecast changes, no text emphasis is added to the full statement re-write.

RELEASE DATE: SEPTEMBER 5, 2018

The Bank of Canada today maintained its target for the overnight rate at 1 ½ per cent. The Bank Rate is correspondingly 1 ¾ per cent and the deposit rate is 1 ¼ per cent.

CPI inflation moved up to 3 per cent in July. This was higher than expected, in large part because of a jump in the airfare component of the consumer price index. The Bank expects CPI inflation to move back towards 2 per cent in early 2019, as the effects of past increases in gasoline prices dissipate. The Bank's core measures of inflation remain firmly around 2 per cent, consistent with an economy that has been operating near capacity for some time. Wage growth remains moderate.

Recent data on the global economy have been consistent with the Bank's July *Monetary Policy Report* (MPR) projections. The US economy is particularly robust, with strong consumer spending and business investment. Elevated trade tensions remain a key risk to the global outlook and are pulling some commodity prices lower. Meanwhile, financial stresses have intensified in certain emerging market economies, but with limited spillovers to other countries.

The Canadian economy is evolving closely in line with the Bank's July projection for growth to average near potential. Following growth of 1.4 per cent in the first quarter, GDP rebounded by 2.9 per cent in the second quarter, as the Bank had forecast. GDP growth is expected to slow temporarily in the third quarter, mainly because of further fluctuations in energy production and exports.

While uncertainty about trade policies continues to weigh on businesses, the rotation of demand towards business investment and exports is proceeding. Despite choppiness in the data, both business investment and exports have been growing solidly for several quarters. Meanwhile, activity in the housing market is beginning to stabilize as households adjust to higher interest rates and changes in housing policies. Continuing gains in employment and labour income are helping to support consumption. As past interest rate increases work their way through the economy, credit growth has moderated and the household debt-to-income ratio is beginning to edge down.

Recent data reinforce Governing Council's assessment that higher interest rates will be warranted to achieve the inflation target. We will continue to take a gradual approach, guided by incoming data. In particular, the Bank continues to gauge the economy's reaction to higher interest rates. The Bank is also monitoring closely the course of NAFTA negotiations and other trade policy developments, and their impact on the inflation outlook.

RELEASE DATE: JULY 11, 2018

The Bank of Canada today increased its target for the overnight rate to 1 ½ per cent. The Bank Rate is correspondingly 1 ¾ per cent and the deposit rate is 1 ¼ per cent.

The Bank expects the global economy to grow by about 3 ¾ per cent in 2018 and 3 ½ per cent in 2019, in line with the April Monetary Policy Report (MPR). The US economy is proving stronger than expected, reinforcing market expectations of higher policy rates and pushing up the US dollar. This is contributing to financial stresses in some emerging market economies. Meanwhile, oil prices have risen. Yet, the Canadian dollar is lower, reflecting broad-based US dollar strength and concerns about trade actions. The possibility of more trade protectionism is the most important threat to global prospects.

Canada's economy continues to operate close to its capacity and the composition of growth is shifting. Temporary factors are causing volatility in quarterly growth rates: the Bank projects a pick-up to 2.8 per cent in the second quarter and a moderation to 1.5 per cent in the third. Household spending is being dampened by higher interest rates and tighter mortgage lending guidelines. Recent data suggest housing markets are beginning to stabilize following a weak start to 2018. Meanwhile, exports are being buoyed by strong global demand and higher commodity prices. Business investment is growing in response to solid demand growth and capacity pressures, although trade tensions are weighing on investment in some sectors. Overall, the Bank still expects average growth of close to 2 per cent over 2018-2020.

CPI and the Bank's core measures of inflation remain near 2 per cent, consistent with an economy operating close to capacity. CPI inflation is expected to edge up further to about 2.5 per cent before settling back to 2 per cent by the second half of 2019. The Bank estimates that underlying wage growth is running at about 2.3 per cent, slower than would be expected in a labour market with no slack.

As in April, the projection incorporates an estimate of the impact of trade uncertainty on Canadian investment and exports. This effect is now judged to be larger, given mounting trade tensions.

The July projection also incorporates the estimated impact of tariffs on steel and aluminum recently imposed by the United States, as well as the countermeasures enacted by Canada. Although there will be difficult adjustments for some industries and their workers, the effect of these measures on Canadian growth and inflation is expected to be modest.

Governing Council expects that higher interest rates will be warranted to keep inflation near target and will continue to take a gradual approach, guided by incoming data. In particular, the Bank is monitoring the economy's adjustment to higher interest rates and the evolution of capacity and wage pressures, as well as the response of companies and consumers to trade actions.

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