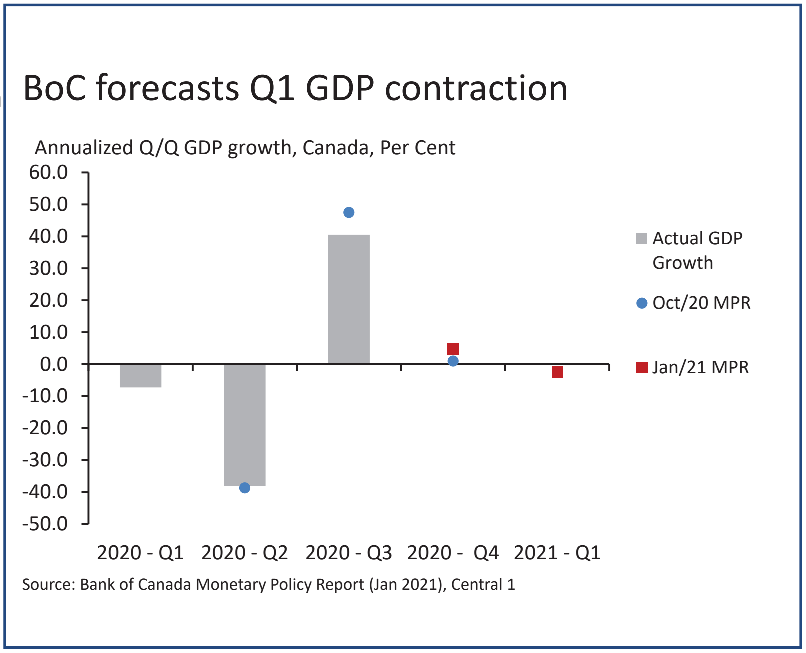
Bank of Canada Rate Announcement

central 1 Economics

January 20 2021

Bank of Canada keeps policy rate unchanged, medium-term growth expectations revised higher



As anticipated, the Bank of Canada (BoC) left its policy rate unchanged today at 0.25 per cent and re-emphasized that it would maintain this rate until "*economic slack is absorbed so that the two per cent inflation target is sustainably achieved*". The BoC expects this to occur in 2023. The Bank also maintained quantitative easing (QE) at a pace of at least $4 billion per week but also signaled an intent to slow down purchases as the economic recovery strengthens. Importantly, the BoC re-emphasized that the effective lower bound for the policy rate was 0.25 per cent.

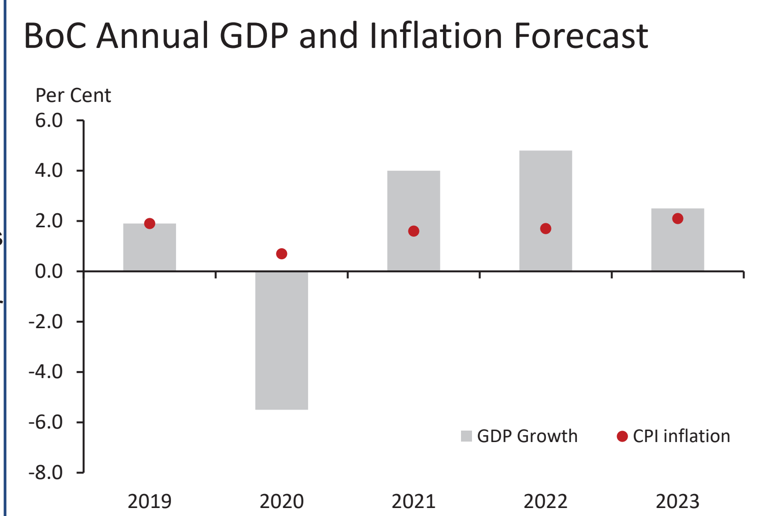
The accompanying Monetary Policy Report laid out the BoC's view of the economy and medium-term economic projections informing current and future policy decisions. Broadly, after a weak start to 2021, economic conditions are expected to improve significantly, and growth forecasts have been revised higher.

Not surprisingly, the rampant second wave of COVID-19 is weighing on current and Q1 economic conditions around the globe but these are propped up by government's fiscal support to households to help navigate the ongoing health crisis. Businesses have also adapted to a pandemic environment by shifting online. The BoC anticipates improved medium term economic momentum as current vaccine deployment, which was earlier than expected, lifts global growth and is already being observed in forward looking indicators such as commodity prices. Short-term U.S. activity, hampered by virus spread, will be lifted by fiscal stimulus spending. The U.S. government has already approved $900 billion which will start to flow this quarter. It is likely that further amounts will be disbursed under the Biden administration.

Global growth estimates and forecasts were revised higher for 2020, with a contraction of 2.9 per cent compared to a 4.0 per cent contraction in October's report. Global growth of 5.6 per cent is forecast for 2021 and 4.6 per cent for 2022. In the U.S., 2021 growth was lifted to 5.0 per cent from 3.1 per cent in October's MPR, with growth of 3.9 per cent in 2022 and 2.0 per cent in 2023.

Similarly, the second wave weighs on Canadian economic growth in the first quarter as lockdown restrictions curtail activity. The BoC expects a contraction in Q1 of an annualized 2.5 per cent due to the effects of the health crisis. This was preceded by a stronger than previously expected Q4 growth pegged at 4.8 per cent, although a weaker than expected performance in Q3 2020 meant that the handoff in GDP to 2021 largely as expected. Timing of a rebound will depend on the end of restrictions and vaccine deployment, but a Q2 rebound is expected with exports and investment gaining traction by end of year. Annual GDP is forecasted to have contracted 5.5 per cent in 2020, with growth of 4.0 and 4.8 per cent in 2021 and 2022. Slower consumer demand growth hampers 2021 growth, while 2022 expectations are sharply above October's forecast of 3.7 per cent with significantly strong consumer spending expected. Growth slows to 2.5 per cent in 2023. Fiscal measures continue to support the recovery, while housing slows, and trade firms.

Economic slack remains elevated despite relatively strong rebounds in employment. The gap is estimated to have been in the range of -2.75 per cent and -3.75 per cent in Q4, which is in line with the worst of the Great Recession. Narrowing this gap will take time and be observable in inflation dynamics. While there are temporary factors expected to boost CPI inflation this quarter, average inflation comes in at 1.6 per cent for 2021 and 1.7 per cent in 2022, before rising to 2.1 per cent in 2023.



Source: Bank of Canada Monetary Policy Report (Jan 2021), Central 1

There are significant uncertainties to the outlook, but they largely reflect the evolution of the pandemic. At this point, the BoC has been clear about its plans to keep its policy rate at 0.25 per cent until inflation stabilizes, which is reasonably pegged for 2023. That said, QE will be pared back and given the stronger medium- term outlook, reductions later this year is reasonable.

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