Bank of Canada Rate Announcement

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central 1 Economics

Upbeat BoC tapers QE as economy recovers

In a positively upbeat statement, the Bank of Canada shifted gears with its latest policy rate announcement and release of the Monetary Policy Report. In line with our expectation, the Bank held the policy interest rate at 0.25 per cent and commenced its exit from quantitative easing (QE) by lower its weekly target net purchase Government of Canada bonds to $3 billion from $4 billion as the economy continues to improve.

More importantly, signals abound that the policy rate hike could be pulled forward to the second half of 2022. Bank forward guidance has consistently "*committed to holding the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved*". The latest statement has moved this timing forward, and "*is now expected to happen sometime in the second half of 2022.*" Previously, sustained two per cent inflation was expected in 2023. That said, there is flexibility in how quickly the Bank would move once target inflation is reached.

The change in tone reflects the marked improvement in global and national economic outlook despite the uncertainties related to the pandemic's third wave.

Global growth is now seen to expand 6.8 per cent this year (revised up from 5.6 per cent) after a 2.4 per cent contraction in 2020. The U.S. underpins this revision with a 7.0 expansion this year, although much of the global economy outside the Euro area is expected to grow at a faster pace. U.S. growth is lifted by fiscal spending, specifically the $1.9 trillion American Rescue Plan. Global growth hits 4.1 per cent and 3.3 per cent in 2022 and 2023. Risk appetite for commodities has risen.

In Canada, Q1 2021 growth was revised up to 7.0 per cent, which is a far cry from the contraction previously expected as households and businesses adapted through technology and other means. The pandemic's third wave is expected to dampen growth with a Q2 2021 outlook of 3.5 per cent, with lockdowns particularly impacting youth, low-wage earners and women.

Annual GDP growth is forecast to reach a hefty 6.5 per cent this year (up from 4.0 per cent in the January MPR), 3.7 per cent in 2022 and 3.2 per cent in 2023. Given the strong Q1 2021 showing, the level of GDP has shifted higher by 2.5 per cent higher this year and 1.5 to 2.0 per cent in 2023 compared to January's MPR. Broadly, increased vaccinations will lift consumer demand. High savings is an upside risk to consumption. Meanwhile housing remains strong but decelerates, while exports and business investment improve. Federal stimulus of $85 billion is incorporated, although the budget lift came in at $101 billion.

The output gap is seen to close by mid-2022. Upward revisions to potential GDP growth amidst less long-term scarring on the economy moderates some inflationary pressure going forward.

Rapid growth in housing prices was a highlighted risk but the Bank expects that new home supply, particularly in smaller markets where demand has surged will rebalance the market as could measures from regulators including OSFI.

CPI inflation will temporarily spike in 2021 to the upper end of the 1-3 per cent target range due to base year effects from the initial stages of the pandemic and higher gas prices but this is transitory. Average inflation is 2.3 per cent this year, 1.9 per cent in 2022 and 2.3 per cent in 2023. Sustained two per cent inflation is expected to occur in the second half of 2022.

The Bank of Canada is clearly more upbeat these days than recent months. While the pandemic's third wave brings significant uncertainty, the Bank looks to be exiting QE and priming the markets for an earlier hike. That said, this is still contingent on how damaging and persistent the pandemic's third wave is and the pace of vaccinations.

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