Bank of Canada Rate Announcement

central 1 Economics

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Quantitative easing ends, Bank signals earlier hike

The Bank of Canada turned much more hawkish today in its highly anticipated policy rate announcement and release of its Monetary Policy Report. The Bank held the overnight rate at 0.25 per cent as expected but ended its quantitative easing (QE) program and clearly signaled an earlier hike for the second or third quarter of 2022.

The Bank's statement highlighted the ongoing themes in the broader economic recovery and the inflation backdrop.

Globally, the economy continues to progress and supported by vaccinations, but growth remains uneven. Moreover, strong goods demand and pandemic disruptions have constrained growth while boosting inflation globally.

The Canadian backdrop continues to improve despite a second quarter pause and re-openings have largely concentrated in restrictive- sensitive sectors and contributed to some labour shortages in some sectors, although overall slack continues. The Bank expects GDP growth of 5.1 per cent this year, 4.3 per cent in 2022 and 3.7 per cent in 2023. While this marks a downward revision from July, the Bank also cut potential GDP estimates due to supply chain challenges and labour market mis- match, pointing to less of an output gap than previously forecast.

On the inflation front, high CPI inflation is clearly a challenge for the Bank. While noting that supply bottlenecks and energy prices are the drivers, it noted that inflation is stronger and more persistent than expected and will remain high into 2022 before easing to two per cent in late 2022. Caution about wage inflation and inflationary expectations were also noted.

With the ending of QE, the bank also updated its extraordinary forward guidance for rate hikes. While maintaining that it will hike when the economy reaches full capacity, it now expects this to occur sometime from April through September. This reflects lower potential GDP and smaller output gap than previously estimated. On the QE front, the Bank will continue to reinvestment phase of its holdings of bonds.

The accompanying Monetary Policy Report provided a detailed update on the Bank's economic view.

- GDP growth was revised lower for 2021 to 5.1 per cent (from 6.0 per cent), with 2022 down to 4.3 per cent (from 4.6 per cent), and 2023 at 3.7 per cent. This downward revision reflects supply chain challenges and weaker foreign demand. Rebounding growth reflects global management of COVID-19 and higher consumption, business investment and exports.
- The Bank highlighted ongoing slack in the labour market, although the recovery is becoming more even and improving. At the same time, labour shortages are growing in some sectors such as digital, while the re-opening phase has lifted demand in hard hit sectors after prolonged closures or activity below capacity.
- Lower growth reflects supply chain challenges, which has severely affected some sectors like motor vehicles and parts. Short-term supply has been revised lower. This along with labour shortages in some sectors has led the Bank to reduce potential output growth to 1.6 per cent from 2021-23, or 0.2 pp lower than the previously projection. Potential output for 2023 is forecast to be 1 per cent below the pre- pandemic estimate. The output gap for Q3 was smaller at -2.25 to -1.25 per cent, compared to -3.25 per cent to -2.25 per cent in Q2.
- CPI inflation forecasts was revised higher with Q4 2021 at 4.8 per cent year-over-year but forecast to ease to 2.1 per cent year Q4 2022 but rising to 2.5 per cent in Q4 2023. Supply chains, base- year effects, recovery re-pricing and energy prices have contributed to higher prices. Further upward pressure is limited, but excess demand is expected to lift inflation into 2023 reflecting the Bank's willingness to let the economy run hot as target inflation is sustainably achieved. The Bank currently sees inflationary expectations as well anchored.

With today's rate announcement, the Bank will likely move up its first pandemic hike to July 2022 and gradually hikes thereafter. We have revised our outlook two hikes in 2022 and three in 2023 as the Bank moves closer towards the neutral rate. This will be contingent on the evolution of inflationary pressures, and there remains ongoing uncertainty for the economy on the upside and downside.

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Terms

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