Bank of Canada Rate Announcement

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central 1 Economics

Bank of Canada increases policy rate again but signals an end to further hikes

There were no surprises at the Bank of Canada's first rate decision of 2023, as it lifted its policy rate by another quarter point to push the target overnight rate to 4.5 per cent and continued its quantitative tightening path. Importantly, and as minor relief to consumers and businesses, the Bank expects to pause from here on out, at least temporarily.

The Bank's statement and accompanying Monetary Policy Report outlined the thinking and economic environment behind the decision.

Specifically, inflation trends are improving. While still high, global inflation is easing on lower energy prices and improved global supply chains. Interest rate hikes are curbing consumption, although economic trends have shown to be sturdier than expected in the U.S. and Europe. China is also creating upside risk for inflation as its economy rapidly re-opens.

The Bank noted that Canadian inflation is easing on gas prices and durable goods pricing, although inflation remains elevated. That said, headline inflation is projected to decline to 3 per cent in the middle of this year and 2 per cent in 2024. The trend in core inflation is moderating and is expected to curb broader inflation going forward. On the economic growth front, the Bank revised its Canadian GDP growth projection for 2022 to 3.6 per cent, with growth of 1 per cent this year and 2 per cent in 2024. Labour markets remain tight.

Today's policy rate decision gives way to a period of rate stability as the Bank assesses the impact of previous rate hikes on the economy. While some interest rate-sensitive sectors like housing have already reacted to rate tightening, monetary policy can take 18 months to work through the broader economy. The Bank is threading the monetary policy needle, trying to set rates that will bring down inflation, but not so much as to create undue economic hardship. The Bank stated, "If economic developments evolve broadly in line with the MPR outlook, Governing Council expects to hold the policy rate at its current level while it assesses the impact of the cumulative interest rate increases." There remains upside risk to policy rates as the future decisions will be data dependent.

If inflations fails to retreat or economic conditions come in much stronger the Bank will likely hike again. That said we expect the Bank to hold pat through 2023 before embarking on rate cuts through 2024.

Monetary Policy Report Highlights

The Bank's accompanying Monetary Policy Report provides a deeper dive into the Bank's economic forecast. Highlights included:

Global economy: Growth projections were revised higher on stronger consumption. Growth is forecast to come in at 3.6 per cent this year (+0.4 pp), and 1.9 per cent in 2023 (+0.3 pp) and 2.4 per cent in 2024 (-0.2 pp). U.S. and European growth were revised higher, while China growth expectations were lifted following a end to the country's COVID-zero strategy. Inflationary pressures are abating on commodity prices, but core measures remain high with stronger services prices and wages. Interest rates are still working through the economy and will continue to rise. That said, bond yields have eased amidst lower risk premiums and expectations for rate cuts.

Canada economy: GDP growth was revised higher in Canada. Projected growth in 2022 came in at 3.6 per cent (+0.3 pp), 1.9 per cent in 2023 (+0.1 pp) and 2.4 per cent in 2024 (-0.2 pp). While a modest change, particularly in the latter two years, there is a slightly stronger consumer demand and government spending profile than previously forecast. Broadly, growth declines as effects of interest rates dampen spending. In later 2023, growth is forecast to accelerate into 2024 with population growth supporting the real economy.

On a quarterly basis, Q4 2022 growth was projected at an annualized 1.3 per cent, revised up from 0.5 per cent with a slowing to 0.5 per cent in Q1 2023.

The main drag is consumer spending growth which is forecast to slow to 0.7 per cent in 2023 from 2.7 per cent in 2022 and rise to only 0.9 per cent in 2024. Consumers are expected to cut purchases and delay spending on bigger ticket items and, as the year progresses, slowing growth in leisure services is expected as rates and wealth impacts bite. Housing contracts 0.7 per cent in 2023 and expands 0.3 per cent in 2024. Exports will likely slow with the U.S. and global economy as will business investment

Inflation: The bank projects CPI inflation to retreat to an average of 3.6 per cent this year (and a slip to 3 per cent around mid-year) and average 2.3 per cent in 2024. Inflation reaches its target of 2 per cent in 2024.

Lower gasoline prices, better supply conditions and falling shipping costs are contributing to easing goods inflation. However, the services sector remains sturdier and is likely to prop up prices in the near-term. Services price growth is likely to slow. While the economy is in excess demand and wages are still rising, interest rates are slowing the labour market and wage growth has moderated in the 4-5 per cent range. This is still too high, but the risk of a wage-price spiral has declined.

The Bank's estimate for the output gap for Q4 came in at 0.5 per cent to 1.5 per cent, pointing to more excess demand than previously projected. Potential GDP was revised up, but by less than real output.

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