Economic Commentary

October 23 2024

Bank of Canada cuts 50 bps, more to come

There was little surprise today as the Bank of Canada cut its target for the overnight rate by 50 basis points today to 3.75 per cent, aligning largely with forecast consensus, and maintained its path of quantitative tightening. The Bank noted that more rate cuts are to come provided the economy and inflation evolves as anticipated. The timing and pace of cuts will be contingent on this evolution. We expect the next move to be a 25-basis point cut, albeit with the risk of it being another 50 point reduction.

The Bank's statement was largely neutral and factual in tone and highlighted recent economic trends and its economic projections. The U.S. economy remains stronger than previously expected, with some softness in the euro area and China, while also noted that global financial conditions have eased amidst softer inflation and lower rate expectations.

For Canada, the Bank noted the recent slowdown in economic growth and forecast for a growth rate of about 1.75 per cent in the second half of the year. At the same time per capita measures, particularly consumption, have been weak, which is in part attributed to struggles in the youth labour market. Export growth has remained robust. The economy is in excess supply amidst a rising unemployment rate.

This slowdown is expected to be temporary with the Bank anticipating an acceleration in annual growth to 2.1 per cent in 2024 and 2.3 per cent in 2025, which is still pretty robust. On the inflation front, the Bank noted the steep decline to 1.6 per cent, and while oil prices have contributed, shelter inflation is beginning to ease, and excess supply in the economy is reducing overall inflation. Core inflation is normalizing. This was not entirely alarming to the Bank, and it expects inflation to trend back towards target, with shelter inflation easing, but other components firming as excess supply in the economy abates. It sees pressures on inflation roughly balancing out over the horizon.

The Bank provided a clear indication that further cuts are to come but remain data dependent stating, "If the economy evolves broadly in line with our latest forecast, we expect to reduce the policy rate further. However, the timing and pace of further reductions in the policy rate will be guided by incoming information and our assessment of its implications for the inflation outlook. We will take decisions one meeting at a time." While the direction is clear and we are still expecting a 25-bps cut in December, we see some potential downside risks to the Bank's outlook which could trigger a deeper reduction, although we still see a terminal rate of 2.75 per cent in the first half of 2025.

The Bank's Monetary Policy Report outlined the Bank's assessment of current conditions and the economic outlook underpinning the decision. Forecast quarterly annualized GDP growth is 1.5 per cent in Q3 and 2.0 per cent in Q4 before accelerating in 2025 and 2026 to average above two per cent. This may be too optimistic for Q3 growth given the monthly industry-GDP trend and ongoing drag from mortgage renewals. The Bank expects to see more consumer spending and business investment as interest rates decline. There will be a drag from slower population growth, but per capita consumption is forecast to increase. Increased productivity will provide some offset to weaker population growth, while the housing market is forecast to pick up due to demand factors but still be constrained by supply. Investment is also expected to increase. These drivers are likely to boost growth, but timing may be delayed.

The Bank currently forecasts inflation to remain near target in its forecast with a nearly 2.1 per cent year-over-year increase in Q4, which is a considerable leap from September's 1.6 per cent. It expects inflation to trend around 2.0 per cent through 2025. Core inflation is forecast to slow toward 2.1 per cent in late 2024 from 2.3 per cent in Q4 2024. The uptick from September toward 2 per cent in part to upward pressure from smaller drag from energy prices, although global volatility makes this a wild card. At the same time, pushing down inflation will be effects of diminished shelter cost inflation and excess supply in the economy. The Bank estimated an output gap of 0.75 and 1.75 per cent, but this will be reduced over time from stronger economic growth which is expected to boost goods price inflation. We could see inflation undershoot which would require a more aggressive rate adjustment.

Bryan Yu
Chief Economist
Central 1 Credit Union
byu@central1.com