LAURENTIAN BANK

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Bank of Canada Decision – Policy Rate Elevated for Longer

The BoC pauses again today, keeping its policy rate of 4.50%. But the hiking bias, rather than the pause, stands out more from today's statement. The message, overall, sounds more hawkish as the BoC expresses mounting concerns about where inflation ends up late this year and next.

The BoC looks confident about ongoing consumer inflation cooling in the near term, from 5.2% in February to 3% mid-year. We track the same, rapid moderation in the coming months. However, the BoC reveals its discomfort about the next step: bringing down CPI inflation from 3% to 2% over a rather long period of time. According to the *Monetary Policy Report (MPR)*, total CPI inflation is projected to reach 2.5% in late 2023 and 2.1% in late 2024. Put simply, Canadians will have to wait before they see an increase in the cost of living they were used to, during the 2010s decade. Medium-term inflation concerns come from multiple sources and are abundantly cited in the statement: the persistence in service CPI inflation, high wage inflation in the 4%-5% range, insufficient retrenchment in inflation expectations and the absence of normal price-fixing behaviour from companies. All these factors need to show progress: far from a done deal. For instance, we notice a bunch of recent surveys revealing a higher-than-normal number of businesses looking to increase prices, fitting with the BoC's view that aggregate demand still exceeds supply.

The *MPR* base case scenario is a soft-landing scenario, as in the past. The BoC upgrades its Canadian real GDP 2023 growth forecast to 1.4% (1.0% in January) due to a solid start for North America, so far this year. It downgrades its Canadian real GDP 2024 growth forecast to 1.3% (from 1.8%) as the global economy slows and labour market conditions move closer to balance. Valuable colour about the incomplete adjustment of households to higher interest rates are provided in the *MPR*: the mortgage costs-to-disposable income ratio is about mid-way through its ascent as borrowers continue to renew their mortgages. This ratio, including both principal and interest, is projected to stay near 8.5% in 2024-25 versus about 7% before the tightening cycle started in 2022.

Also in the *MPR*, the BoC cites widening corporate credit spreads and higher U.S. bank funding costs resulting from the mid-March U.S. banking stress events. According to a separate NY Federal Reserve consumer survey released last Monday, the % of Americans saying it is harder to obtain credit rose from 49% in February to 53% in March, one of the highest figures on record. The *MPR* base case scenario incorporates "*a limited tightening in financial conditions due to the recent banking sector stress*", although the tightening could be more severe and persistent: a downside risk cited at the end of the *MPR*. But what matters the most for BoC officials are upside risks to inflation since they are ready to hike if there is insufficient progress in respect to services CPI inflation, wage inflation, inflation expectations and price-setting behaviour from firms.

In summary, the higher for longer narrative gains ground as BoC officials assess, during this conditional pause, if their tightening effort of 2022 turns out to be enough to reach 2% inflation. Market pricing of policy rate cuts this year and next appears a risky proposition and there is a distinct possibility of seeing the re-emergence of policy rate hikes in market expectations at some point.

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