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Bank of Canada (Jan Decision) – 3,2,1 … No Liftoff Today but Rates Normalization Coming Up

With total CPI inflation sitting at a 3-decade high, no slack left in the economy and improving labour market conditions including wage growth acceleration, Bank of Canada officials removed their exceptional forward guidance on the path for interest rates: "*The Governing Council therefore decided to end its extraordinary commitment to hold its policy rate at the effective lower bound. Looking ahead, the Governing Council expects interest rates will need to increase, with the timing and pace of those increases guided by the Bank's commitment to achieving the 2% inflation target*".

In contrast to our expectations of a 25bps liftoff this morning, the overnight rate target stayed at 0.25%, reflecting in part the current brief negative impact of Omicron on the Canadian economy. The Bank of Canada also elected to proceed in steps: dropping the forward guidance *before* raising rates. The communication channels set the stage for a much-needed normalization of monetary policy to bring inflation back to target. In the *MPR*, the BoC projects CPI inflation to ease from 5.1% in 2022Q1 to 3.0% in late 2022, and 2.2% in late 2023. We can infer from the Atlanta Fed shadow policy rate estimate of approximately -1% that monetary conditions in North America are too stimulative relative to inflation (chart 1). This negative shadow policy rate reflects the impact of Federal Reserve treasury purchases once the federal funds rate sits near the zero-lower bound. The same model can be applied to the BoC who embarked on a gargantuan QE program in 2020. Our central bank owns slightly more than $400B of the $1.3T marketable federal debt market.

Rate hikes of 25bps on March 2nd, April 13th and June 1st will be necessary to bring back the shadow policy rate into positive territory in 2022, particularly in light of CPI inflation peaking at around 5% in 2022H1. We do not think BoC officials consider raising rates by 50bps in one meeting alone. This would reflect a more urgent approach to monetary tightening, and we believe this would have implied raising rates today.

If future COVID-19 variants and other non-pandemic factors do not materially disrupt the MPR's base case scenario of above-trend real GDP growth (4.0% in 2022, 3.5% in 2023), the BoC plans to embark on a quantitative tightening journey sometimes this spring: "*The Bank will keep its holdings of Government of Canada bonds on its balance sheet roughly constant at least until it begins to raise the policy interest rate. At that time, the Governing Council will consider exiting the reinvestment phase and reducing the size of its balance sheet by allowing roll-off of maturing Government of Canada bonds*". QT should act as a partial substitute to rate hikes and allow the BoC to refrain from hiking at every of its remaining seven decisions in 2022. All else equal, QT would also prevent the yield curve from completely flattening throughout this year.

This being said, the amount of bonds rolling off the balance sheet in 2022, 2023 and 2024 appears too small relative to the required withdrawal of stimulus (chart 2). Given the maturity structure of assets bought during the QE phase, the central bank can only partially normalize its balance sheet even if it decides to rapidly end the reinvestment phase. However, the winddown could be faster if the BoC decides to roll off assets acquired before QE (around $80B in GoCs). Governor Macklem also mentioned during his press conference following the decision that the Bank of Canada does not consider outright sales of bonds in the secondary market to speed up quantitative tightening. This apparent limitation of QT brings us back to the BoC policy rate outlook. Four policy rate hikes in 2022 and two additional ones in 2023 are necessary to bring back the overnight rate target to the pre-COVID level of 1.75%. We do not see a 1.75% policy rate as a major headwind considering the 2.25% mid-point BoC neutral rate. However, this estimate is subject to change. On one hand, the absence of any intention from the government of Canada and the Biden Administration to restrict fiscal policy and the disinvestment phase of baby-boomers call for a higher neutral rate. On the other hand, excess savings and a total debt-to-GDP ratio above 300% in both Canada and the U.S. are offsetting forces.

Bottom Line: The Bank of Canada went as far as they could today in terms of policy shift, short of hiking. This paves the way for a mixture of policy rate hikes and QT going forward. We expect the BoC and the Fed to take the necessary actions to bring down CPI inflation close to target by acting on the controllable sources of inflation *i.e.* non-pandemic related.

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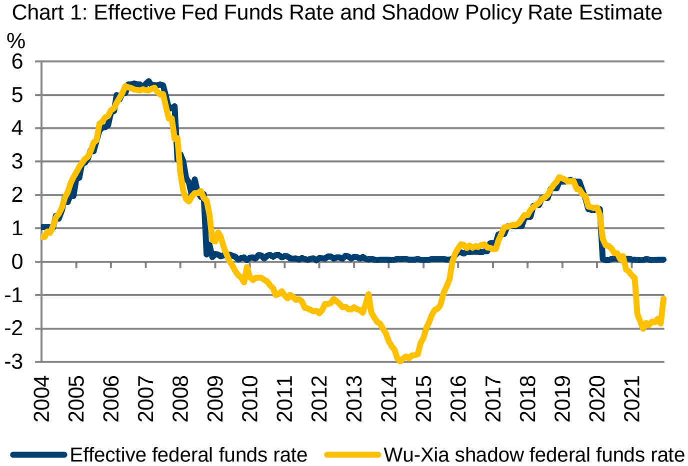
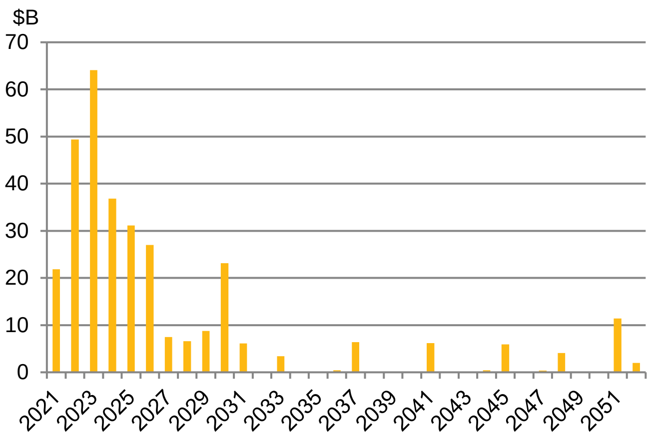
Chart 1: Effective Fed Funds Rate and Shadow Policy Rate Estimate



Sources: Atlanta Federal Reserve , and Wu and Xia (2015).

Chart 2: Bank of Canada - GBPP Maturities



Source: Bank of Canada and LBS Econ. Res. and Strategy Calculations.