ECONOMIC RESEARCH AND STRATEGY

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Bank of Canada October Decision — A Very Long Walk to 2% Inflation

The Bank of Canada left its policy rate unchanged at 5.00% for a second consecutive policy meeting this morning. Slowing economic activity taking the form of a moderate contraction in real GDP per capita and the modest cooling in CPI inflation from previous highs were the main factors supporting this decision.

The combination of a downward revision to real GDP growth next year (from 1.2% to 0.9%) and an upward revision to CPI inflation (from 2.5% to 3.0%) stands out from the new *Monetary Policy Report (MPR)*. Notably, the very slow cooling of the CPI inflation results from the intertwined connections of three pillars: corporate pricing behaviour, consumer price expectations and wage inflation. Several passages of the *MPR* show a sense of discomfort among BoC officials about these three factors feeding each other. First, companies still want to increase prices often and by a large magnitude over the next 12 months. Second, past and current inflation keeps consumer expectations too high, between 4%-5% over the next 1–2-year horizon. Third, we observe the same 4%-5% growth range for wage inflation. Job vacancies trending lower and labour force growth outpacing job gains are encouraging signs of re-balancing, but there is still a long way to go to contain wage inflation. And, as the *International Monetary Fund* noted in a recent research report on past high inflation regimes in the world, uncontained wage inflation is a key factor that kept CPI inflation elevated for periods longer than 3 years. Unsurprisingly then, CPI inflation in Canada will remain too high next year.

Core CPI inflation ranged in-between 3.5%-4% over the past year relative to 5% in 2022H1, as the past increase in interest rates has weakened durable goods consumption and goods CPI inflation. Meanwhile, CPI services inflation, the toughest segment to cool down, stays stubbornly high. A more rapid cooling in core CPI inflation in the year ahead is difficult to call even if our economic team estimates that households' adjustment to higher interest rates is going to be slightly more significant in both 2024 and 2025 versus 2023. Indeed, governments' fiscal stance is stimulative as the BoC notes in its statement, delaying the return of 2% inflation. Also, escalating tensions in the Middle East may add further instability in global oil markets.

The inflation fast spinning wheel ultimately led the BoC to keep, without surprise, its tightening bias today. A very long walk to 2% inflation implies a very long period with a restrictive monetary policy stance. We previously have expected the policy rate to stay at 5.00% until June 2024 to prevent the real policy rate from becoming too restrictive. But the small window of opportunity to pull back slightly the overnight rate target gets even narrower. Accordingly, the risk is tilting in favour of holding the nominal policy rate at 5.00% for a longer period, until July or September 2024.

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