Laurentian Bank Securities

ECONOMIC RESEARCH AND STRATEGY

Bank of Canada Decision – January

The Bank of Canada (BoC) increased the overnight rate target by 25 basis points this morning to 1.25%, a level unseen since the BoC was in an easing mode during the global financial crisis (see chart below). The BoC decision is supported by the improved economic momentum observed since last fall: "*Recent data have been strong, inflation is close to target, and the economy is operating roughly at capacity*".

Without signaling a "one and done" rate hike for 2018, the growing concerns expressed by the BoC relative to NAFTA uncertainty were undeniably front and center. Never mentioned in a statement accompanying the decision before, NAFTA was cited twice today. Notably, "*the Bank's outlook takes into account a small benefit to Canada's economy from stronger US demand arising from recent tax changes. However, as uncertainty about the future of NAFTA is weighing increasingly on the outlook, the Bank has incorporated into its projection additional negative judgement on business investment and trade*".

The economic outlook unveiled in the *Monetary Policy Report (MPR)* already shows a moderation in real GDP growth (from 3.0% in 2017, to 2.2% in 2018 and to 1.6% in 2019). This base-case scenario assumes NAFTA remains intact. If a restrictive new trade agreement becomes reality, Canadian real GDP growth could come up short of expectations, notably through weaker Canadian exports and less capital investment from companies in Canada. Some big unknowns would be the magnitude of the depreciation of the Canadian dollar and the response from fiscal authorities to offset the negative shock. A scenario including increased protectionism could even lead the BoC to reduce its policy rate.

In this context, it is difficult to predict the next move of the data-dependent BoC. Despite the many unknowns related to NAFTA, there are nevertheless new signs supporting our view that the BoC won't be able to hike its policy rate 3-4 times during 2018. First, the Canadian economy can grow further without triggering CPI inflation pressures, thanks to a stronger potential: "*The Bank continues to monitor the extent to which strong demand is boosting potential, creating room for more non-inflationary expansion. In this respect, capital investment, firm creation, labour force participation, and hours worked are all showing promising signs*". Second, BoC officials intend to keep the policy rate low enough to support the expansion even though the economy is running near full capacity (see chart below): "*While the economic outlook is expected to warrant higher interest rates over time, <u>some continued monetary policy accommodation will likely be needed</u> to keep the economy operating close to potential and inflation on target*." Thus, it is still difficult for us to forecast more hikes through 2019 than the three 25bps increases the BoC announced during the last six months.

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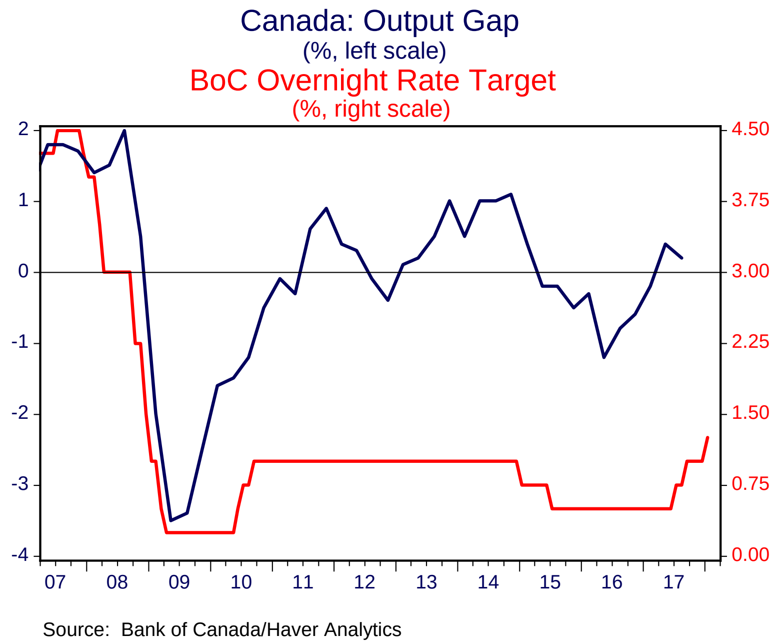

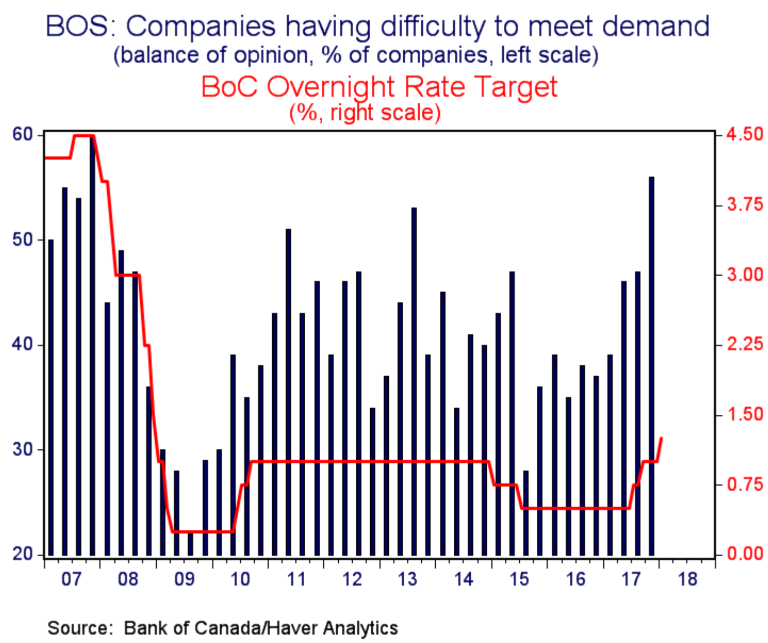

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