

ECONOMIC RESEARCH AND STRATEGY



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Bank of Canada March Policy Decision –

Additional CPI Inflation Cooling Necessary to Maintain the Policy Rate Pause

The BoC hit the pause button today in respect to the overnight rate, leaving it unchanged to 4.50% after the cumulative steep ascent of 425bps.

BoC officials appropriately justified today's policy rate hold by the pairing of ongoing cooling in CPI inflation and weaker activity from households and businesses. For instance, the two key core CPI metrics edged down at a faster pace than before in January near 5% year-over-year. The BoC also mentions 3-month annualized core measures standing close to 3 ½%, another way of expressing progress. Accordingly, today's statement does not include the January mention of an economy in excess demand.

But the cooling cannot stop here. Total CPI inflation must continue to soften, near 3% by mid-year according to the BoC, to prevent the resumption of policy rate hikes. Our short-term forecast tools suggest this goalpost can be reach, with CPI inflation potentially siting around 2 ¾% in June and July. However, one upside inflation risk relates to the sudden absence of further normalization in the price setting behaviour of firms. According to the 2023Q1 Survey of Business Conditions released last week by Statistics Canada, close to one-third of firms expect to raise prices over the next 3 months, virtually unchanged from the previous quarter (see chart). Ideally, the percentage share of companies planning to increase prices must decline close to 15% to restore price control. The other stickiness-type concern relates to the 2023H2-early 2024 inflation outlook. Price increase intentions by businesses do not fade quickly enough. According to the Canadian Federation of Independent Business, firms plan to increase prices by approximately 3.5% on average over the next 12 months, significantly above the MPR total CPI inflation 2023Q4 projection of 2.6% (see chart). If these intentions become reality, the BoC would have to lift the policy rate to 5% at least. At least, the latest survey-based inflation indications and the absence of softening in wage inflation running hot above 4% lead us to refute the idea of policy rate cuts this year. Also, it makes little sense to discuss the pivot market rhetoric if the BoC carries on with quantitative tightening. It worth simply paying attention to the title of today's statement reiterating the continuation of quantitative tightening. It modestly raises the threshold in case the debate is about holding versus increasing the policy rate. Weekly balance sheet data indicates a rapid reduction in Government of Canada Bonds held by the BoC for instance, down \$100B since early 2022 to \$325B as of last week.

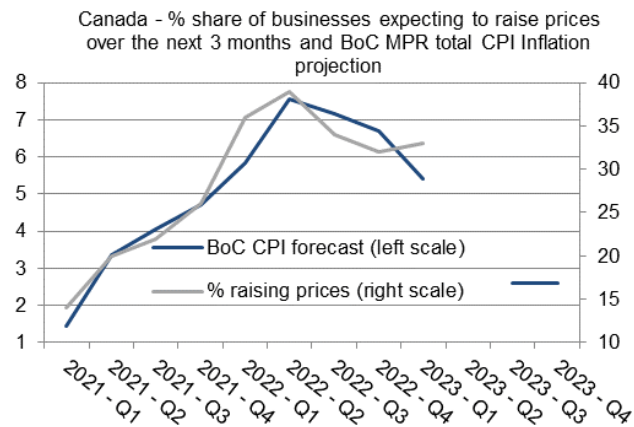
Like January, today's statement makes it clear the BoC is ready to lift the policy rate if the future CPI inflation path surpasses expectations on the high side. Also, investors should not shape their BoC policy rate outlook on the premise of chasing the U.S. Federal Reserve, something the FX market seems to have understood based on the USDCAD swift depreciation near 1.38 on Tuesday. As BoC Deputy Governor Paul Beaudry mentioned mid-February, "our paths back



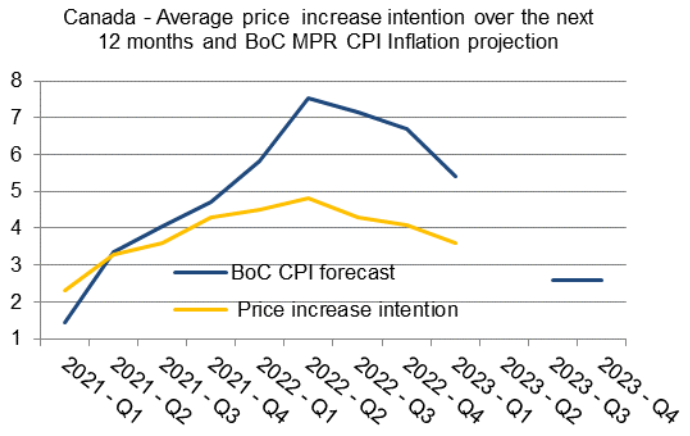
to target might differ”, referring to the 2% inflation target. After all, Canadian households’ sensitivity to interest rates is unambiguously larger than Americans due to higher leverage. Market talks of policy rates divergence are more frequent at this stage of the business and monetary tightening cycles. Australia is another good example. The Reserve Bank of Australia announced earlier this week a dovish 25bps hike, saying it is moving closer to a pause. The Reserve Bank of Australia policy rate of 3.60% is significantly lower than the BoC at 4.50% even if Aussie’s CPI inflation run faster near 9%.

So far, the biggest event this week has been Tuesday’s hawkish comments from Fed Chair Powell relative to a higher terminal rate and a possible return of jumbo hikes, contributing to the largest U.S. 2s10s yield curve inversion since the early 1980s. On Wednesday morning, high-frequency economic reports were too strong to remove the partial market pricing of a 50bps Fed policy hike on March 22nd. The ADP report indicated a solid net job creation of 244K in February. Another report showed an insufficient 0.4M drop in job openings near 10.8M in January although lower EPS figures reported by S&P500 companies should contribute to bring down job postings going forward. To prevent a 50bps hike by the Fed later this month, Friday’s U.S. nonfarm payrolls print must come in at 100K or below with the unemployment figure moving up by at least 0.2pp, considering mild weather conditions boosted the January NFP print by 217K according to the San Francisco Fed. In our view, convincing cracks in next week’s U.S. CPI report for February are very unlikely because the Cleveland Fed nowcast total and core CPI figures are too high, standing at +0.45% month-over-month.

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Source: Canadian Survey on Business Conditions, Bank of Canada



Source: Canadian Federation of Independent Business, BoC

