LAURENTIAN BANK SECURITIES

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Bank of Canada (Dec. Decision) – Still Looking for a mid-2022 Policy Rate Liftoff

The last monetary policy decision meeting of the year did not reveal any major changes to the BoC officials' mindset. The steady progress in economic conditions is consistent with the forward guidance calling for a policy rate liftoff somewhere around mid-2022, as previously announced at the October policy meeting.

The Bank of Canada did not go as far as the Reserve Bank of Australia on Monday openly mentioning that Omicron will not derail the economy. In other words, the BoC played it safe, acknowledging that the Omicron variant "has injected renewed uncertainty".

Plenty of encouraging news were identified, but not enough to solidify the need for an early 2022 policy rate liftoff. The statement cites accelerating growth in the U.S., easing COVID-19 restrictions, strong consumer confidence tied to vaccination rates. Also, the recent acceleration in wage growth and higher inflation expectations are more than ever on top of the BoC's watch list.

Even if the Canadian economy only stood 1.5% below its pre-pandemic level in 2021Q3 and that significant progress in labour market conditions occurred in November, there are still a few quarters to go until the remaining slack in the economy is fully absorbed. Granted, the blockbuster November LFS favours an April policy rate liftoff, earlier than our previous July call. Also, Fed Chair Powell recent comments about faster QE tapering, possibly ending the program in March instead of mid-2022, provide an opportunity for Governor Macklem to tighten its policy stance sooner than later, without generating a strong reaction in the currency. Thus, if the Omicron variant only puts a very small dent in economic momentum, we would adjust our forecast by projecting four 25bps overnight rate target increases in 2022 (instead of three), starting in April (instead of July).

After the liftoff, the next step relates to how far the Bank of Canada and other central banks can go in terms of withdrawing monetary accommodation. In our view, the neutral rate, estimated in 2020 by BoC staff between 1.75%-2.75%, has diminished during the pandemic to at least its 1.75% lower bound due to growing inequalities, heightened preference for precautionary savings, a steady global search for yield by investors and a ballooning total private-public debt-to-GDP ratio of 350% according to the BIS, versus 300% before the pandemic. Granted, productivity gains including teleworking and the current rebound in immigration and labour force participation may offset some of these factors. The Canadian real neutral rate of interest (r*) estimated by the Federal Reserve stood at 1.4% in April 2020, implying a nominal neutral rate of 3.40%. Nonetheless, the U.S.' 0.5% estimated r* restrains the Canadian neutral rate. Even if the economic stars perfectly align, we have a tough time seeing the overnight rate target returning to its pre-pandemic level of 1.75%, even if the size of the BoC balance sheet remains elevated in the medium-term.

Mandate renewal coming up

The year is not entirely over for the Bank of Canada. Finance Minister Chrystia Freeland and BoC Governor Tiff Macklem should issue a joint statement about the 5-year mandate renewal before Christmas. We lean in favour of the status quo given the current pace of inflation at a two-decade high. We forecast CPI inflation to stay stubbornly high in the first half of 2022, averaging 3.0% versus 3.3% this year. In our view, some easing in global shipping costs observed lately and the supply response in some commodities including oil, lumber and copper are encouraging for next year. But several other inflationary sources are heating up. Notably, wage growth is picking up and consumers withdraw some of their excess savings. These two elements could drive up services-related inflation in 2022. Beyond 2022, risks are tied to the upside. The necessary decarbonization of the economy comes with a steep price tag. Numerous natural disasters induced by climate change will continue to inflate commodity prices for cotton, lumber and agricultural products, among others. Furthermore, geopolitical tension can generate idiosyncratic price spikes along the way.

The second most likely option for the mandate renewal would be to move in line with the Federal Reserve, adding an employment maximisation element to the mandate. Such as move would not be a major surprise since Governor Macklem has often referred to labour market conditions as an input in its monetary policy decisions. The challenge, however, would be to communicate to the public and financial markets how a dual mandate is superior to a 2% target, and how it will be enforced.

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