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Bank of Canada Preview: Decisions, Decisions

by Avery Shenfeld

The Bank of Canada, under its new Governor, has reiterated that the current 0.25% is as low as they are likely to go, and hikes are clearly out of the question. But don't assume that with policy rates on hold that you can skip reading the July 15th Monetary Policy Report.

The fact that it's the first drafted under the leadership of Tiff Macklem needn't imply a change in tone. But we will get the first post-Covid forecast from the Bank, and even though there will be alternative scenarios laid out, their path will speak volumes about the medium-term rate outlook.

There Is a Rate Forecast... If You Know Where to Look

Unlike the Fed, the Bank of Canada doesn't publish a forecast for policy rates. But there is a substitute for the Fed's "dot plots," if you know where to look. It's in the chart showing the forecast for the "output gap". The BoC favours that measure over the Fed's focus on the unemployment rate, but they serve the same purpose: both are key to the central bank's expectations for underlying inflation trends.

While the BoC doesn't have a dual mandate, and solely targets the CPI a couple of years out, for all intents and purposes you can think of it as an output gap targeting central bank. That was most apparent in a BoC speech on "Flexible Inflation Targeting" by a Senior Deputy Governor way back in 2014, of importance because the orator was none other than Tiff Macklem.

He distinguished between "good" disinflation tied to forces like increased competition, which the BoC would not respond to, from "bad" disinflation tied to a wide output gap, which would compel rate cuts. In sum, it's the divergences from a 2% trend in inflation caused by too much or too little economic slack that matter. As a result, the Bank's trajectory for the output gap is the best guide to when it would begin to unwind policy stimulus.

Looking at the timing of the four tightening cycles in the last two decades, the one exception was that of 2010. That year, the BoC moved many years ahead of the Fed in lifting the overnight rate from 0.25% to 1.0%, despite an output gap that was still estimated at 1.5%. We argued at the time that the tightening, however modest in rates, was excessive, as it helped send the Canadian dollar to parity against the greenback.

The result was a stall in the recovery that left the overnight rate on hold for many years, and in our view, the elevated exchange rate contributed to a hollowing out of export capacity. As a result, the Bank didn't take rates above 1% until 2018.

The other tightening cycles (2002, 2004, and 2017) only commenced with an average output gap of less than 0.5% (the range was 0.1% to 0.8%), and with forecasts of above-potential growth that would close the remaining slack in short order. That's likely the best benchmark to use in translating the MPR's output gap forecast into a policy rate outlook.

Judging by the rough scenarios laid out in April and the data since then, the better end of BoC scenarios could imply a narrow enough output gap to be consistent with a first hike in the latter half of 2022. But expect the report to emphasize greater risks to downside. With the Fed “dots” not seeing a move until 2023, we still see the most likely outcome as a similar timing for the Bank of Canada, particularly if it lets longer rates provide some braking force by winding down asset purchases in 2022.

All of this assumes that the Bank of Canada provides an output gap projection in the “central planning scenario” Macklem pledged to include. If not, we’ll have to apply some assumptions on potential growth to glean that from the GDP projections. That won’t be easy because potential growth will in turn depend on what the Bank of Canada is assuming about business capital spending and capacity, and the path for immigration and its impact on the size of the labour force.

Asset Purchases: If it Ain’t Broke

Under Governor Poloz, the Bank of Canada took pains to eschew the term “quantitative easing” when it launched into large scale asset purchases. It sought to emphasize its desire to ensure orderly market functioning, with an initial focus on jammed up credit markets at the short end of the curve.

But in moving into purchases of Canadian government bonds, and a subsequent foray into provincials and corporates, the Bank was clearly trying to extend its reach further out the curve, by leaning against the tendency for heavier issuance to steepen out the curve or widen spreads.

With shorter term markets like commercial paper and BAs now well behaved, and the Bank’s holdings of such assets rolling off with maturities, the focus will be on what’s required to keep the rest of the curve in check. Remember that in Canada, mortgages are typically 5-years and under, so containing five-year rates is more critical than what happens at the very long end.

There’s a risk of a steepening curve, particularly if the federal government shifts to longer dated issuance. Moreover, as CIBC’s rate strategist Ian Pollick has shown, longer dated yields are now heavily influenced by bond market developments abroad, rather than domestic forces.

Still, for now, there’s no pressing need for the Bank of Canada to announce a major shift in its approach. We wouldn’t think of it having a target for the absolute size of the balance sheet. It doesn’t take the nearly the equivalent in bond purchases to offset a maturity in short term paper to have the Bank holding as much of the overall risk off the market.

Moreover, there’s no model that translates a given level of central bank assets into an economic impact. Instead, it’s better to think about the Bank as doing what it takes to keep interest rates in check. For now, the market out to five years is very well behaved. Yields aren’t above 0.5%, and there would be little economic lift in trying to nudge them lower at this point. There’s simply little room to do so. With the Bank citing 0.25% as the lower bound for overnight rates, five-year bonds aren’t going to trade below that yield.

So this MPR is unlikely to deliver a major rethinking of the Bank of Canada’s asset purchase program, under the grounds that if it ain’t broke, don’t fix it. But doing what it takes to keep yields in check could soon require greater weekly bond purchases, given the increases we’re seeing in the issuance calendar to meet rising government financing needs. The Bank has only set minimum purchase levels for Government of Canada bonds, so strictly speaking it doesn’t need to actually announce a higher floor to ramp up its purchases if need be. But we expect to see it use this opportunity to at least remind investors of its willingness to do so.

Options Waiting in the Wings

Should yields creep up, two approaches likely being discussed in the halls of the BoC, but not necessarily mentioned in this upcoming MPR, are a conditional commitment (CC) and yield-curve control (YCC). The Bank did use CC back in 2009, when it stated that it wouldn’t raise rates for a year as long as there was no change to the inflation outlook. In the end, due to better than expected growth and an upgraded inflation forecast, it opted to hike one meeting before that year would have been up, perhaps not a great decision in terms of precedent setting.

But it only reached for a CC announcement because the market had been pricing in rate hikes inside a one-year horizon, clearly not an issue today. We can’t foresee a no-hike commitment extending out two years, given the uncertainties on the economy over that long a horizon. But it could still use less formal guidance to signal that it was going to be very patient in starting a tightening, in an attempt to steer expectations beyond a one-year period.

Yield curve control would be more useful further out the curve, and as noted, we see the 5-year rate as the most likely target given its link to mortgages. Should five-year government rates move higher before the economy warranted it, the Bank could commit to purchasing enough bonds to hold the yield at a given level. It might not take much in the way of actual purchases to reinforce that level in the market if it were at 0.5%.

So to play on a historical Canadian quotation, its YCC if necessary, but not necessarily YCC. Either way, the bond market out to five years is going to be sleepy territory for at least the coming year.

Targeting 10-year or longer rates is less likely, and would potentially be more costly for the BoC. Investors might doubt the Bank's willingness to keep those holdings off the market until they matured, undermining the effectiveness of the policy. As the deposit rate rises in the future (when the BoC eventually tightens), bonds bought today with less than a 1% yield would soon move into a negative carry position for the Bank. The offset to the bonds it holds on the asset side are liabilities to banks that pay the deposit rate. That's currently at 0.25%, but it will move up with the overnight target.

Special Boxes

The MPR follows a fixed structure for the most part, with the same chapters and forecast tables in each issue. The exceptions are in boxes that zero in on new topics of special interest. There will likely be a box looking at issues unique to forecasting economic activity while the pandemic is still on, to expand on some aspect of the projections laid out in the MPR.

Another in this issue might look at the degree to which the CPI is understating the typical change in the cost of living for Canadians, given the atypical mix of goods and services being purchased in this pandemic. Relative to that new basket, the CPI is giving an excess weight to gasoline, transit fares, hotel rooms, airline tickets, restaurants and entertainment venues, and too little to food for home consumption, internet services, and other essentials.

Governor Macklem has mentioned this issue in a recent speech, but we see it as useful for assessing living standards, rather than for monetary policy. While some (but not all) of the excessively weighted items are showing lower 12-month inflation than the overall basket, the impact will fade as gasoline prices come off their lows. Moreover, we argued elsewhere that the current core measures are still more important guideposts for monetary policy, not some re-weighted basket.

The only reason consumers can afford to cover the elevated cost of groceries is that they aren't spending on these other items. Otherwise, there isn't the labour income power to sustain higher overall inflation. And in the post-Covid world that we'll have to be entering when policy tightens, consumers will be again shifting back to more normal habits.