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The Bank of Canada is behind the curve, starts raising rates more aggressively to control inflation

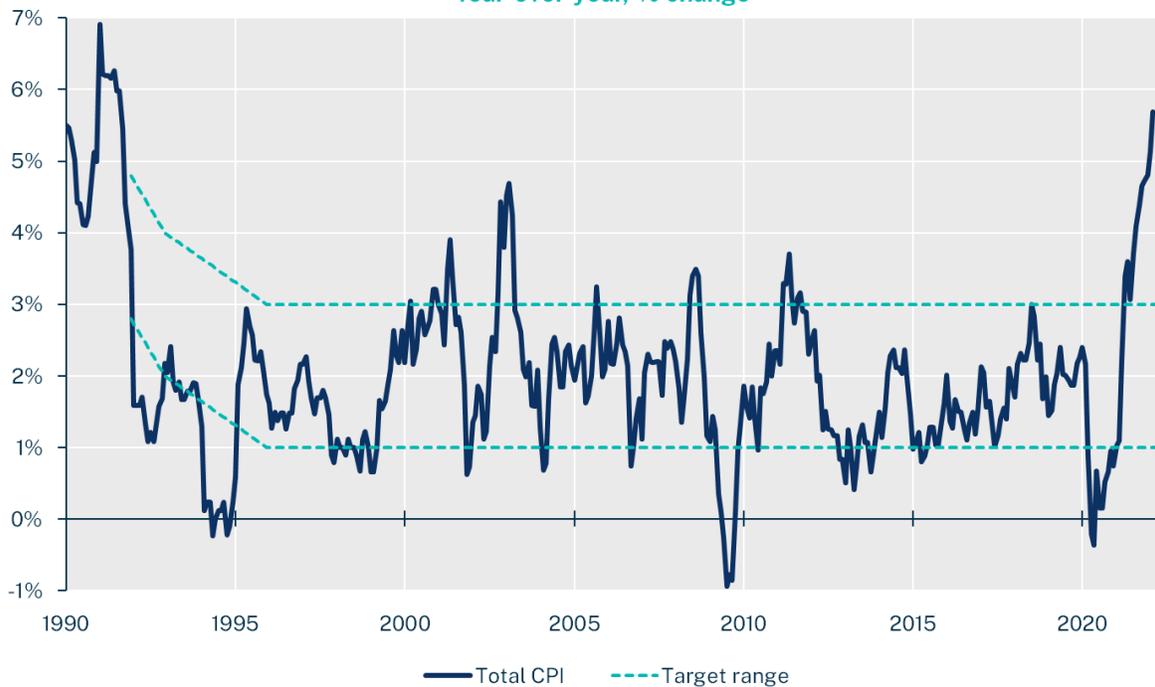


Stephen Tapp, Chief Economist

April 13, 2022

Canadian inflation

Year-over-year, % change



Source: Statistics Canada

“With a major overshoot of inflation now confirmed, the Bank of Canada sees the economy running into a period of persistent excess demand. Even with today’s aggressive move, the Bank’s policy rate remains stimulative, and the broadening of price and wage pressures means medium-term inflation risks are rising. Canadians should expect more interest rate hikes ahead. The Bank will likely follow this move with another 50 basis point hike in June.”



KEY TAKEAWAYS

- **The Bank’s policy interest rate is moving up:** As expected in financial markets, today the Bank of Canada (BoC) raised its policy rate by 50 basis points (0.5%) to 1%. Canada is the first G7 country to hike rates by a half-percentage point in one move during the pandemic.

With a significant overshoot of inflation now confirmed and the policy interest rate still in a stimulative position, medium-term inflation risks continue to rise. Canadians should expect more interest rate hikes ahead — with the Bank likely to follow this move with another 50 basis point hike in June.

Where will it stop? Markets expect this tightening cycle to eventually end with the Bank’s policy rate rising to just over 3%, which is only slightly above the Bank’s updated “neutral rate” range of 2% to 3%. Even higher rates will likely be required to ultimately get inflation under control.

- **The Bank’s balance sheet will shrink:** The BoC complemented their rate hike by shifting into “quantitative tightening” mode to reduce the size of its pandemic-inflated balance sheet. As of April 25, the Bank will stop buying Government of Canada (GoC) bonds to replace maturing assets. Over the next two years, about 40% (or nearly \$170 billion) of the Bank’s \$422 billion of GoC bond holdings will mature.
- **The Bank downgraded its global economic outlook:** In its April *Monetary Policy Report*, the BoC revised down its economic projection for the global economy in 2023, reflecting persistent disruptions to commodity prices as well as global trade and finance channels, due to Russia’s invasion of Ukraine.

Growth in the U.S. economy is also expected to be slower in 2022 and 2023, owing to tighter financial conditions as the Federal Reserve moves more aggressively to control American inflation.

- **The Bank’s outlook for Canada’s economic growth is largely unchanged:** Growth in Canada’s economy is now expected to be slightly stronger in 2022 (4.2%), but slightly weaker in 2023 (3.2%). As such, the overall level of activity is largely unchanged over the projection. That said, expect more oil and gas activity due to higher commodity prices, which will offset slower consumer spending growth as interest rates rise, and slower (non-commodity) export growth, given weaker foreign demand.



- **The Bank expects Canada’s economy to run into a position of significant excess demand over the projection:** The BoC judges that Canada’s economy has now fully recovered from the pandemic, as its “output gap” estimate is essentially closed in 2022Q1.

Over the course of 2022, with projected growth (4.2%) running well above potential output growth (1.7%), the economy quickly moves into “excess demand” in this projection — which appears to hit roughly 2.5% by the end of 2022, and isn’t brought back into balance by the end of the projection.

- **Canadian inflation is expected to be higher for longer:** Once again, there was a significant upward revision to Bank’s CPI inflation forecast. Inflation is now expected to be 5.3% in 2022, and 2.8% in 2023, still above the Bank’s target and comfort level. Most of this change is attributed to Russia’s war, which raises commodity prices and exacerbates supply disruptions.
- **But wait... there’s more fiscal spending to come:** The Bank’s latest forecast doesn’t yet factor in new fiscal measures from last week’s Federal Budget, which included about \$35 billion, on net, over six years. That said, the Bank’s preliminary analysis suggests the impact on their forecast would be “positive, but modest”. With a new Liberal-NDP supply and confidence agreement, and more program details to follow after Budget 2022, don’t rule out more fiscal spending in future budgets and updates.



SUMMARY TABLES

Bank of Canada projections	2021	2022	2023	2024
Real GDP growth				
Global	7.0 (6.8)	3.5 (3.6)	2.5 (3.4)	3.2
U.S.	5.7 (5.6)	2.8 (3.7)	1.9 (2.5)	1.5
Canada	4.6 (4.6)	4.2 (4.0)	3.2 (3.5)	2.2
CPI inflation				
Canada	3.4 (3.4)	5.3 (4.2)	2.8 (2.3)	2.2
Potential output growth				
Canada	2.3	1.7	3.3	2.5

Source: Bank of Canada's April 2022 Monetary Policy Report (previous projection in parenthesis).

Canadian inflation	Yr/yr % change	
	Feb	Trend
Consumer Price Index	5.7	↗
Energy	24.1	↗
Transportation	8.7	↗
Shelter	6.6	↗
Food	6.7	↗
Excluding food & energy	3.9	↗
Goods	7.6	↗
Services	3.8	↗
Average of BoC core measures	3.5	↗
CPI-trim	4.3	↗
CPI-median	3.5	↗
CPI-common	2.6	↗



MONETARY POLICY CHARTS

Canadian unemployment rate

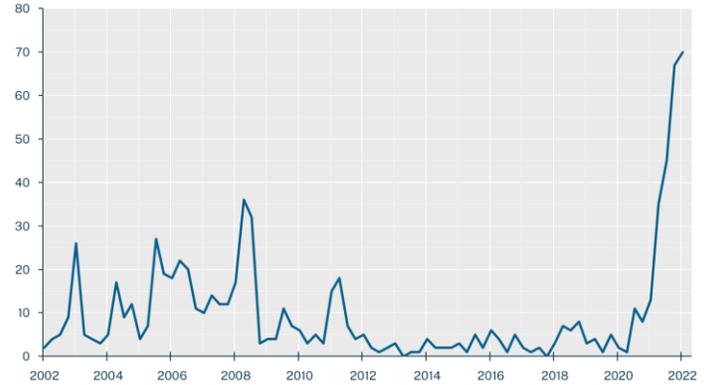


Source: Statistics Canada

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Business Outlook Survey: Firms Expecting Inflation Above 3%

% of respondents, annualized CPI inflation over next 2 years

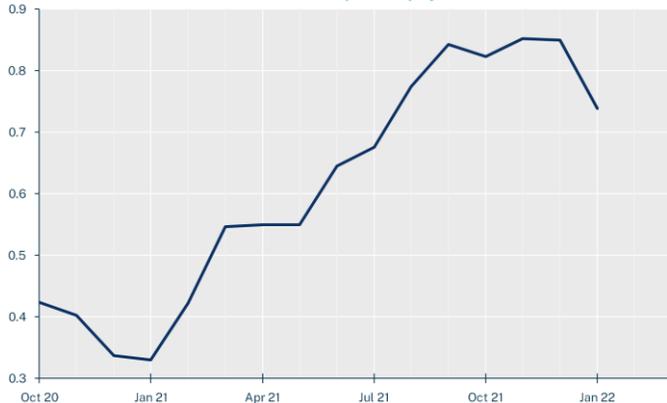


Source: Bank of Canada

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Canadian labour market tightness

Job vacancies per unemployed

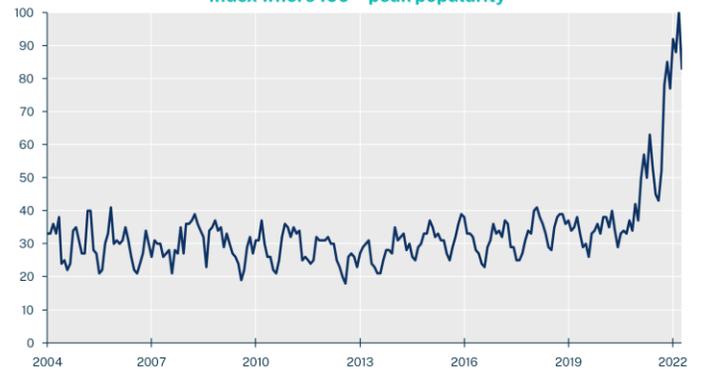


Source: Statistics Canada

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Google searches for "inflation" in Canada

Index where 100 = peak popularity

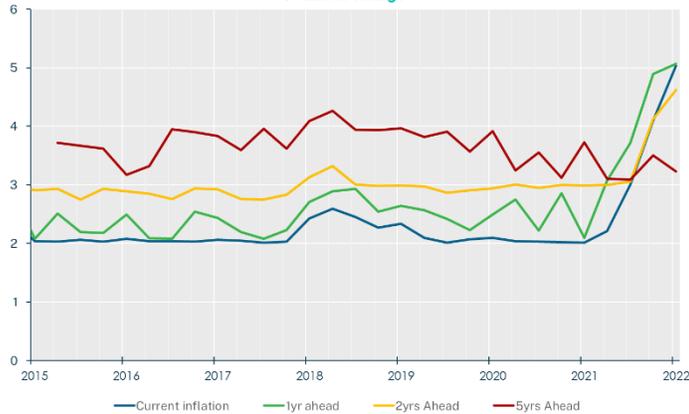


Source: Google

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Canadian consumer inflation expectations

% annual change

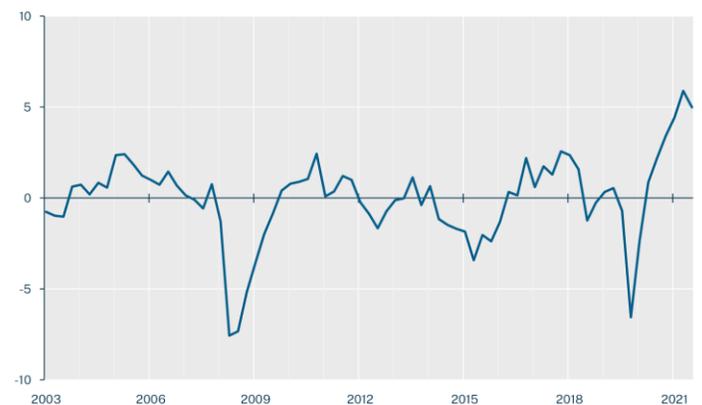


Sources: Bank of Canada; Canadian Chamber of Commerce

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Business Outlook Survey Indicator

Index



Source: Bank of Canada

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Total industrial capacity utilization

% , seasonally adjusted

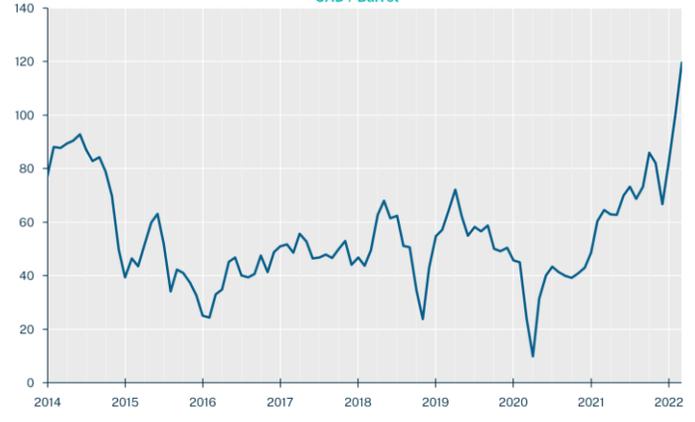


Source: Statistics Canada

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Oil prices: western Canadian select

CAD / Barrel



Source: Bank of Canada

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Bank of Canada output gap estimates

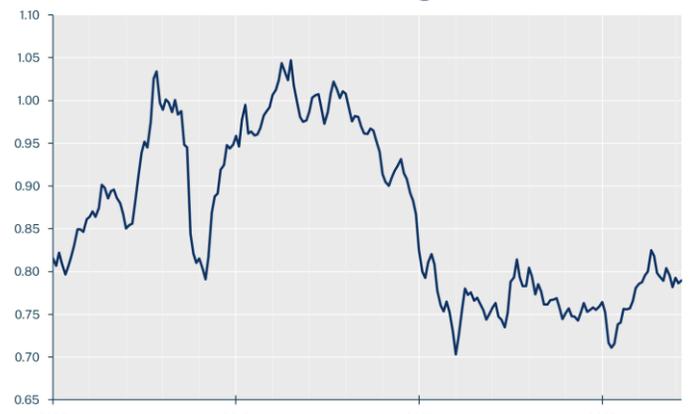
%



Source: Bank of Canada

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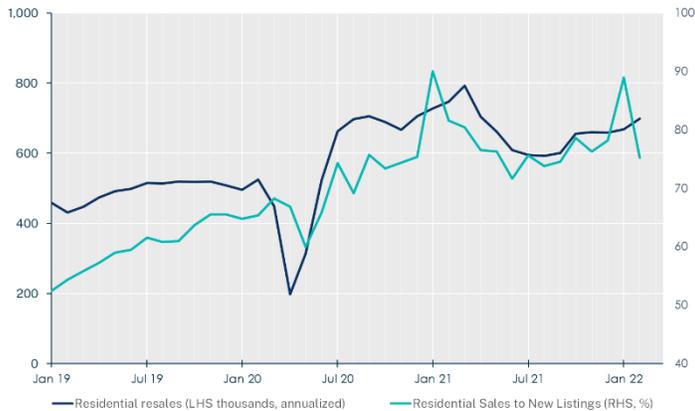
CAD/USD exchange rate



Source: Bank of Canada

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Canadian Home Sales and Listings

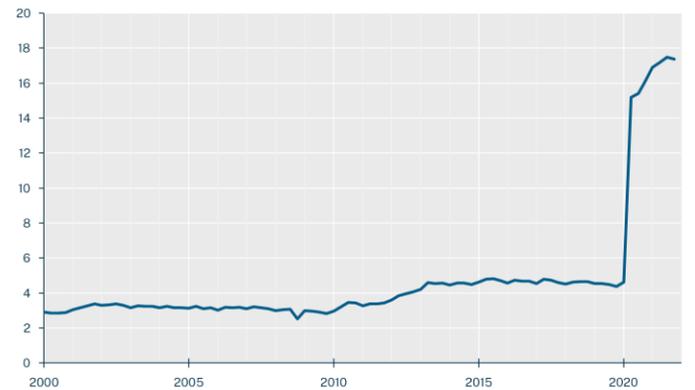


Source: The Canadian Real Estate Association

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BoC holdings of government of Canada securities

% of GDP



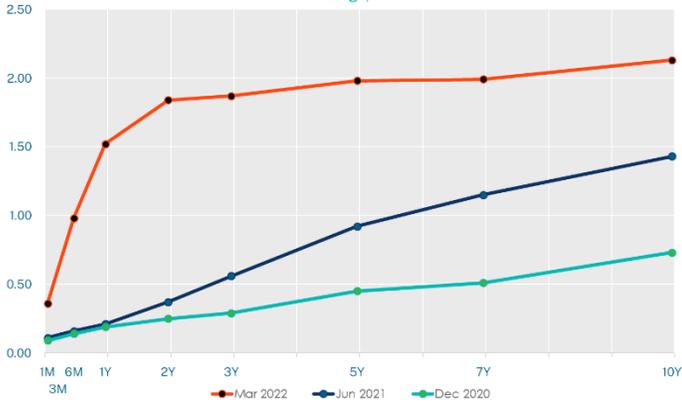
Source: Bank of Canada

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Canadian yield curve steepening

Average, %



Source: Bank of Canada

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Canadian and U.S. CPI inflation

% change since February 2020



Sources: Statistics Canada; Bureau of Labor Statistics

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Bank of Canada policy rate

%



Source: Statistics Canada

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Canadian inflation

Year-over-year, % change

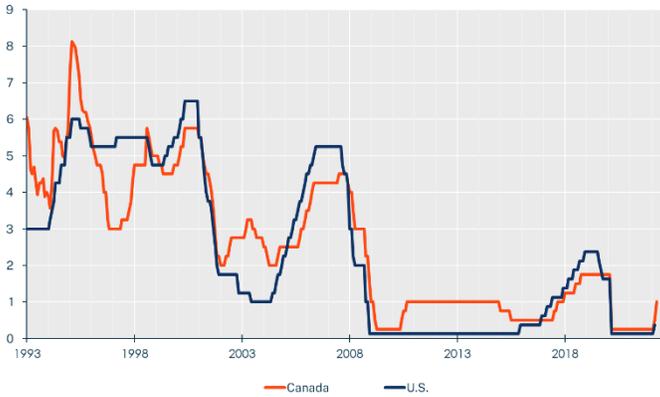


Source: Statistics Canada

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Federal Reserve and Bank of Canada policy rates

%



Source: Canadian Chamber of Commerce

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Canadian core inflation measures

Year-over-year, % change



Source: Statistics Canada

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