April 21, 2021

BoC slows bond buying as economic outlook improves

- Growth forecasts upgraded substantially
- Rate hike guidance brought forward to H2/22
- QE tapered from $4B to $3B per week

The Bank of Canada made some substantial upward revisions to its growths forecast alongside today's policy announcement. Canadian GDP is now seen increasing 6.5% in 2021—a touch stronger than our 6.3% forecast and well above the 4% gain projected back in January. That reflects both the economy's unexpected resilience through the second wave of COVID-19 infections (the bank's Q1/21 growth forecast was revised sharply higher) and an improving outlook for the second half of the year when immunization will be more widespread and the economy is expected to re-open on a sustained basis. Stronger global growth, particularly in the US, and higher commodity prices are also helping. Today's forecast, finalized before Monday's budget release, assumed $85B in federal fiscal stimulus, which Governor Macklem said was roughly consistent with the $101B in new spending (over three years) announced on Monday. The BoC noted near-term risks from the current third wave and associated lockdowns but still looks for the economy to grow in Q2/21 (+3.5% annualized, matching our forecast).

Given this improved outlook, and even with estimates of potential GDP marked higher, the BoC now sees the economy returning to full capacity in the second half of next year. Inflation, too, is expected to return to the bank's 2% target on a sustained basis around that time. With the bank's forward guidance continuing to note that these are the conditions it wants to see before raising interest rates, this is a clear indication that the policy rate is likely to begin moving higher in the second half of next year (consistent with our forecast) rather than in 2023 as previously indicated.

Rate hikes are still contingent on vaccinations effectively reducing virus threat and remain more than a year away, but the BoC is taking early steps toward reducing the amount of extraordinary accommodation provided by its QE program. As expected, it announced that the weekly pace of bond buying will slow from $4B per week to $3B per week. We think further, gradual tapering over the second half of the year will result in the bank moving to re-investment only around the turn of this year. In the near-term, less new issuance by the government means a reduction in BoC demand will be met with slower bond supply, limiting upward pressure on longer-term interest rates. But we still expect longer-term rates will move gradually higher as tapering continues and rate hikes come into clearer view.

Today's forecast upgrades, QE tapering and forward guidance add up to a more hawkish BoC meeting than we've seen in recent months. But the bank is also signaling that it won't over-react to a near-term increase in inflation, nor a modest overshoot of its 2% target later in its forecast horizon—today's forecast shows headline inflation averaging 2.3% in 2023 thanks to modest upward pressure from excess demand. And as usual, the BoC doesn't seem prepared to use its policy tools to address overheating housing markets. Governor Macklem noted "some signs of extrapolative expectations and speculative behaviour" and the bank's policy statement said it said it will "continue to monitor the potential risks associated with the rapid rise in house prices." However, the bank has consistently flagged other policy tools (including macro-prudential regulation—Macklem welcomed OSFI's proposal for a slightly more stringent stress test) as better suited to addressing housing risks.

Josh Nye | Senior Economist, RBC Economics | Royal Bank of Canada | T. (416) 974-3979

For more economic research, visit our website at *www.rbc.com/eaconomics*