

April 13, 2022

BoC opts for outsized hike in battle against high inflation

- Today's 1/2 percent (50 bp) rate hike is the largest single-meeting increase since May 2000
- BoC also announced quantitative tightening (QT)
- "Interest rates will need to rise further"—RBC sees 2% overnight rate by October

The Bank of Canada accelerated its tightening cycle today, building on March's 25 bp rate hike with a larger, 50 bp move that lifts the overnight rate to 1%. The bank also said it will begin quantitative tightening (QT) later this month, shrinking its balance sheet by ceasing reinvestment of maturing GoC holdings. With 40% of its holdings maturing in the next two years, QT will reduce the size of the bank's balance sheet relatively quickly. That move has been well telegraphed, though, and increases in the overnight rate—which the BoC emphasized is its main policy tool—will be more impactful for financial conditions going forward.

Today's 50 bp move, the first hike of that magnitude in 22 years, suggests the BoC has lost the patience it demonstrated back in January when it took a pass on raising rates. With inflation surging (we think next week's March CPI report will be in the 6% range, another 30-year high), the unemployment rate falling rapidly (now at its lowest level since at least 1976) and businesses noting widespread capacity and price pressures, the BoC wants to move toward a more neutral policy stance in short order. That goal post shifted slightly today, with the bank revising its estimate of the neutral rate higher by 25 bps to a 2-3% range. Our forecast assumes more standard, 25 bp hikes going forward—until the overnight rate hits 2% in October—though we think another 50 bp increase will be an option on the table in June.

Near-term inflation and jobs data will be key determinants of the size of upcoming rate hikes. The BoC lifted its Q1/22 GDP growth forecast to 3% and sees activity accelerating in Q2 with a 6% annualized gain. The bank doesn't publish an unemployment rate forecast but if that growth is accompanied by a further decline in the unemployment rate to 5% or lower that would support another 50 bp hike in June. The BoC also lifted its inflation forecast and now sees headline CPI averaging almost 6% in the first half of 2022 (up from 5% previously, largely due to the inflationary impact of Russia's invasion of Ukraine) before slowing to 4.5% in late-2022 and 2.4% toward the end of 2023. We think the bank will have limited tolerance for further upside surprises relative to that forecast, though that's not something we expect at this stage.

The BoC doesn't provide an expected path for policy rates but Governor Macklem gave some guidance at his press conference, noting Canadians should expect the overnight rate to rise toward the bank's assumed 2-3% neutral range. He emphasized that monetary policy is not on a pre-set course, and that the BoC could pause its tightening cycle once monetary policy is closer to neutral if demand responds quickly to higher rates, or it might need to take rates "modestly above neutral" to get inflation back to target. Macklem's comments suggest a higher peak in the overnight rate than the 1.75% we saw last cycle. But we think the bank's forecast for GDP growth of 3.2% and 2.2% in 2023 and 2024, respectively, would be difficult to achieve if it followed the market path and lifted the overnight rate to 3% by mid-2023. While today's meeting suggests upside risk to our forecast for the BoC to halt its tightening cycle at 2%, we continue to think the market is over-priced for rate hikes in 2023 when the bank will have to balance growth risks (which we view to the downside relative to today's forecast) with inflation that should be moving toward its target, if not quite fast enough.

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