March 2, 2022

Liftoff! BoC hikes rate from lower bound

- Today's 25 bp hike was fully expected by analysts
- Near-term inflation will be higher than in January forecast
- "Interest rates will need to rise further"; BoC considering when to start QT

The BoC lifted its policy rate for the first time since 2018, having kept it near zero for nearly two years of the pandemic. The Russian invasion of Ukraine was noted as a major new source of uncertainty, but after a close call not to hike in January, there appeared to be a low bar to raise rates today and recent data easily cleared it. While January's jobs numbers were disappointing (200,000 jobs lost, unemployment rate +0.5 ppts) the labour market has bounced back quickly from past waves of COVID-19, and falling case counts and easing restrictions suggest the post-Omicron rebound should be equally robust. GDP growth was stronger than expected in Q4 and StatCan's flash estimate surprisingly suggested the economy didn't contract in January, lending upside risk to Q1 growth. The bank said recent GDP data "confirms its view that economic slack has been absorbed." January's inflation print was in line with the BoC's forecast but further gains are likely in the near-term given rising food and energy commodity prices related to the Russia-Ukraine conflict.

The BoC will have to weigh additional inflationary pressure brought on by that conflict against two-way domestic impacts (increased revenue for commodity producers, higher prices for consumers) and concerns about the global economic outlook. Central banks would normally look through geopolitically-driven commodity price pressures, but with inflation already so far above target the BoC has said it is more concerned about upside risks to inflation than downside. Indeed, it said "persistently elevated inflation is increasing the risk that longer-run inflation expectations could drift upwards." In addition to inflation expectations, the bank will be keeping an eye on financial conditions. Government bond yields have fallen amid growth concerns and rising risk aversion, but corporate credit spreads have widened. Other financial channels have been fairly steady—the Canadian dollar has been in a tight range over the past month and the TSX has held up well relative to other equity markets. At this early stage, we don't think geopolitical developments preclude a follow-up hike in April, nor do they argue for the more aggressive tightening path that markets continue to price.

Consistent with previous guidance, the BoC said it will "be considering when to end the reinvestment phase and allow its holdings of Government of Canada bonds to begin to shrink." We've yet to see a topic for Governor Macklem's economic progress report tomorrow but think he could use the speech to provide more details on what QT will look like—whether the BoC plans to gradually phase out reinvestment or immediately shift to a smaller share of primary market purchases. Those detail could be followed by an actual QT announcement as soon as April's meeting depending on how financial conditions evolve in the interim. We'll of course also be looking for any comments on how the Russia-Ukraine conflict will impact Canada's economy and the path for monetary policy.

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