



# Reflections on Current Canadian Monetary Policy

*Christopher Ragan*

*January 9, 2024*





# Overview

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1. A Remarkable Few Years
2. When Will Rate Cuts Begin?
3. How Much Will Rates Fall?

# 1. A Remarkable Few Years.

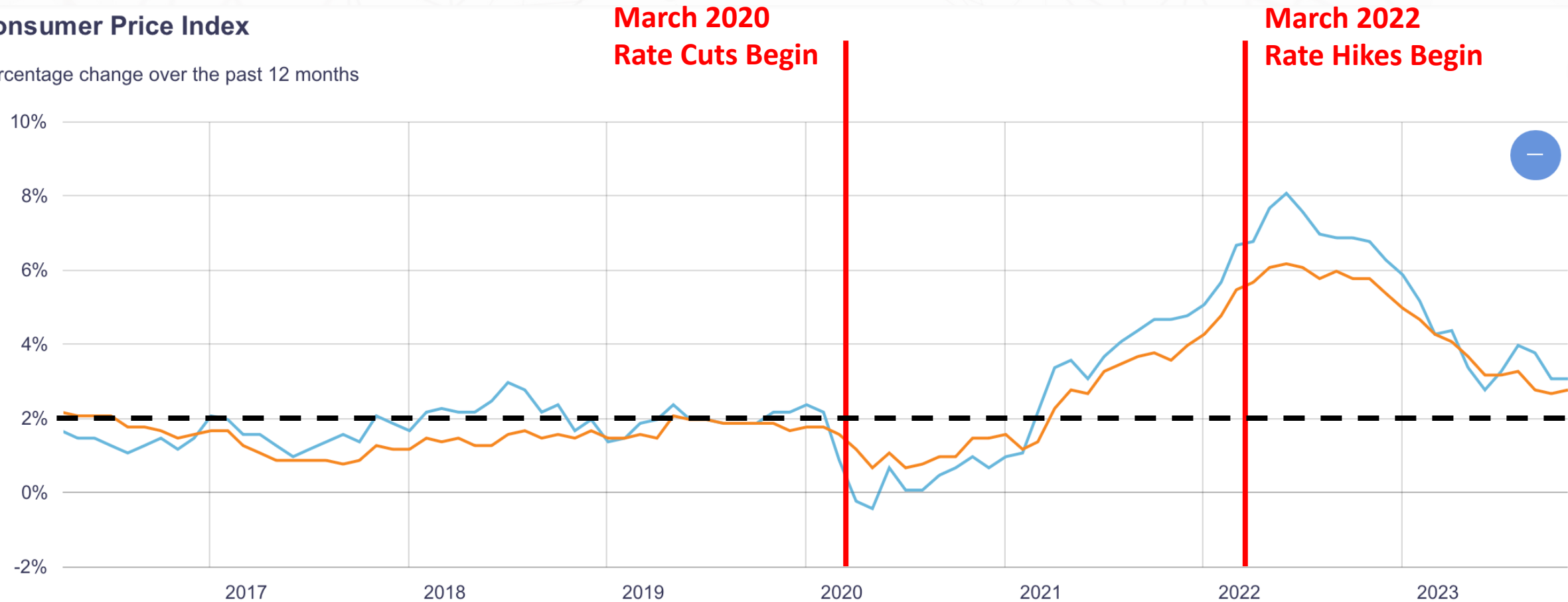
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1. A massive “intentional” negative aggregate supply shock...
  - plus a massive “linked” negative aggregate demand shock.
2. A huge increase in government spending to provide financial support...
  - plus a huge increase in the Bank of Canada’s balance sheet (QE).
3. Supply-chain disruptions across many parts of the economy...
  - plus (eventually) a lot of pent-up demand.
4. A war which drove up energy and commodity prices...
  - plus inflation expectations which became unanchored.

# Result: A Complicated Inflation.

## Consumer Price Index

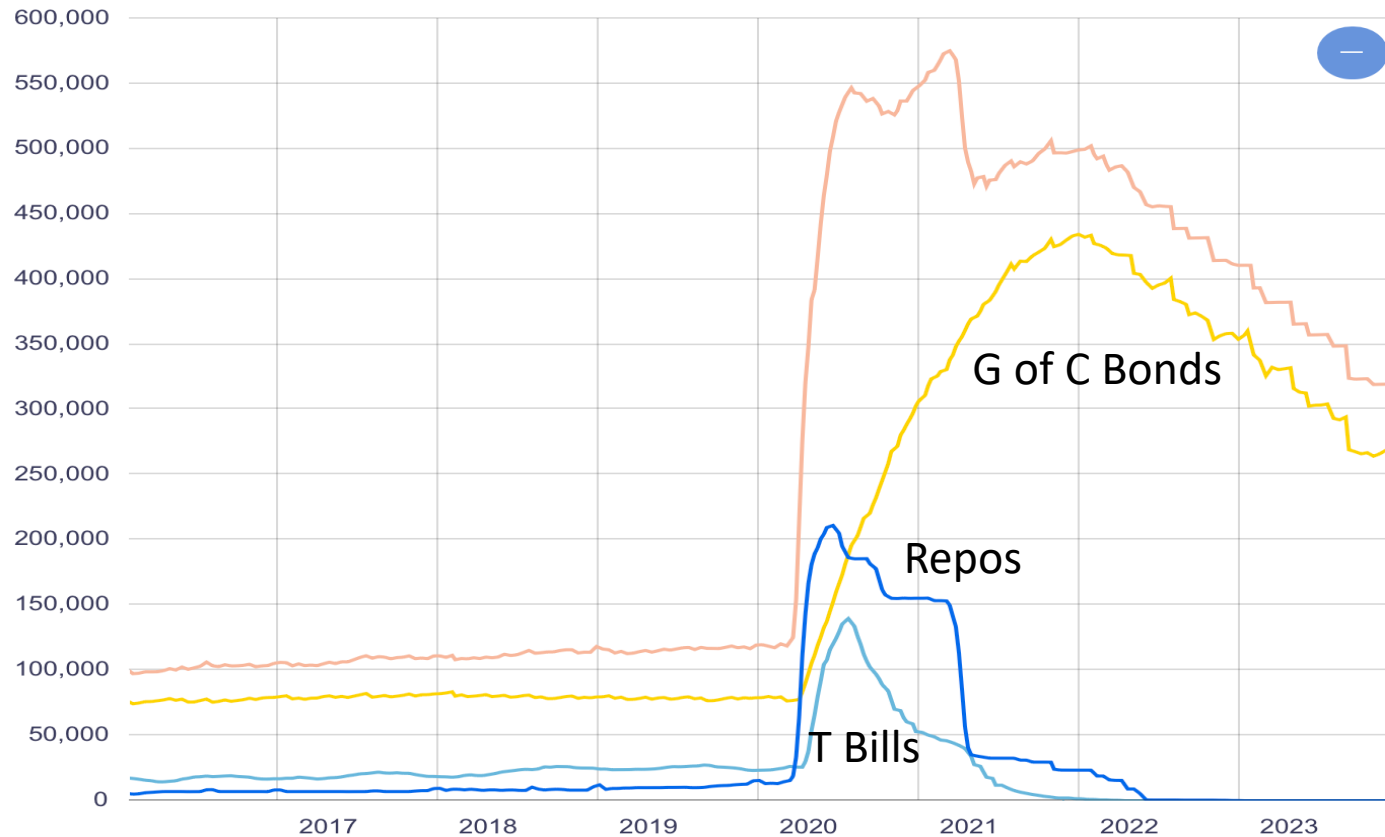
Percentage change over the past 12 months



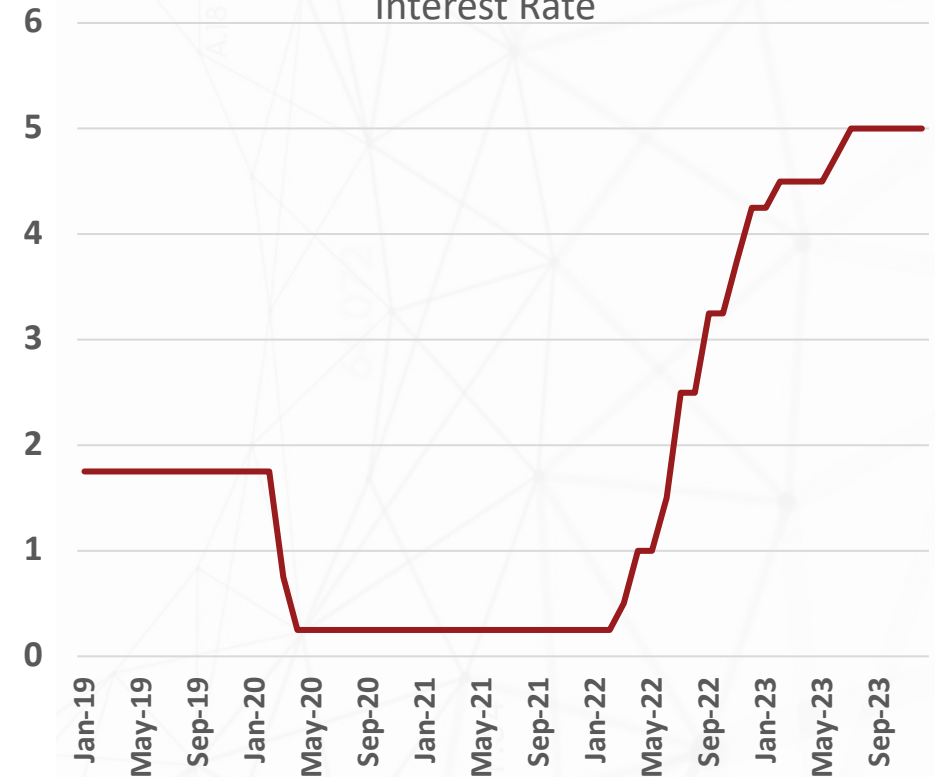
# Dramatic Policy Actions.

## Bank of Canada assets and liabilities: Weekly

Weekly Wednesday, Millions of dollars



## The Bank's Target for the Overnight Interest Rate



## 2. When Will Rate Cuts Begin?

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1. Remember that policy works with a lag and thus is forward looking.
2. ➔ The last rate hikes (in July 2023) were probably expected to remain in place for 12-18 months.
3. ➔ The Bank will likely want to see signs of “excessive” slowing of the economy before implementing “early” rate cuts.
4. Are there signs of “excessive” slowing?



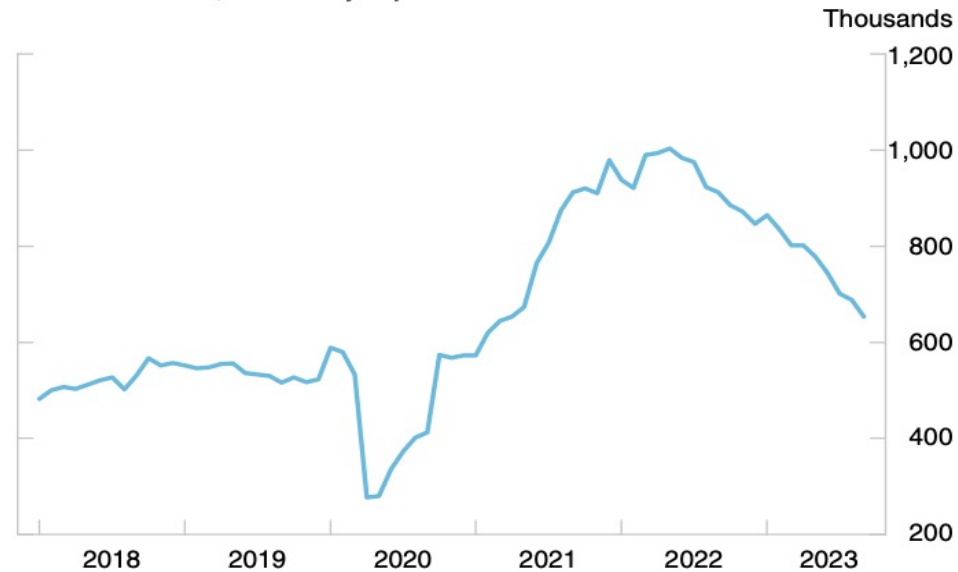
# Gently Slowing Economy.

The Bank estimates that the output gap is close to zero – between -0.25% and 0.75% of potential GDP.

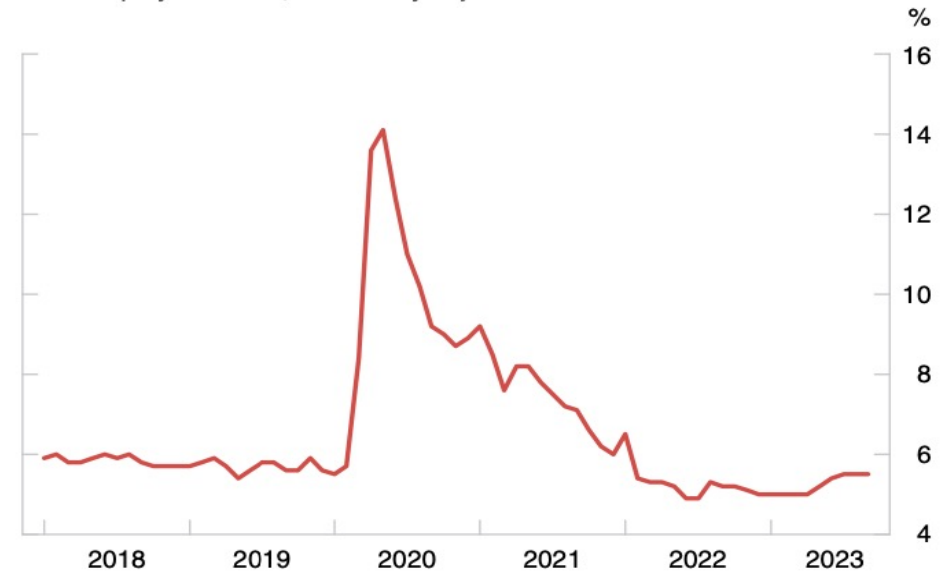
**Chart 6: The labour market has eased substantially but remains tight**

Monthly data

a. Job vacancies, seasonally adjusted



b. Unemployment rate, seasonally adjusted



Note: Due to data limitations at the onset of the pandemic, official job vacancy statistics from the Job Vacancy and Wage Survey are unavailable from April to September 2020. These missing values as well as the values for August and September 2023 are estimated using Indeed online job postings data.

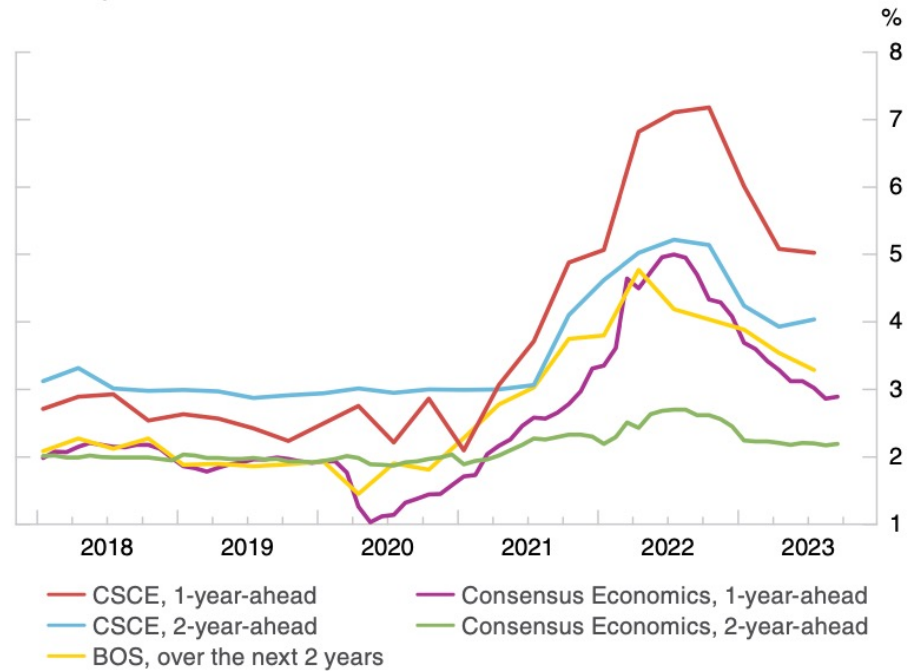
Sources: Statistics Canada, Indeed and Bank of Canada calculations

Last observation: September 2023

# Expectations and Wage Growth Still Elevated.

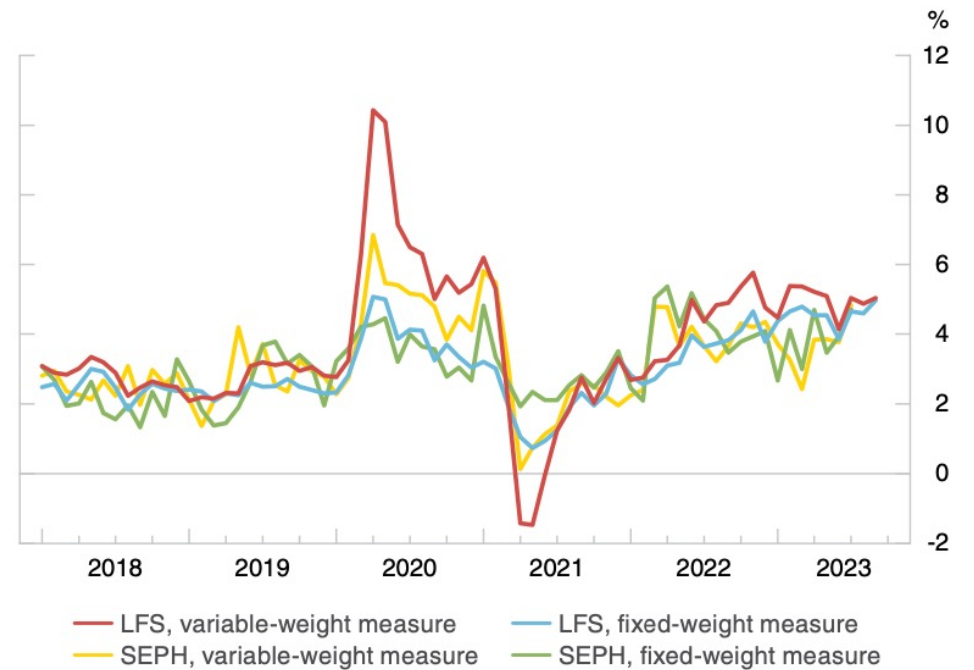
**Chart 13: Near-term inflation expectations are high**

Quarterly and monthly data



**Chart 7: Measures of wage growth have been in the 4% to 5% range**

Year-over-year percentage change, monthly data





### 3. How Much Will Rates Fall?

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The “neutral” interest rate:

- real GDP = potential output
- inflation is at its target
- all dust has settled after monetary policy actions

Think about the market for loanable funds in long-run equilibrium:

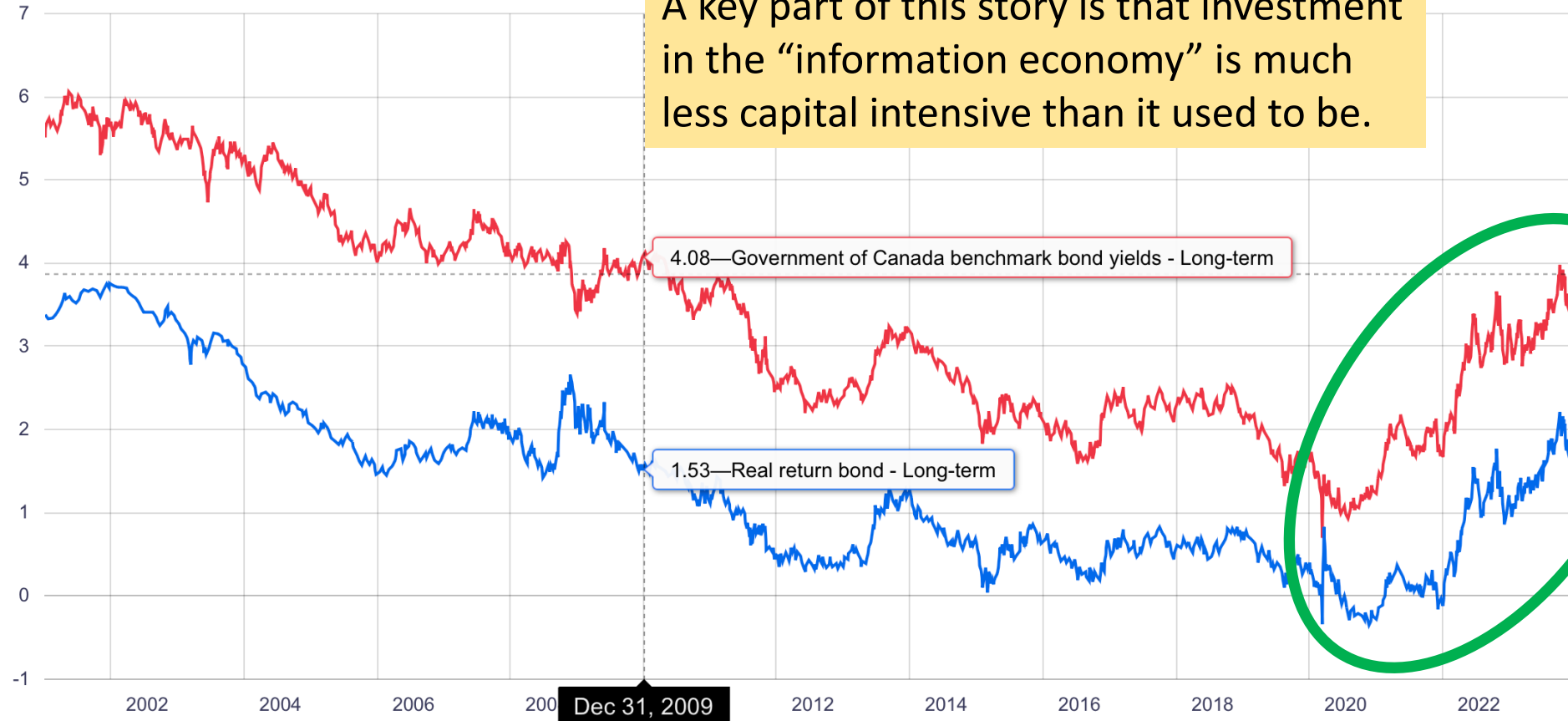
→ investment demand = saving supply

The B of C estimates the nominal neutral policy rate to be 2% - 3%.

→ roughly 2+ ppts of rate cuts, eventually

# Secular Stagnation – Still?

Selected bond yields



# Forces Raising the Neutral Rate?

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1. Widespread replacement of old infrastructure over the next few decades?
2. Massive (mostly private) investment for energy transition?
  - ➔ Increase in demand for investment
3. High government debt and ongoing budget deficits (partly from defense spending)?
  - ➔ Decrease in supply of national saving



# After Higher for Longer: Outlook for Bank of Canada Rates and Inflation

*Warren Lovely*

*January 9, 2024*

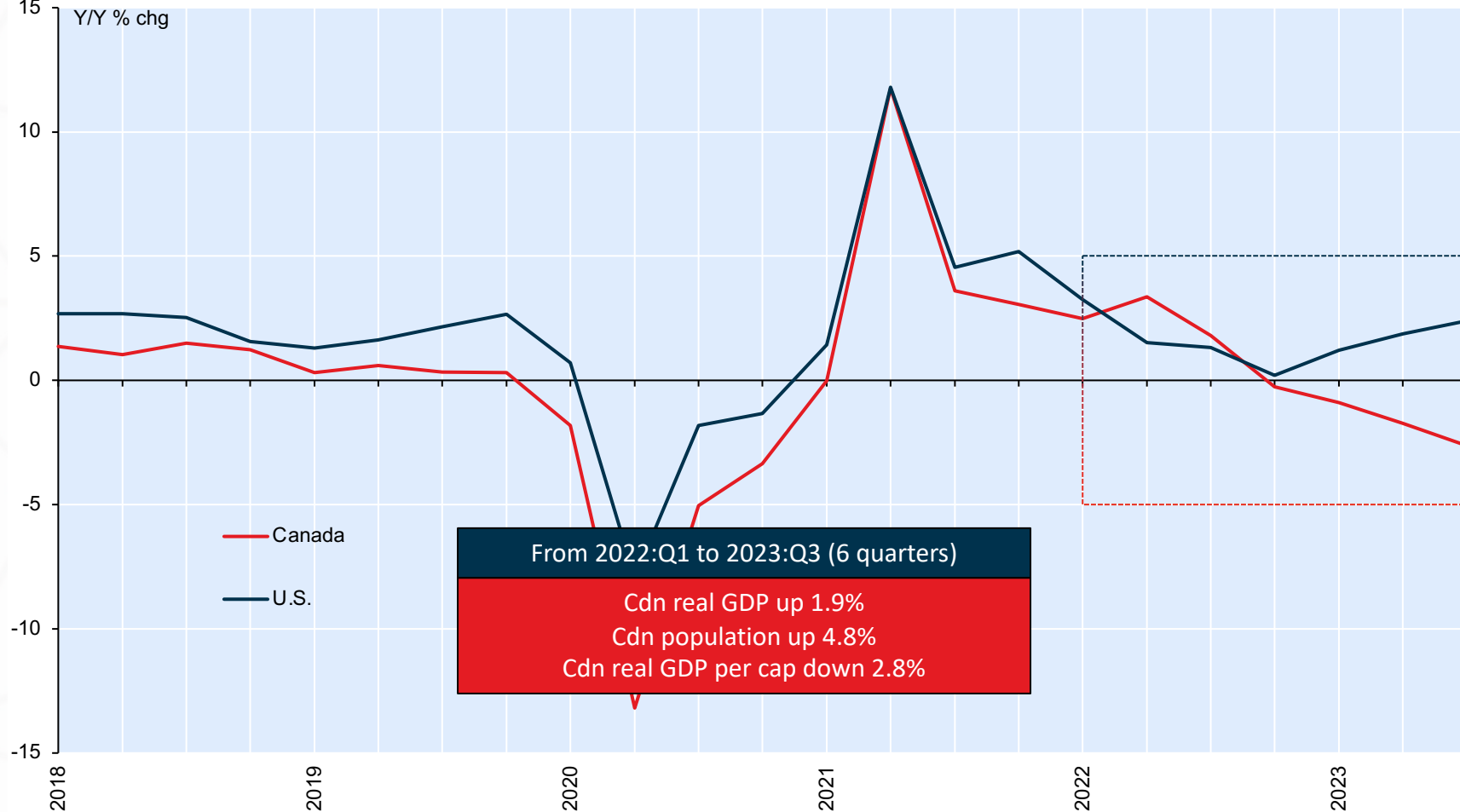




# Canada's economy feels strain from 'restrictive' policy rates

Pressure particularly evident when you strip out / control for Canada's surging population

Growth in real GDP per capita: Canada vs. U.S.

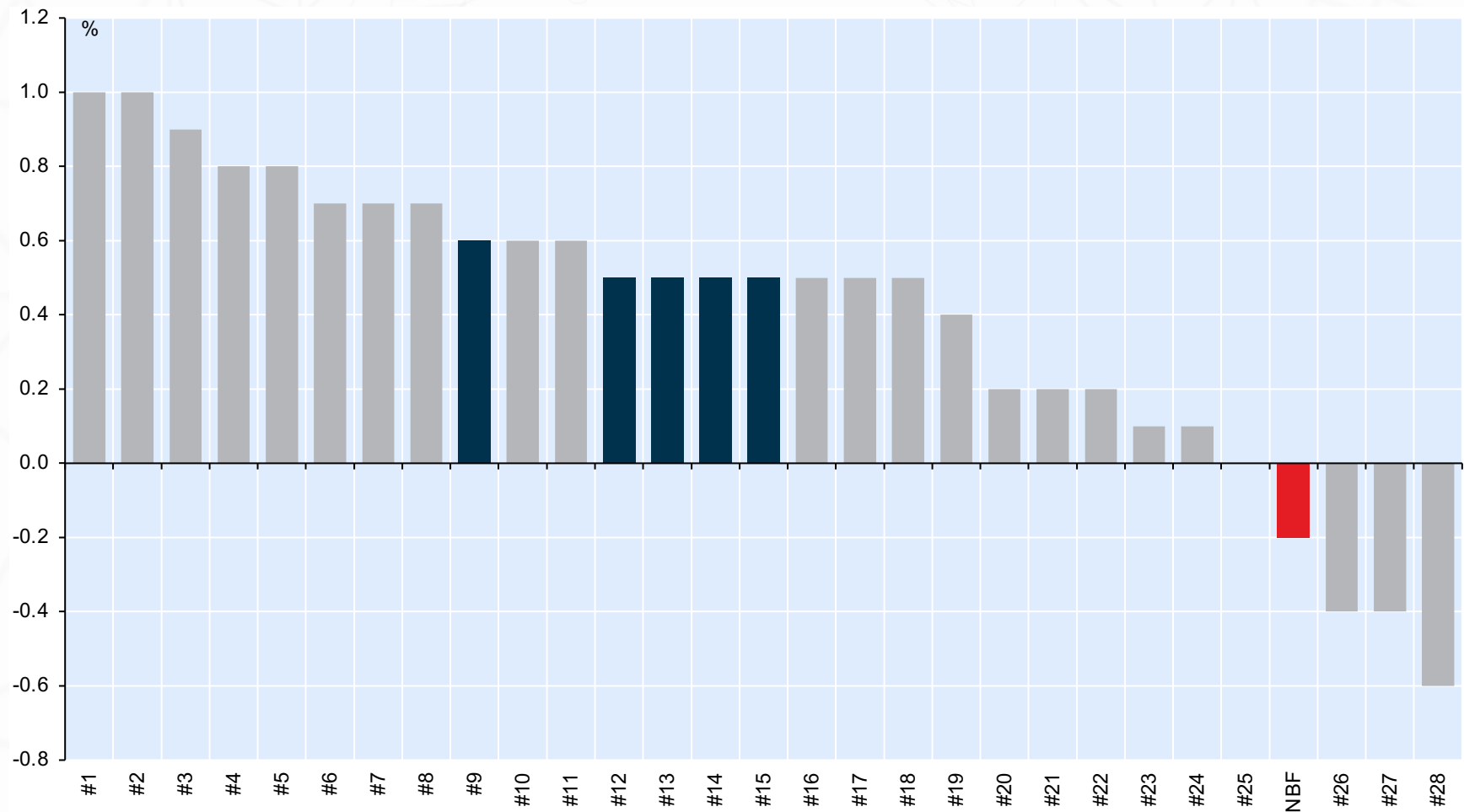


Source: NBF, StatCan, FRED

# 2024 likely to be tougher year for economy than many expect

Hard to see where growth is really going to come from, with global economy generally struggling

2024 Canada real GDP growth: Current Bloomberg consensus expectations



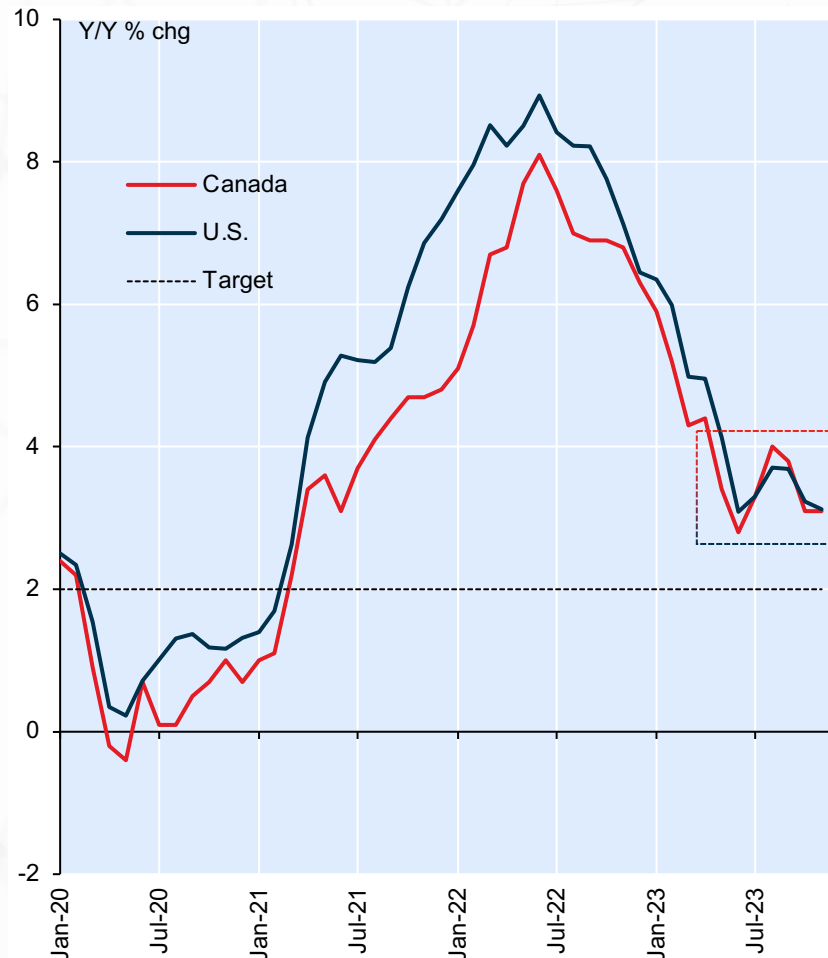
Source: NBF, Bloomberg | Note: As at 8-Jan-2024; red bar denotes NBF, while blue bars denote other Big-6 Cdn banks



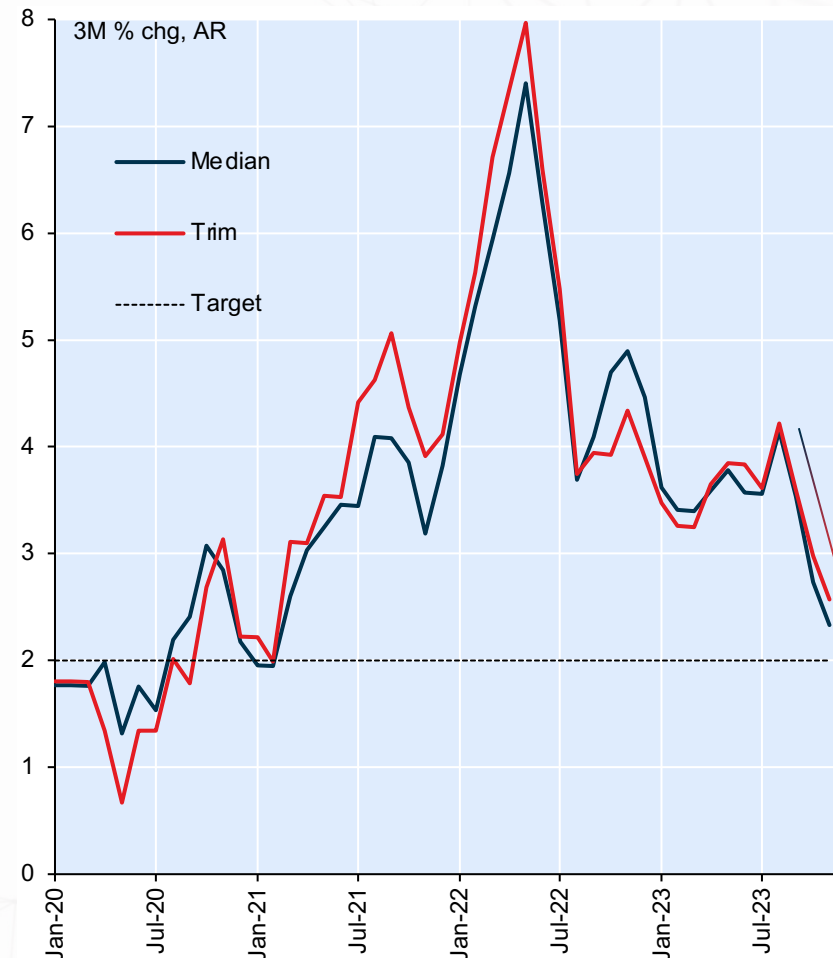
# Can we get all the way 'home' on inflation?

Lately there have been some encouraging developments when it comes to Canadian core inflation

Headline CPI inflation: Canada & U.S.



Canada core CPI inflation momentum

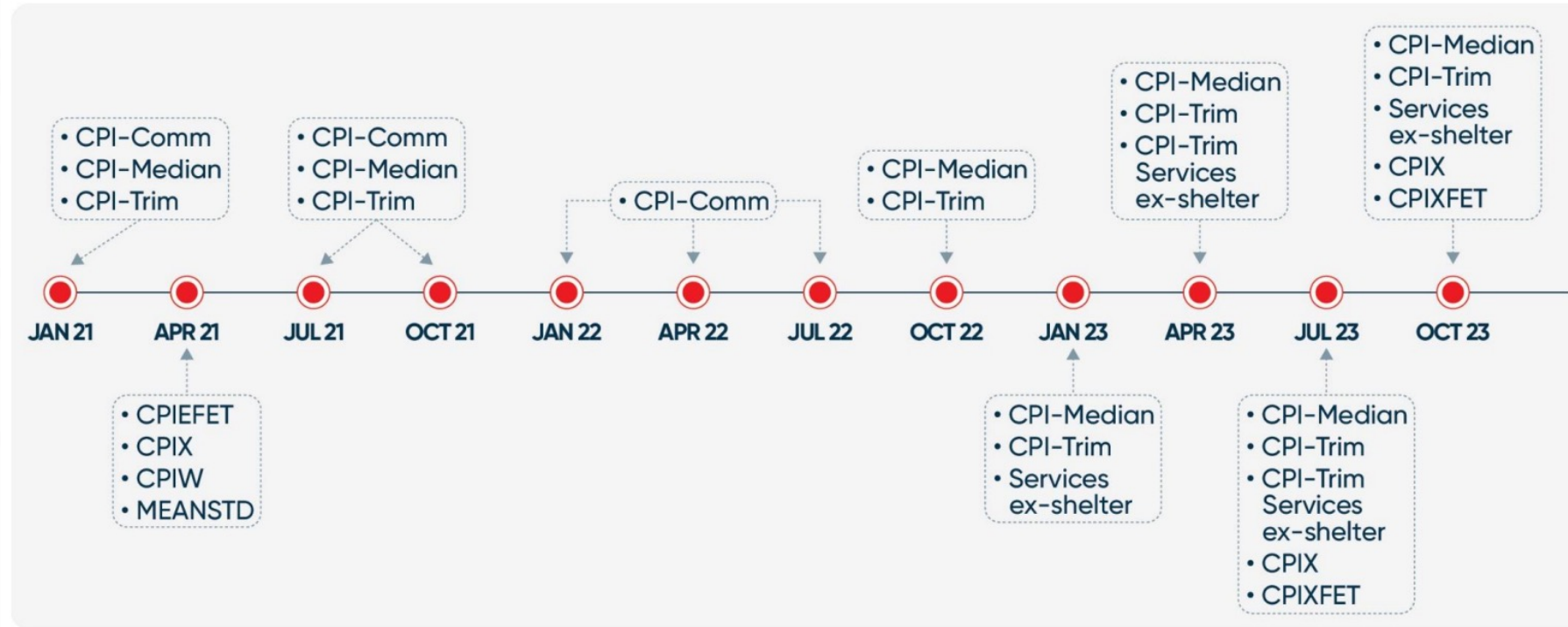


Source: NBF, Bloomberg, StatCan, BLS

# Aside: Will the real underlying inflation measure please stand up!?

BoC should prioritize in-depth reassessment of core inflation measures

Core inflation measures emphasized by the Bank of Canada since 2021

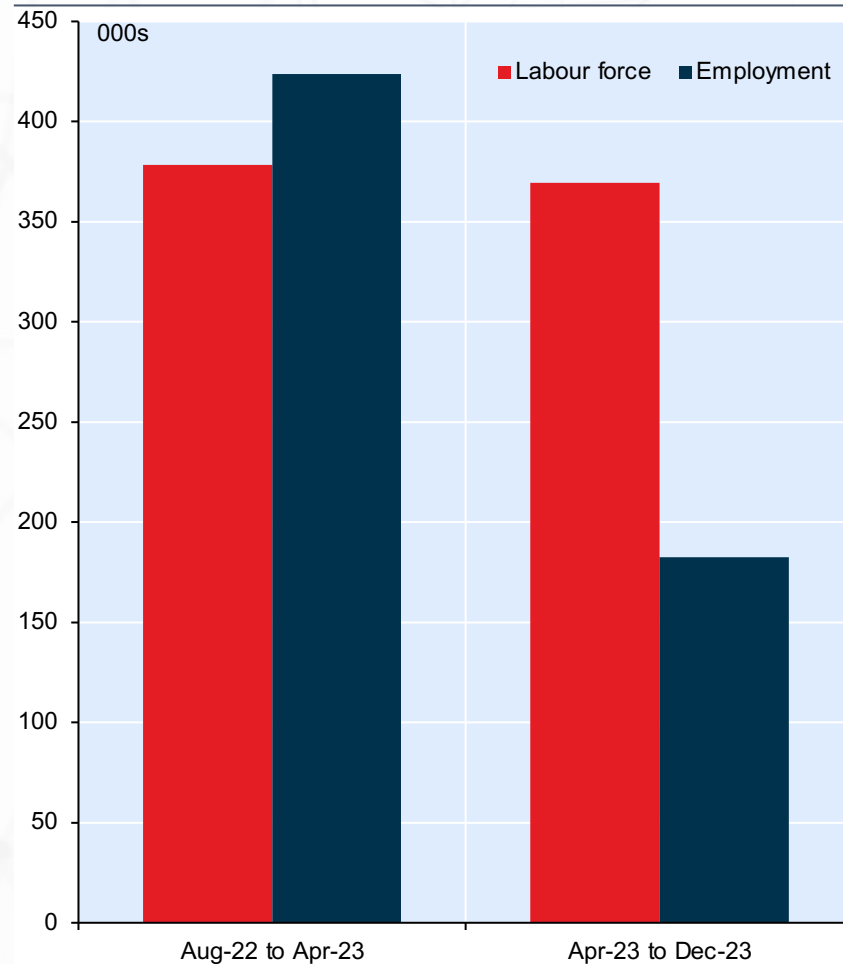


*"The methodology used to extract core inflation from public inflation rates must not change frequently or be perceived by the public as obscure or under the control of the monetary authorities." — BoC staff report, 2001*

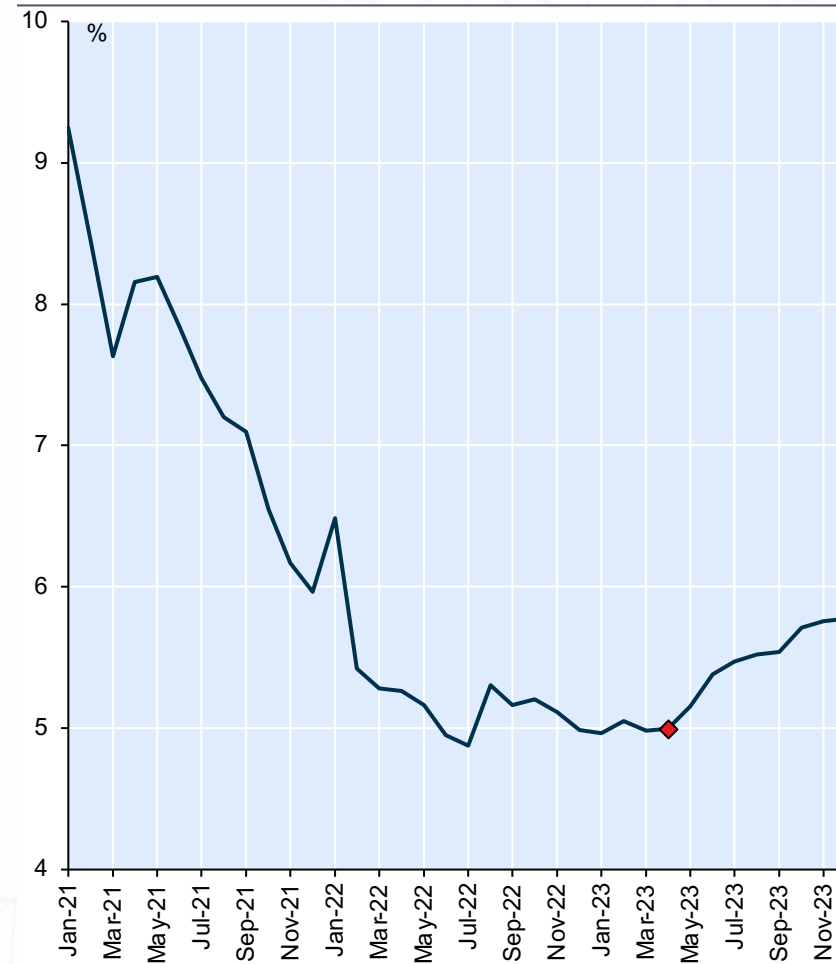
# Hiring not absorbing flood of new labour market entrants

Slower hiring / abundant labour supply suggests wage inflation will ease... beware monthly LFS 'noise'

Canada labour force vs. employment growth



Canada unemployment rate



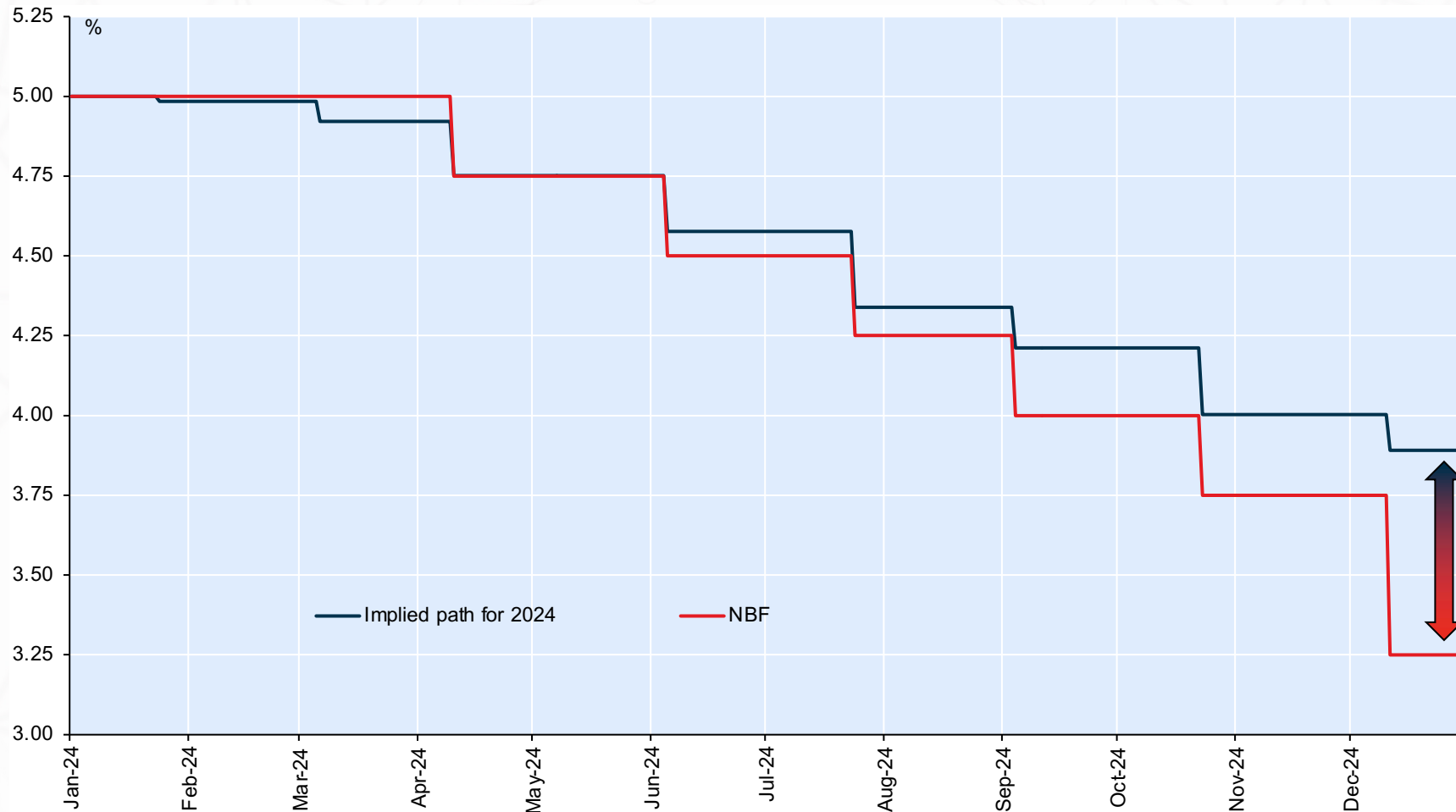
Source: NBF, StatCan



# Rate cut talk has ramped up!

Expectations fluid and imminent cuts unlikely... but the BoC could cut more than currently discounted

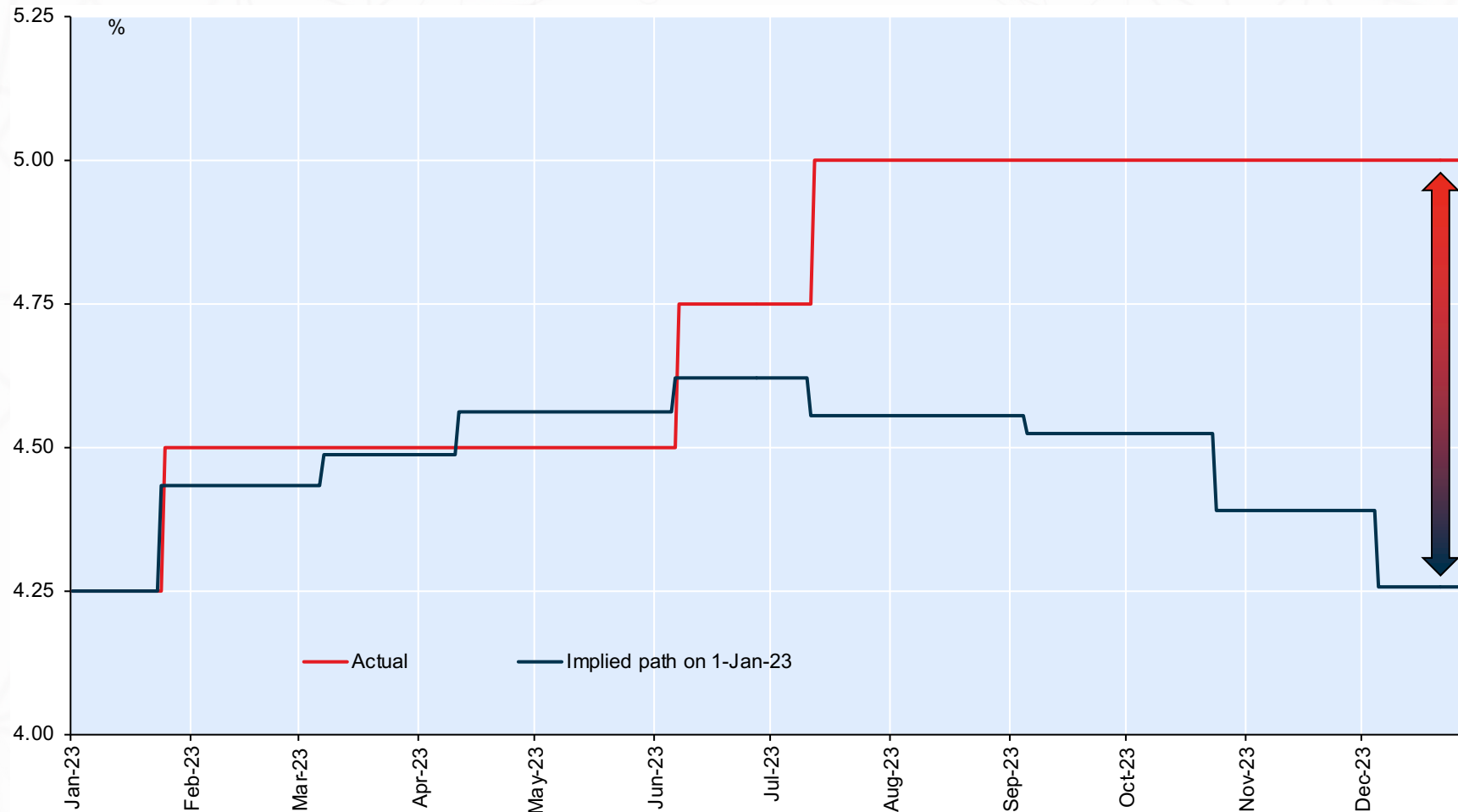
BoC overnight target rate path in 2024: Market-implied vs. NBF



# Mind you, the quick pivot to rate cuts never materialized in 2023

Despite relatively modest tightening (compared to 2022), markets were way off

BoC overnight target rate path in 2023: Actual vs. expected

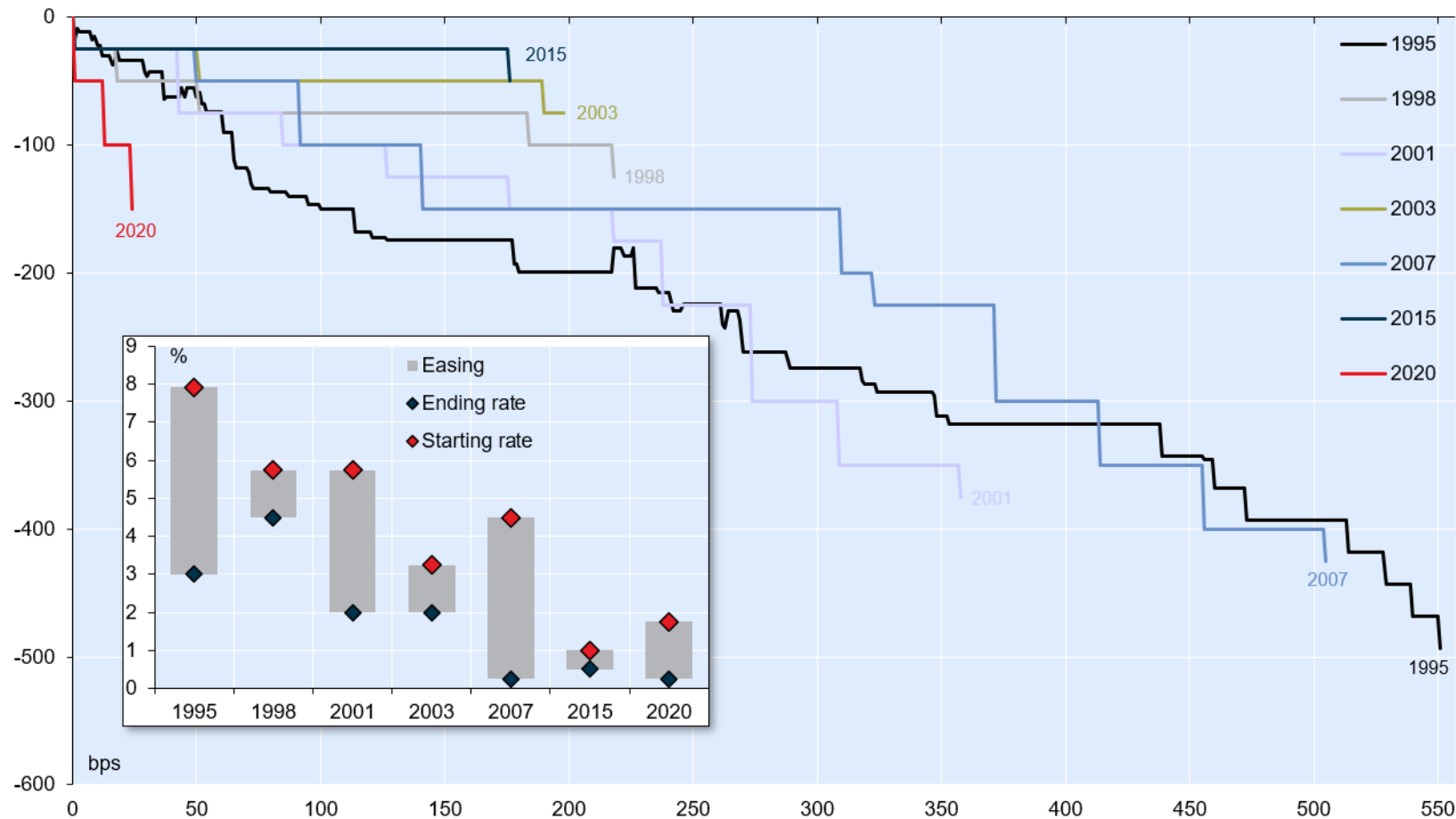


Source: NBF, Bloomberg | Note: Implied path based on Bloomberg's WIRP function

# Another caution: All easing cycles are different

The amount of easing is of course influenced / limited by the starting level

Historical BoC easing cycles [Inset: Change in BoC policy rate by easing cycle]

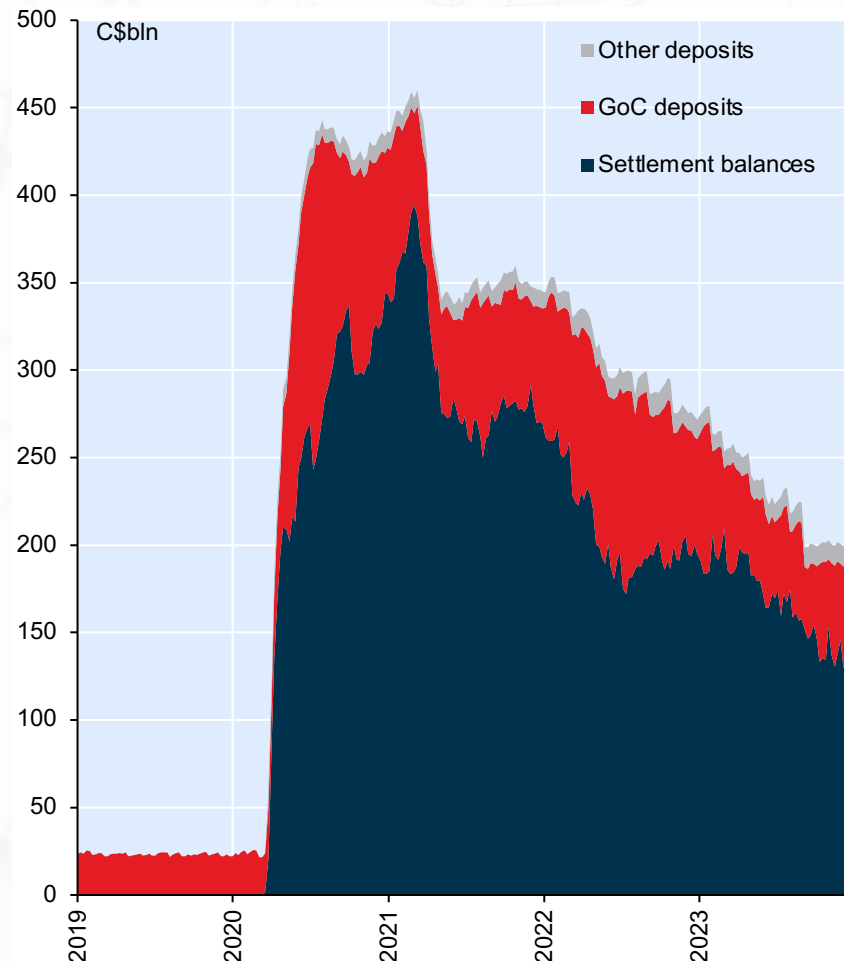




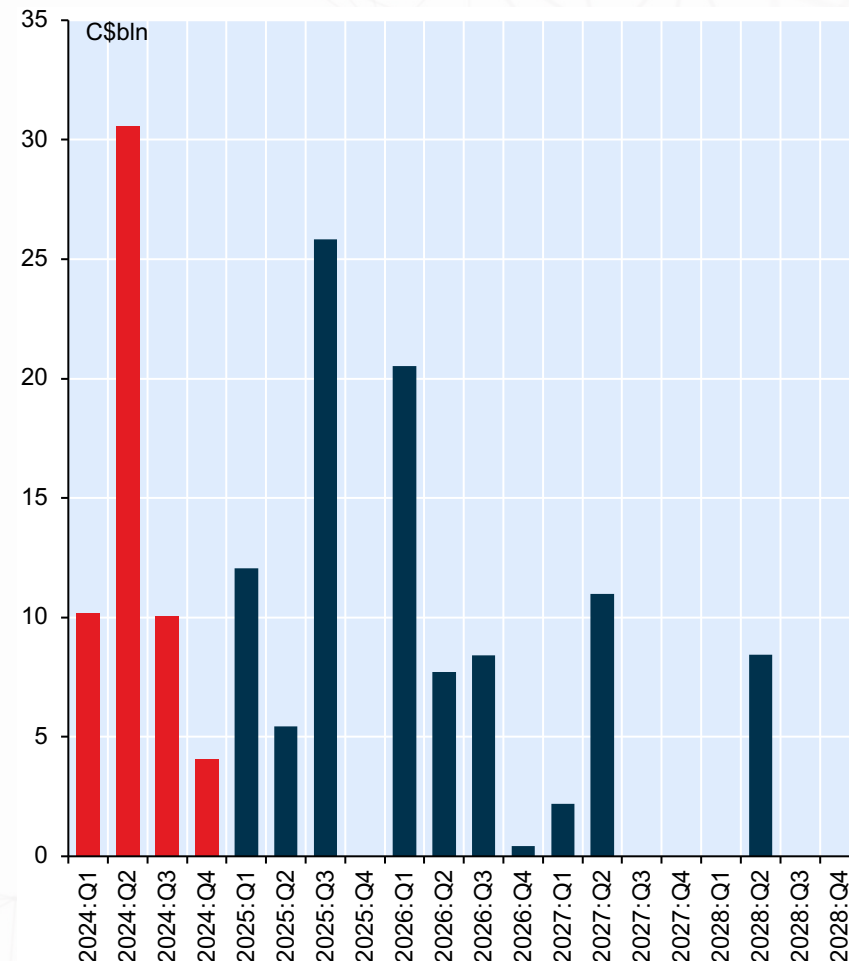
# Liquidity drain via QT set to become a growing focus

More than \$50 billion will roll off the BoC's balance sheet in 2024, concentrated heavily in Q2

Select Bank of Canada liabilities



BoC holdings of GoC bonds: Maturity profile

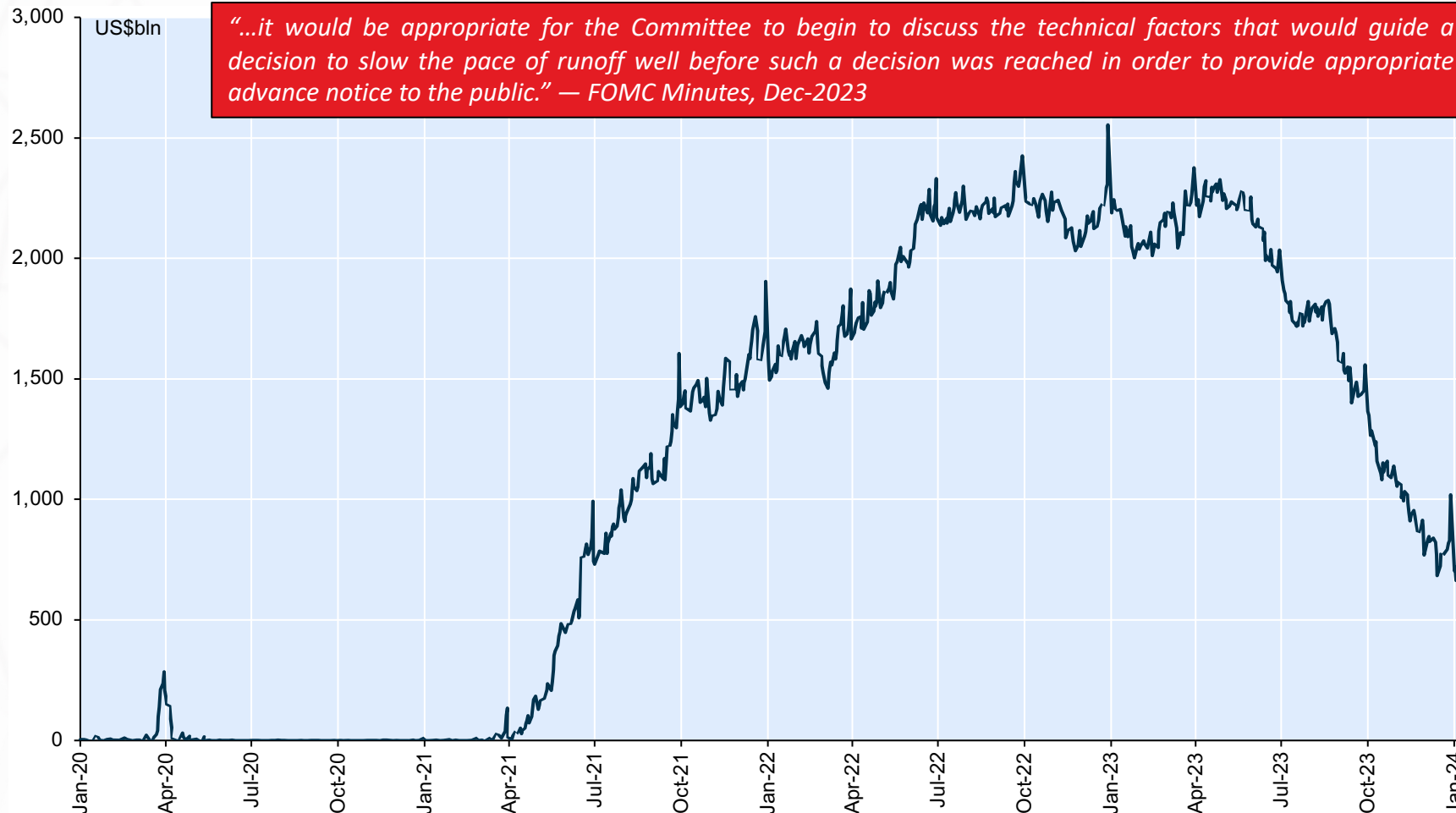


Source: NBF, BoC | Note (L): Latest balance sheet snapshot as of 27-Dec-23

# Fed's balance sheet run-off a growing focal point

Open discussion of Fed balance sheet runoff coming... advance notice appropriate for BoC too

New York Fed overnight reverse repo operations (ON RRP)



Source: NBF, NY Fed, Bloomberg