Bank of Canada Review: January 2021

The Bank of Canada kicked off 2021 holding monetary policy steady for the seventh consecutive time Wednesday, January 20, maintaining forward guidance until slack is absorbed.

The Bank remains accommodative, maintaining the overnight rate at 25bp (effective lower bound), rejecting an option to make a micro-cut of 5-10bp. Quantitative easing stimulus (QE) via asset purchases continues at C$4B a week.

However, the Bank did state "the amount of [QE] stimulus needed will diminish over time -- if the economy and inflation play out broadly in line or stronger than we projected". But much depends on the efforts to combat the spread of Covid-19, successful rollout in effective vaccines, in order to ease lockdown measure and revitalize the economy.

Relevant Links

Policy Announcement:
https://tinyurl.com/Bank-of-Canada-January-2021-Pr

Monetary Policy Report Opening Statement:
https://tinyurl.com/Bank-Of-Canada-MPR

Monetary Policy Report Webcast:
https://tinyurl.com/Bank-of-Canada-MPR-Webcast

Bank of Canada 2021 Policy Schedule:

The next scheduled date for announcing the overnight rate target is March 10, 2021. The next full update of the Bank’s outlook for the economy and inflation, including risks to the projection, will be published in the MPR on April 21, 2021.

As announced, starting with this decision the target for the overnight rate will take effect on the business day following each rate announcement.

Wednesday, January 20*
Wednesday, March 10
Wednesday, April 21*
Wednesday, June 9
Wednesday, July 14*
Wednesday, September 8
Wednesday, October 27*
Wednesday, December 8
*Monetary Policy Report published

Business Address – MNI Market News, 5th Floor, 69 Leadenhall Street, London, EC3M 2DB

Bank of Canada January 20, 2021 Policy Statement

The Bank of Canada today held its target for the overnight rate at the effective lower bound of ¼ percent, with the Bank Rate at ½ percent and the deposit rate at ¼ percent. The Bank is maintaining its extraordinary forward guidance, reinforced and supplemented by its quantitative easing (QE) program, which continues at its current pace of at least $4 billion per week.

The COVID-19 pandemic continues to take a severe human and economic toll in Canada and around the world. The earlier-than anticipated arrival of effective vaccines will save lives and livelihoods, and has reduced uncertainty from extreme levels. Nevertheless, uncertainty is still elevated, and the outlook remains highly conditional on the path of the virus and the timeline for the effective rollout of vaccines.

The economic recovery has been interrupted in many countries as new waves of COVID-19 infections force governments to re-impose containment measures. However, the arrival of effective vaccines combined with further fiscal and monetary policy support have boosted the medium-term outlook for growth. In its January Monetary Policy Report (MPR), the Bank projects global growth to average just over 5 percent per year in 2021 and 2022, before slowing to just under 4 percent in 2023. Global financial markets and commodity prices have reacted positively to improving economic prospects. A broad-based decline in the US exchange rate combined with stronger commodity prices have led to a further appreciation of the Canadian dollar.

Canada’s economy had strong momentum through to late 2020, but the resurgence of cases and the reintroduction of lockdown measures are a serious setback. Growth in the first quarter of 2021 is now expected to be negative. Assuming restrictions are lifted later in the first quarter, the Bank expects a strong second-quarter rebound. Consumption is forecast to gain strength as parts of the economy reopen and confidence improves, and exports and business investment will be buoyed by rising foreign demand. Beyond the near term, the outlook for Canada is now stronger and more secure than in the October projection, thanks to earlier-than-expected availability of vaccines and significant ongoing policy stimulus. After a decline in real GDP of 5 ½ percent in 2020, the Bank projects the economy will grow by 4 percent in 2021, almost 5 percent in 2022, and around 2 ½ percent in 2023.

CPI inflation has risen to the low end of the Bank’s 1-3 percent target range in recent months, while measures of core inflation are still below 2 percent. CPI inflation is forecast to rise temporarily to around 2 percent in the first half of the year, as the base-year effects of price declines at the pandemic’s outset — mostly gasoline — dissipate. Excess supply is expected to weigh on inflation throughout the projection period. As it is absorbed, inflation is expected to return sustainably to the 2 percent target in 2023.

In view of the weakness of near-term growth and the protracted nature of the recovery, the Canadian economy will continue to require extraordinary monetary policy support. The Governing Council will hold the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. In our projection, this does not happen until into 2023. To reinforce this commitment and keep interest rates low across the yield curve, the Bank will continue its QE program until the recovery is well underway. As the Governing Council gains confidence in the strength of the recovery, the pace of net purchases of Government of Canada bonds will be adjusted as required. We remain committed to providing the appropriate degree of monetary policy stimulus to support the recovery and achieve the inflation objective.

MNI Policy Reviews

MNI STATE OF PLAY: BOC Needs QE For a While, Depends on Rebound

By Greg Quinn

OTTAWA (MNI) - Bank of Canada Governor Tiff Macklem said Wednesday quantitative easing is needed for a while given the economy won't return to full output until 2023, but added he may taper federal government bond purchases if the economic rebound is better than projected.

"This will be a gradual process," he said at a press conference when asked about scaling back the purchases. "We expect a protracted recovery, this is going to take some time, we are going to need this program for some time."

The bank affirmed it will keep buying at least CAD4 billion a week of debt until the recovery is well underway. The written decision said that "as the Governing Council gains confidence in the strength of the recovery, the pace of net purchases of Government of Canada bonds will be adjusted as required."

Canada's dollar strengthened as the decision on QE and to hold the 0.25% interest rate upended some bets on a "micro" rate cut or more stimulus amid the second wave of Covid-19.

Macklem did tell reporters that if things became significantly worse he could adjust QE or other tools to add more stimulus as well, consistent with past comments.

TAPER IN APRIL?

The BOC raised its 2022 growth forecast much more than it reduced the expectation for this year, citing faster-than-expected vaccine rollouts that will propel consumer spending and business investment. GDP will gain 4% this year instead of the 4.2% predicted in October, while gaining 4.8% next year instead of 3.7%.

The BOC's economic forecast paper Wednesday said its CAD548 billion balance sheet may shrink in coming months as CAD140 billion of t-bills and term repos come due, though that's not a good measure of the amount of stimulus. Macklem said in response to a question from MNI that reduced holdings of short-term assets reflect the passing of the market squeeze at the start of the pandemic, and the longer-term government bond purchases being made now are a sign of stimulus at work.

Economists surveyed by MNI before the decision said the BOC will taper: to CAD3 billion in April. Some investors also see the BOC needing to avoid frictions created with the central bank on track to own half the government bond market this year. The BOC said today its purchases have lifted the central bank's share of the federal bond market to 36% from 32% in October, and Macklem in December said he was very far away from a point where markets would be hindered.

MNI INTERVIEW: BOC Taper Easier Than Full Asset Exit: Perrault

By Greg Quinn

OTTAWA (MNI) - The Bank of Canada will taper QE again after the second pandemic wave passes, while failing to fully slim down the balance sheet even as the economy is restored later on, former central bank official and Scotiabank chief economist Jean-Francois Perrault told MNI.

Governor Tiff Macklem's statement Wednesday he could slow asset purchases if growth is stronger than expected was a nod to how the program was intended to work all along, not a radical policy shift, Perrault said. The BOC isn't primed for a sudden tapering from the current pace of at least CAD4 billion a week at the next meeting, given much of nation is still in lockdown, Perrault said.

"We need to put a little more distance between the virus and policy actions," said Perrault, former assistant deputy minister at the finance department and assistant chief at the BOC's domestic analysis branch. "You want to wait a few months before you start to say we are going to rethink our policy stance," he said about the pace of QE. "I'm sure something will happen sometime in the year."

The Fed when it scaled back QE after the 2008 crisis shifted to slowing purchases and then letting maturing assets roll off the books, a path the BOC will likely follow, Perrault said.

SWOLLEN BALANCE SHEET

That implies a long time will be needed to shrink down the BOC's balance sheet even after an October taper from CAD5 billion a week. Since that move, the BOC has also bought longer-term assets and the portfolio's weighted maturity has lengthened to seven years from six years. Other major central banks have failed to fully unwind emergency policies deployed during the 2008 financial crisis, some of which Canada avoided until Covid-19.

"The QE unwind will almost certainly involve a significant measure of 'we're just going to let things roll off,' as opposed to outright selling," Perrault said.

The BOC's balance sheet swelled to a record of about CAD550 billion through the pandemic from CAD125 billion beforehand. Some CAD140 billion of balance sheet assets will come due in the next three months, mostly t-bills and repos, which the BOC said may trim the balance sheet.

Sources have told MNI the BOC may wind up QE purchases by mid-2022, in a poll taken before Wednesday's rate decision. The BOC has said QE will continue until the recovery is well underway.

STRONGER ITERATIONS

Governor Macklem showed more optimism about medium-term growth in his latest decision, and his view of slack being used up in 2023 is now likely the very latest that goal will be reached, Perrault said.

The domestic economy stands to gain from consumer spending and U.S. growth that could hit 7% this year on fresh fiscal stimulus, he said. America's fiscal boost would spark demand from the buyer of three-quarters of Canada's exports.

"Fundamental underpinnings of the recovery are quite solid," Perrault said. "There is potential for things to be even stronger in future iterations" of the BOC's economic forecasts, he said.

Macklem told reporters after the rate decision that while he could slow asset purchases if the economy does well, "we expect a protracted recovery, this is going to take some time."

Analyst Reviews

CIBC: The forecast looks for a GDP drop in Q1 as social distancing measures take a bite out of activity, but tied to optimism on vaccines, has lifted growth for the next 2 years to 4% in 2021, and nearly 5% in 2022, only a touch below CIBC's projection but a big upgrade to the Bank's '22 outlook. That would have also implied a faster closing of the output gap, but the Bank has also raised its forecast for the economy's non-inflationary potential output, concurring in part with what CIBC economics found in pointing to less scarring to the economy's potential than the BoC had earlier feared. As a result, it doesn't project a period of sustained inflation above its 2% target until 2023, which maintains its prior outlook for rates to be on hold until then.

The Bank seemed less interested in making a strong statement about the risks to exports or inflation from an appreciating exchange rate, although the MPR mentioned it as a "headwind." Since having seen Macklem raise those concerns, markets had priced in some odds of a 10-15 basis point cut in the overnight rate today as tactic to counter those headwinds or weaken the currency. But pushing overnight rates still lower risked sending t-bill yields or CORRA into negative territory, one reason, along with the improving outlook, that the Bank didn't do so today. Indeed, by continuing to call 25 bps as the "effective lower bound", the Bank has nearly ruled out a further cut should the economy disappoint in the months ahead. That, and the upgraded outlook, saw the Canadian dollar climb sharply after the announcement, a reaction that the Bank might try to jawbone against down the Road.

Goldman Sachs: As we had expected, the BoC turned negative on Q1 growth while striking a cautiously optimistic tone for the medium-term based on earlier-than-expected availability of vaccines, significant ongoing fiscal stimulus, and upgrades to global growth. The Bank forecasts -2.5% annualized growth in Q1 but has upgraded 2021 Q4/Q4 growth by 0.8pp to +4.6%. While the Q1 downgrade pushes 2021 annual average growth down to +4.0% (vs. +4.2% previously), the level of GDP is expected to reach its pre-pandemic levels in 2021H2 (vs. early 2022 previously). Policymakers revised up potential growth over the forecast period to +1.4% (vs. 1.1% previously) reflecting stronger expected investment, higher immigration targets, and positive historical revisions.

As a result, the BoC upgraded its end-2021 and end-2022 inflation projections as we expected, and introduced persistent cost pressures as a new upside risk to inflation. Specifically, the 2021Q4 and 2022Q4 CPI projections were upgraded to 1.5% (vs. 1.3% previously) and 1.9% (vs. 1.8%) and inflation is now projected to reach 2% in 2023Q2. The moderate inflation upgrades reflected higher growth projections, partly offset by higher potential output. The Monetary Policy Report (MPR) added persistent cost pressures due to "structural changes to global value chains" to its list of inflation upside risks, which also includes stronger household spending and additional US fiscal stimulus. It did, however, add a stronger Canadian dollar as a downside risk.

The Bank left its policy rate and pace of asset purchases unchanged, but the policy statement hinted at tapering by clarifying that "As the Governing Council gains confidence in the strength of the recovery, the pace of net purchases of Government of Canada bonds will be adjusted as required." While Governor Macklem listed a micro-cut as part of the artillery (alongside asset purchases and yield curve control) to provide more stimulus "if the economy turns out to be substantially weaker than expected", his opening statement suggested that the next step would likely be a reduction in QE stimulus "if the economy and inflation play out broadly in line or stronger than projected". The Bank left its guidance (based on slack and inflation) and projected 2023 timing for liftoff unchanged.

JP Morgan: The Bank of Canada kept all aspects of monetary policy unchanged this morning as expected, including the policy rate (0.25%), C$4 billion weekly QE program, and the output-based forward guidance. Also as expected the Bank strongly confirmed the need for the current level of highly accommodative monetary policy. Moreover, Governor Macklem emphasized that the Bank can and will add more stimulus if needed. And the governor clearly stated that it is too early for the Bank to consider slowing the purchase of Government of Canada bonds.

The Bank expects a protracted and choppy recovery, which means the QE program will be needed for some time. The governor highlighted that a lower policy rate (although not in negative territory) and YCC were among the tools ready to be deployed as necessary. Despite the strong forward guidance already in place, with so much uncertainty at present, the Bank wished to remove any question surrounding the continuation of its highly accommodative monetary policy and emphasized that it would deploy more monetary stimulus to the economy as needed. We see this as a continuation of Governor Macklem's more aggressive communication strategy.

In terms of the forecast changes in the Monetary Policy Report, real GDP growth in Canada was raised from 3.8% to 4.6%Q4/Q4 in 2021 and lowered a tick to 2.9%Q4/Q4 in 2022. Our view on 2021 is more constructive (5.2%Q4/Q4). We expect a larger boost to growth in 2021 from domestic final sales and a smaller drag from net exports. We also assume a lift from increased US fiscal stimulus; the Bank only assumes that aspect to be a possible upside risk to the outlook.

As the Bank has maintained through the last two forecast updates (July & October), uncertainty remains elevated and the strength of the recovery will depend on the evolution of the virus and the rollout of the vaccine. Based on vaccine rollout plans, the Bank expects a sustained rebound in consumption of services and, as the year progresses, uncertainty to fade and household and business confidence to improve. The Bank expects inflation to return to the 2% target in the first half of the year, but only temporarily and largely linked to firming energy prices and base year effects. Then inflation will be pulled down again based on excess supply in the economy. The Bank expects 1.6%oya in 2021 while we expect a pace closer to 2%oya this year based on stronger growth.

Scotiabank: In response to the Bank of Canada's overall suite of communications, Canada's government bond yields increased by about 2bps across the curve today as US Treasury yields fell slightly. FX markets signalled the same interpretation as the Canadian dollar became the day's star pupil through a half cent appreciation versus the USD after reining in a somewhat stronger initial response.

Overall the suite of communications sets a very high bar against expectations for any further policy easing as we slip into tracking mode on their forecasts. They are saying they're on auto pilot for a time. Barring a shock out of left field, the next move is likely to tighten policy but even I think that's a 2022 story. As 2021 evolves, market rates through the front-end will more convincingly price such expectations alongside vaccine take-up and data.

TD Securities: The Bank of Canada left its policy regime unchanged at today's announcement, maintaining the overnight rate at the Effective Lower Bound (ELB) at 25 bps, continuing with a minimum of $4bn per week in QE, and maintaining its forward guidance for both the overnight rate and the QE program. Implicitly the BoC also reaffirmed that it sees 25 bps as the ELB.

The overall tone of the communique was constructive; while the Bank acknowledged that the outlook remains highly uncertain, it did note that earlier than expected vaccine arrivals and additional policy support have boosted the longer-term growth outlook - going so far as to state the longer-term outlook is now "stronger and TD Securities Global Rates, FX & Commodities Strategy 20 January 2021 1 more secure" relative to October. The news wasn't universally positive, as the BoC looks for a 2.5% annualized drop in GDP in 2021Q1, but the broader sense of relief was palpable.

The BoC continues to pledge to keep the overnight rate at the ELB until slack is fully absorbed, which they still expect in 2023. There is some scope for additional upward forecast revisions in January (the Bank's 2021Q1 is perhaps a touch pessimistic), but any positive revisions to 2021 would probably be offset by negative revisions to 2022. Crucially, the BoC is evidently unswayed by recent arguments for a micro-cut (indeed, they may view money market dislocations as evidence supporting their initial assessment of the ELB at 25 bps). The Bank is not going to shut the door completely to a potential adjustment; the ELB is state dependent, and if the recovery goes off track they may then judge that the ELB has shifted to 10 or 15 bps. But now that the Bank has implicitly reaffirmed the ELB at 25 bps, a technical adjustment in March or April seems very unlikely.

The Monetary Policy Report affirmed the positive impact of a more rapid vaccine rollout, with the Bank's forecast for 2022 GDP growth revised higher to 4.8% from 3.7% in the October MPR. The Bank also revised 2020 GDP to show a slightly smaller contraction (-5.5%), due to stronger momentum into year-end. 2020Q4 GDP growth was revised higher by 3.8pp (annualized), although the Bank is now calling for a Q1 contraction (-2.5% ann) to shave 0.2pp from 2021 GDP growth as lockdowns take their toll. However, the Bank also revealed upward revisions to potential output, reflecting less scarring than previously anticipated, and is still looking for the output gap to close in 2023.