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Op-ed: For the BoC, promises were made to be broken

By Warren Lovely & Stéfane Marion

Let us be blunt: Having achieved full employment, Canada no longer requires extraordinarily stimulative monetary policy. Indeed, maintaining such a loose policy standing much longer risks compromising Canada's longer-term economic and financial market prospects, jeopardizing this nation's hard-won inflation bona fides.

Our recommendation to the Bank of Canada: Use Wednesday's rate announcement (the final decision for calendar 2021) to telegraph a possible (read needed) normalization of monetary policy in the first quarter of the New Year, implementing the first of multiple interest rate hikes no later than March.

Yes, we're mindful of lingering virus risks. Like others, we're monitoring the situation closely, as the highly infectious omicron variant pops up in more corners of the globe (including here at home). Fresh virus-related restrictions have the potential to (further) impair the outlook for global growth, undercutting support for commodity prices. That's a non-trivial consideration for our still-resource-intensive economy. We're likewise aware that some other forecasters may favour a more becalmed/patient stance when it comes to the onset and pacing of interest rate hikes in Canada. While there's notionally two side to every argument, to us, the case for near-term removal of monetary stimulus is sound.

Say what you want about base effects and snarled supply chains, sky-high inflation – not just in Canada, but in the U.S., across Europe and elsewhere – is impossible to ignore. At least it should be, pursuant to the BoC's *current* monetary policy mandate. We hasten to add that the BoC's existing policy mandate expires December 31st and is thus due to be confirmed any day now. It's telling that the U.S. Federal Reserve is opting to retire the term 'transitory' as it relates to the inflation narrative south of the border. We'll admit to having similar thoughts when it comes to consumer price pressures in Canada, particularly now that our labour market is drum tight.

As ever, we're reticent to over-react to a single bit of data, particularly a series as choppy as Canadian employment. But Friday's jobs report suggests over 150,000 net new jobs were created in November, lifting the six-month employment tally north of 750K. The national unemployment rate is now back down to 6% – a level that would have been considered at or perhaps below NAIRU in pre-COVID days, as per Bank of Canada published research. If there's a constraint to job growth at this point, it's a shortage of workers rather than a dearth of job openings. Think of this as the human capital equivalent of the supply chain pressures we're spending so much time thinking about.

We heard the BoC lamenting labour market 'uncertainties' a few weeks back. Perhaps recent job gains are less-than-ideal. Surely not everyone has participated in the recovery to an equal extent. Still, today's vibrant labour market and record labour force participation for the prime-aged workforce is simply inconsistent with a target policy rate at the effective lower bound of 0.25%, to say nothing of a Bank of Canada balance sheet laden with $420 billion in Government of Canada bonds.

You may prefer to look past our notoriously choppy jobs data. Perhaps you go in for housing data. Well then, you're likely reading about a reacceleration in activity (constrained only by a lack of properties) and downright steamy price gains in key markets. Maybe fiscal policy is more your jam, in which case you're no doubt aware of marginal stimulus on offer in some provincial capitals, with likely more to come as 2022 elections take shape in some important jurisdictions. Federally, certain extraordinary programs are being walked back, but the minority Liberal government seems intent to funnel every bit of today's revenue gusher right back into the economy. All told, Canada's fiscal impulse is supportive of jobs and growth, arguing for less monetary policy accommodation, all else equal. Turning to the most esoteric data of all, GDP, we've parsed the Q3 national accounts and accompanying revisions to prior periods. Technically, the level of real GDP in this country is no higher than what the BoC had assumed in its October's Monetary Policy Report. To be precise, Q3 output looks to stand 0.2% *below* the Bank's implied forecast. So unlike employment, Canada has yet to stage a full recovery in real GDP. We won't really debate the point.

That brings us to the Bank of Canada's 'conditional commitment' to hold the policy rate at the effective lower bound until the output gap is closed. As recently as late-October, the BoC saw the output gap closing 'sometime in the middle quarters of 2022' (i.e., April to September). If you glanced at Canada's fresh and anemic labour productivity data – it landed alongside Friday's stellar jobs report – you might argue that potential growth has moved down, not up. So Canada's output gap, to the extent there's much of one left, could be closing a bit quicker than previously thought. There's guesswork involved here to be sure. But again, the message from the labour market is that slack is all but non-existent.

The BoC won't treat us to a new economic forecast on Wednesday. We'll need to wait until a January 26th Monetary Policy Report to see how the central bank's view of the world has really evolved. Absent a fresh and definitive read on output gap, it might nonetheless be appropriate for the Bank of Canada to distance itself from the 'conditional commitment' on the policy rate, if only to allow an overdue normalization process to get underway sooner. It's here where promises were made to be broken… or alternatively, where forecasts were made to be revised.

Rate hikes and balance sheet run-off: For a Canadian economy proving so resilient, with jobs so plentiful and inflation so elevated, the time is nigh for demand to be calmed.

Note: National Bank's official interest rate forecast calls for a first BoC rate in Mar-2022, followed by 4 additional hikes over the balance of the year. For 2022, the forecasted end-of-year level for the overnight target rate is 1.5%, which compares to a projected fed funds rate (upper bound) of 1% at the end of next year. We anticipate further normalization, albeit at a reduced rate, in calendar 2023. Complete details will be provided in our upcoming issue of Monthly Fixed Income Monitor.

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