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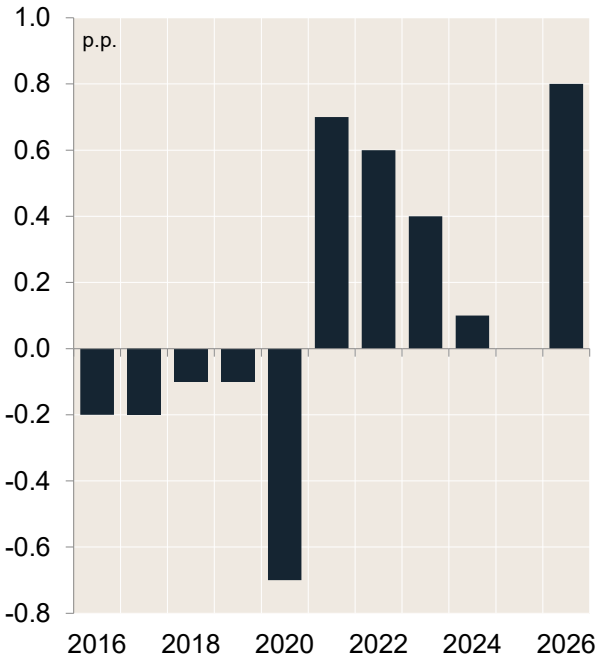
Canada Watch

By Matthieu Arseneau and Alexandra Ducharme

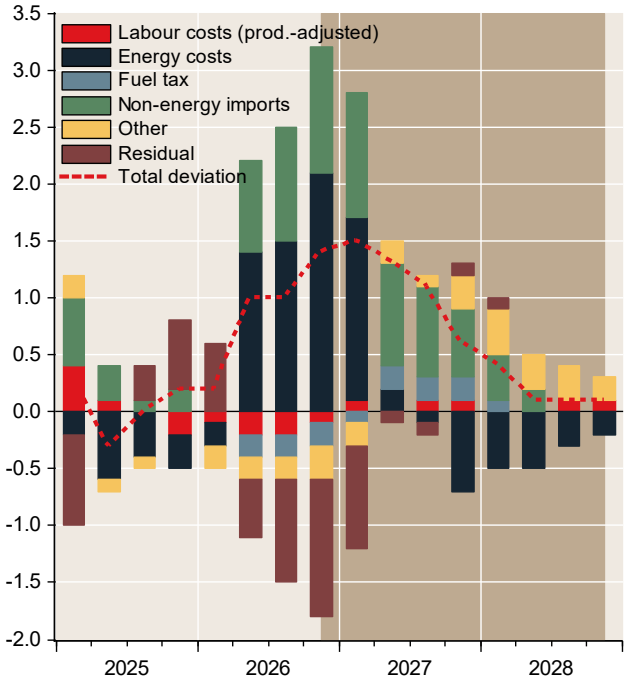
Following previous rate hikes by the Bank of Japan, the ECB and the Fed, the Bank of Canada joined the tightening cycle this morning, announcing a 25-basis-point hike that brought its policy rate to 2.50%. Just two weeks ago, markets and economists may not have viewed a rate hike as a foregone conclusion. Oil prices were high and little progress had been made toward resolving the conflict in the Middle East, but core inflation remained under control, and both the economy and the labour market continued to show signs of excess supply. In an interview in Asia, however, the governor went out of his way to prepare markets for a hike, warning that the risk of inflation becoming more widespread and persistent had increased. While most economists remained skeptical that this was the right course of action, investors largely priced in the scenario that unfolded this morning. Along with the rate hike, the Bank released new inflation forecasts that showed the 2027 average rising from 2.0% to 3.1%, 0.8 percentage points above the consensus average, a large margin by historical standards that highlights the reasons behind many economists' discomfort. Why is the Bank so concerned about inflation in 2027, when the energy price shock will be behind us by then? A chart in the Monetary Policy Report (MPR) shows that the main reason is prices for non-energy imports. These are expected to rise, reflecting the weaker currency, increasing transportation costs and Canadian counter-tariffs, while domestic price pressures are expected to remain contained amid excess supply. While it remains to be seen how much of these higher costs businesses will be able to pass on to consumers, we have another concern about the forecast. As today's Hot Chart shows, the new model underpinning the Bank's inflation forecast appears to have overstated inflation so far in this oil shock, with sizable residuals— that is, the unexplained factors currently holding inflation down. The Bank of Canada has therefore acted on an inflation forecast that diverges sharply from economists' consensus. It is a bold call, particularly given the model's recent performance and the inherent uncertainty surrounding inflation forecasts.

Canada: Is the Bank of Canada scared to be scared?

CPI forecast in October for the year ahead, gap between Bank of Canada and consensus



Contributions to the deviation from the 2.0% CPI target, Bank of Canada forecast



NBC Economics and Strategy (data via Bank of Canada, Consensus economics)

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