Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Bank of Canada Watchers

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Re: **INCREASED STIMULUS LURKS IN BANK OF CANADA'S UNCHANGED RATE-SETTING**

Last week, the Bank of Canada left its target for the overnight rate at 25 basis points while scaling back its quantitative easing (QE) program, reducing the pace of its purchases of government of Canada debt from $3 billion a week to $2 billion.

Lifting its foot off the QE pedal is warranted given recent inflation readings and other underlying metrics. At the same time, however, the unchanged overnight rate target actually represents an easing of monetary policy since the Bank's last announcement seven weeks ago, because inflation expectations have increased (lowering the *real* overnight rate), and the recovering economy has probably raised the level of the overnight rate that would be consistent with steady growth and 2-percent inflation (the so-called neutral rate).

Let's unpack these two changes, starting with inflation expectations, and then consider the implications for the Bank's policy down the road.

There are several ways to measure inflation expectations in Canada. None are perfect, but how they change over time is probably more telling than their levels. First, the economic analysis departments of Canada's six major commercial banks have moved their forecasts up since the Bank's last announcement. Their average forecast for inflation during 2021 has increased from 2.45 percent seven weeks ago to 2.83 percent, and their average forecast for 2022 has gone from 2.32 percent to 2.48 percent. Second, the Bank of Canada's survey of consumer expectations (released on July 5) showed a spike in one-year-ahead inflation expectations of almost a full percentage point. Third, the spread between nominal and real return on long-term Government of Canada bonds (a measure of longer-term inflation expectations) has been creeping up. It's still below 2 percent – a good thing – but telling in its direction.

The increase in inflation expectations is an adjustment to realized inflation and reflects a bet that recent higher inflation is more than a blip. Headline inflation moved up from 3.4 percent to 3.6 percent between April and May, putting a dent in the idea that the April number was just a "base effect" reflecting the unusually low level of prices in April 2020, at the height of the first pandemic lockdowns. Moreover, all of the Bank's core measures, designed to capture underlying inflation, increased between April and May. The annualized three-month increase in two of the Bank's three preferred core measures, "CPI-trim" and "CPI-median", were 3.5 and 3.1 percent, respectively, in May. And, according to the Bank's July Monetary Policy Report, headline inflation is expected to sit slightly above 2 percent in the medium term.

Higher inflation expectations mean that the Bank's real policy rate (the overnight rate target minus expected inflation) is lower, and thus more stimulative.

This brings us to the second consideration: what the current state of the economy implies for the neutral level of the policy rate.

This equilibrium neutral rate equates planned savings to planned investment. Let's look first at what is happening with household savings, and then briefly at planned investment.

The lack of spending opportunities during the lockdowns combined with federal income support programs led to record household saving: an unprecedented 27.2 percent in the second quarter of 2020. It has come down as the economy gradually reopens, but is still, at 13.1 percent in the first quarter of 2021, higher than at any point since 1993. The Bank's survey of consumer expectations showed that households plan to run down those savings.

Investment is also picking up. The Bank's Business Outlook Survey (also published on July 5) reports a continued improvement in business sentiment, with expected increases in sales leading to plans to hire more staff and invest in increased productive capacity.

A reduction in planned savings and more planned investment necessarily means a higher neutral rate. A higher neutral rate with a fixed overnight rate means a more stimulative monetary policy.

What are the implications for policy? With the Bank's policy rate at its effective lower bound, higher inflation expectations combined with a higher neutral rate suggests policy is more stimulative than it was seven weeks ago.

What this means is that further tightening is likely required, which can be accomplished through further reductions in bond purchases as a first step. Eventually, it could mean bringing forward the timing for rate hikes, which last week's announcement suggested would not happen until the second half of 2022.

Sometimes an unchanged overnight rate can be more stimulative – as it was this time around. For Bank of Canada watchers, further tightening may not be far down the line.

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