**FMG QuickTake: October July 2023 Policy Decision**

**Summary:**
- The Bank of Canada left rates unchanged
- They downgraded growth of 2023 and 2024
- But are increasingly concerned that inflation is proving sticky - and upgraded their forecasts for CPI
- They also believe that the return to 2% CPI will take longer than previously thought
- They could have raised rates today to deal with this risk - but believe that policy is working, (hence lower growth), albeit slowly and want to give it time

**Important Takeaways -**
- Where will rates go from here? *Probably nowhere for a while*
- Is the BoC finished hiking? *Probably - but they aren't confident in that forecast in any way*
- But will this mean quick cuts? *No. That is the trade-off. No hike now, no cut later - “higher for longer”*

The good news is...tight monetary policy *is* working (quotes from BoC):
- The outlook for GDP over 2024 has been revised down because of weaker consumption and house spending. The weakness is due to a more prolonged impact from past monetary policy tightening and higher long-term interest rates
- Excess demand pressures have been easing. The output gap is now estimated to be between -0.75% and 0.25% in the third quarter of 2023

The bad news is....tight monetary policy *is not* working (quotes from BoC):
- Progress toward the 2% target is proving to be slow
- Core inflation has been more persistent than expected
- Inflation is now projected to stay around 3 ½% until the middle of 2024...and is forecast to ease to about 2 ½% in the second half of 2024...This is 3-6 months later than previously expected
- A considerable amount of uncertainty surrounds the forecast. Three month rates of core inflation have remained elevated - in the range of 3 ½% to 4% for the past year
- The bank's preferred measures of core inflation show little downward momentum

**Observations -**
Considering the rate was held at 5% - there was still lots of juicy stuff in today's announcement and MPR that will require monitoring ahead:

**Policy *is not* working:**
- “Core inflation has not declined as much as expected. It has made little progress after falling on a year-over-year basis”
- Inflation needs to fall to stop rates rising - “Governing council wants to see downward momentum in core inflation”
● The potential for a Wage price spiral - “There is a risk that inflation expectations could become a driver of wage and price setting behaviour”
● “Inflation risks have increased”
● “Corporate pricing behavior has yet to normalize. Businesses continue to increase prices more frequently and by a larger amount than normal”
● “Businesses are still able to easily pass on cost increases and wage growth remains strong”
● “High inflation expectations could also feed into wages”
● “Labour market remains tight and wage pressures persist”

Policy is working:
● “Past interest rate increases are working through the economy”
● “Hiring and investment intentions have been trending down”
● “The share of businesses reporting binding labour shortages has returned to close to its historical average”
● “Economic growth is expected to remain muted”
● The economy is back in balance - “excess demand pressures have been easing. The output gap is now estimated to be between -0.75% and 0.25% in the third quarter of 2023” (zero is equilibrium)
● “The economy is projected to move into modest excess supply in the fourth quarter of 2023”

Conclusions -
As Governor Macklem said, “the path to a soft landing has gotten narrower”
Look at the evolution of the projections for CPI and GDP in the Monetary Policy Reports from Apr, July and October:

Crucially, the confidence in the projections has been lowered - growth was wrong and so was inflation.

The cold truth is that this Monetary Policy Report is a little scary. The Bank of Canada has one job to do - get inflation to 2% and keep it there. It clearly sees that as a more difficult job than expected and is concerned that they will be forced to inflict more damage on the economy in order to achieve that goal. They do not forecast this (growth will be sub-longer term trends for the next 2 years) - but as we just said - they are less confident of this forecast.
Market Reaction -

A little weird, frankly. Rates have risen (fair), but the curve has steepened (less fair). The guidance we got today was a doubt-caster on “no move and higher for longer”. More like “even higher soon and that might hurt longer term”. That said, the Canadian curve was/is more inverted than the US - and the US has steepened again today. Given that this is a detailed firehose of information - it is hardly surprising that it has not made the impact one would usually expect.

What Next? -

It’s a waiting game.

As the BoC put it, “Higher interest rates take time to work - they affect demand first and then inflation”. This is all reasonable. However, as the BoC stressed, they need to see the second development consistently - and soon”. A failure for this to happen would lead to further rate hikes. Will businesses and consumers start to reduce pricing and spending behaviours to make this happen? How bad would the economy have to become from here for this to happen? The bar has been lowered for the fall in inflation for now. But it needs to happen. And it cannot start rising again if 5% is to become the peak of the policy rate.

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