HSBC Global Research

27 October 2021

Bank of Canada

Economics

Canada

Surprise! QE ends, earlier policy rate lift off likely

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- Bank of Canada left its policy rate unchanged, but announced the end of the quantitative easing program
- The outlook for inflation was revised upward, while the outlook for economic growth was revised downward
- But, with supply side factors weighing on potential, the output gap will close earlier than previously expected, a key condition to raise the policy rate

Facts

The Bank of Canada left its policy unchanged at 0.25%. However, the more important news was the announcement of the end of the quantitative easing campaign. As a result, the Bank of Canada will enter the reinvestment phase during which it will maintain the size of its holdings of Government of Canada (GoC) bonds.

Leaving the policy rate unchanged was expected; ending the QE program and entering the reinvestment phase today was not. We had expected the BoC would reduce its net purchases of GoCs, but not all the way down to zero.

Updated economic forecasts showed upward revisions to the outlook for inflation and downward revisions to the outlook for economic growth. Nonetheless supply side disruptions were also seen having a negative impact on potential GDP growth and a headwind to the increase in the supply of goods and services. Thus, even though the growth profile was lowered, the economy is now seen running out of slack “in the middle quarters” of 2022. This is earlier than had been indicated in previous economic updates.

The Bank now projects GDP growth of 5.1% this year (down from 6.0% in the July economic update), and 4.3% next year (down from 4.6%). Projected CPI inflation was revised to 3.4% y-o-y in 2021 (up from 3.0%) and to 3.4% in 2022 (up from 2.4%). That said, the BoC still expects inflation to decline over time. For example, from a peak of 4.75% at the end of 2021, the Bank forecasts the rate of inflation falling to around 2% at the end of 2022.

The Governing Council again committed to leave the policy rate unchanged “until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved,” a condition now expected to occur around mid-2022 rather than in the second half of 2022.

Implications

The policy statement was hawkish, pointing toward an earlier closing of the output gap, and thus to an earlier start to the rate hike campaign than the BoC had previously been indicating.

The QE program will cease and the Bank now enters the reinvestment phase. This implies that the Bank will only purchase sufficient Government of Canada bonds to maintain its holdings. However, given the lumpy nature of maturities of Government of Canada bonds, the BoC announced that it will move to a monthly target for bond purchases of between CAD4bn and CAD5bn.

Ending the QE program and entering the reinvestment phase is a crucial step in the process leading to rate hikes. QE had been used to reinforce the Bank's forward guidance to leave the policy rate unchanged. That reinforcement has now been removed. This, alone, is not a commitment to raise the policy rate earlier than had been expected, but it does suggest that raising the policy rate will be an option at policy meetings earlier in 2022 than had been anticipated.

In addition, the key criteria before raising the policy rate has been pulled forward slightly. Specifically, the economy absorbing remaining slack. Whereas previously the Bank had said that the economy would reach potential "in the second half of 2022," it now says that this might happen "in the middle quarters of 2022."

Ending the QE program and an earlier projected closing of the output gap thus pulls forward the possible timing for an increase in the policy rate. In fact, in the press conference, Governor Macklem noted that a policy rate increase could be considered sometime between April and September, as the economy hits potential, compared to an earlier focus on the second half of 2022.

The earlier closing of the output gap came despite downward revisions to GDP growth in 2021 and 2022 and a reduced outlook for business investment. The contribution to GDP growth from business investment is now forecast to be 0.2 percentage points (ppt) in 2021 (down from 0.5 ppt), and 0.8 ppt in 2022 (down from 1.1 ppt).

Today's Monetary Policy Report showed that the lower growth profile for business investment will weigh on potential output growth, which was revised to 1.6% over 2021 to 2023, compared to projected potential output growth of 1.8% in the July economic update.

In addition, the Bank noted that the supply of goods and services will be constrained in the short-term by other factors such as, global supply chain disruptions and labour supply mismatches. These headwinds are assumed to peak in Q4 2021 and to slowly dissipate through 2022.

The Governing Council thus concluded that even though GDP growth will be slower this year and next, the decline in potential GDP growth and supply side challenges imply that the output gap would close earlier than had been previously anticipated. Given that the Governing Council has said that the policy rate would remain unchanged until slack was absorbed, today's statements point toward an earlier than expected policy rate lift off.