RBC Economics

Daily Economic Update

July 15, 2020

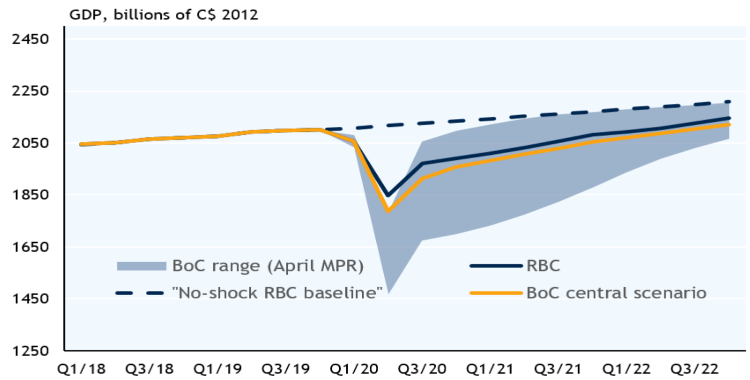
BoC adopts 'low for long' forward guidance

- Overnight rate and QE unchanged
- Forward guidance suggests no rate hike before 2023
- Pandemic doing long term damage to Canada's economy

The Bank of Canada held its key policies steady today, leaving the overnight rate at its effective lower bound of 0.25% and continuing asset purchases at the current pace (including at least $5 billion in GoC bonds per week). The bank did deploy an additional policy tool: forward guidance. Governing Council is pledging to keep the overnight rate at its current level until the economy is back at full capacity and inflation is sustainably at the bank's 2% target. Based on economic projections in the MPR, that won't be until 2023 or later. By reducing expectations of future short-term interest rates, this forward guidance is intended to keep longer-term borrowing costs low—a goal that is supported by ongoing asset purchases. As Governor Macklem clearly stated the bank wants Canadians to know that borrowing costs will remain low for a long time.

While the bank provided more specific guidance on the path of the overnight rate, it maintained its relatively vague guidance that asset purchases will continue until the recovery is "well underway". Governor Macklem provided a bit of additional clarity, saying the bank wants to see evidence that the recovery is becoming self-sustaining before easing up on QE. We continue to think asset purchases will continue at least through the first quarter of 2021, and likely well into next year.

RBC vs. BoC Real GDP Scenarios



Source: Bank of Canada, RBC Economics

The BoC's economic projections were not surprising given Governor Macklem's earlier comments that the recovery will likely be "prolonged and bumpy". The bank's "central scenario" assumes the Canadian economy contracted at a 43% annualized rate in Q2—a bit more severe than our own -35% forecast, but at the more optimistic end of the range of scenarios presented back in April. A sizeable rebound in Q3 (+31% annualized according to the BoC) will reverse about 40% of the decline in activity over the first half of the year. But from there, the "recuperation" phase will proceed more gradually, with GDP remaining 8.8% lower year-over-year in Q4 (our own forecast is -5.2%) and won't return to end-of-2019 levels until around mid-2022 (similar to our forecast).

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Even then, the economy will be operating below full capacity (i.e. supply will recover faster than demand) and consequently inflation will remain below the bank's 2% target. Of course, there is a significant degree of uncertainty around these forecasts. The bank's "central scenario" presented today assumes there will be no broad-based, second wave of infections in Canada, and that the pandemic will largely run its course by mid-2022.

There was one additional figure in today's MPR that caught our eye. The BoC expects Canada's potential output will be almost 4% lower in 2022 than projected back in January. That is, the bank thinks permanent scarring from the COVID-19 pandemic (less investment, less immigration, permanent business closures) will reduce the economy's long-term productive capacity by 4%. So even when the economy has recovered to "full capacity"—which, again, the BoC doesn't see until at least 2023—GDP will be notably smaller than the previous trajectory we were on