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Commentary

Special Edition Canada Outlook

Bank of Canada raised its policy rate for the first time since the COVID-19 crisis

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First rate hike since the start of the COVID-19 crisis

At its March meeting, the Bank of Canada (BoC) raised its policy rate from 0.25% to 0.5% for the first time since the start of the COVID-19 pandemic in March 2020 when it rapidly lowered the policy from 1.75% to 0.25% in three straight meetings (one scheduled and two unscheduled). This is a widely expected policy change telegraphed by the BoC in its January meeting and widely priced-in by the market. This marks the start of the post-COVID monetary policy tightening cycle as the Canadian economy emerged from the recovery phase into the expansion phase.

Interest rate normalization will continue

Amid strong recent data in growth as reflected in the Q4 GDP (6.7% quarter-over-quarter with the growth level returning to its pre-COVID level) and elevated inflation at 5.1% year-over-year (highest since early 1990s), a rising path for interest rates will be required to moderate growth and bring inflation back to the 2% target over time.

Looking ahead, aside from the recent geopolitical tension, as the COVID-19 situation and the corresponding domestic restriction measures have eased significantly, Canadian domestic economic activities will likely continue with solid growth momentum. A back-to-back rate hike is widely expected at the next meeting on April 13. If realized, this would mirror the last tightening cycle in 2017 when the BoC raised its policy rate in two straight meetings after the Canadian economy recovered from the oil collapse crisis in 2014 to 2015.

In terms of its balance sheet, the BoC will continue its reinvestment phase to keep the overall holdings of Government of Canada bonds roughly constant until such time as it becomes appropriate to allow the size of its balance sheet to decline. Once started, the balance sheet reduction (also known as Quantitative Tightening)

Key takeaways

- At its March meeting, the BoC raised the target rate by 0.25% to 0.5%
- This is a widely expected first rate hike by the BoC since it lowered the policy rate to 0.25% at the start of the COVID-19 crisis
- A rising path for interest rates will be required to bring inflation back to the 2% target

Our views

- With the recent strong growth and high inflation in line with its projection, the BoC embarks on policy normalization
- Geopolitical tension complicates the near-term outlook in both inflation and growth, and adds to the headwinds to risk assets

would complement increases in the policy interest rate in reducing monetary accommodation to the economy.

Geopolitical tension complicates the near-term outlook

Although a rising path for interest rates is the baseline case, the recent elevated geopolitical tension complicates the near-term outlook. The BoC highlighted it is a major new source of uncertainty and is following the situation closely. The heightened uncertainty and the possibility of highly negative outcomes are an immediate threat to the stability of the financial market and the global economy. If the situation remains inadequately resolved, the negative impact from the resulting higher commodity inflation (energy and agricultural) could potentially propagate wider, fuelling global inflationary pressure further and in turn negatively affecting economic growth. The situation would make central banks' policy decisions more difficult in the face of even more elevated inflation. The combination of the tightening of geopolitical tension and the tightening of monetary policy stance by many central banks (e.g. the US Federal Reserve and the BoC) are currently the headwinds to risk assets.

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