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# Canada's next monetary policy framework

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## Highlights

- In the upcoming renewal of Canada's inflation-control target and monetary policy framework, the Bank of Canada (BoC) may propose a change to an average inflation target (AIT).
- A switch to AIT could provide the BoC with more effective policy tools in an environment of low interest rates, but at the cost of replacing the current framework that has kept inflation stable for two decades and is well understood by investors and most Canadians.
- While the outcome has potentially weighty implications for Canadian inflation and growth in the long term, we do not expect that a change in the framework would have much impact on the BoC's current policy stance, Canadian asset prices or the Canadian dollar.

**The Bank of Canada's (BoC) upcoming renewal of its monetary policy framework, conducted every five years, may attract more scrutiny than usual when it is announced.** Elevated year-on-year inflation this year – reaching 4.1% in August – and the recent election focus on rising prices will put increased attention on the Bank of Canada this Fall, as it proposes either to renew or change the current monetary policy mandate after two decades. A new framework could potentially alter the path of future inflation with implications for Canadian financial markets.

**We currently see the renewal decision as a toss-up between two frameworks: the current flexible inflation targeting (FIT) mandate or a switch to an average inflation targeting (AIT) mandate**. With FIT, the BoC seeks to keep year-on-year inflation at 2% over the medium term, with a symmetric target range of 1% to 3%. If it switched to AIT, the Bank would instead target an average inflation rate over some time period, most likely a three-year window. Following a stretch of low inflation, the BoC would need to "catch up" by running inflation hot until average inflation returns to 2%, and vice versa. The US Federal Reserve recently implemented an AIT framework, recognizing that realized inflation remained below its 2% target for much of the past decade. For investors, AIT introduces new questions about how quickly central banks will respond to inflationary pressures.

**Both FIT and AIT performed well in a "horse race" published last year by BoC researchers.** On most economic indicators, AIT was ranked higher than the current FIT framework. AIT outperformed FIT mostly because of the "zero lower bound" problem, i.e., the fact that it is hard for the BoC to bring interest rates below zero to encourage an economic recovery. As an alternative to considering negative interest rates, a central bank can help boost the economy by keeping its policy interest rate *lower for longer*. But this approach may lead to an overshoot in inflation: when the economy starts picking up again after a recession, AIT means delayed tightening by holding rates at zero, resulting in above-target inflation. With AIT, this overshoot compensates for the initial disinflationary period when inflation is below the 2% target. Another recent paper from BoC researchers furthers the argument that inflation overshooting has many benefits, including improving the economic outcomes of the most vulnerable population groups.

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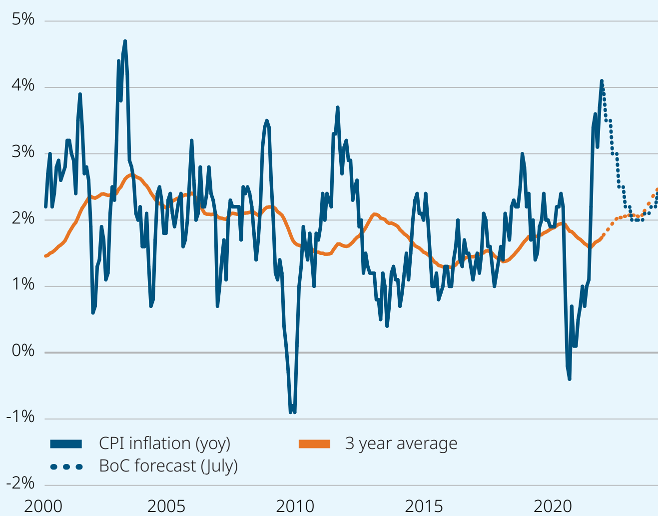
**While the BoC's research could be hinting in favor of a change to AIT, in practice the current framework also allows for a degree of inflation overshooting.** First, FIT has a target range of 1% to 3%, allowing inflation to rise above the 2% mid-point. And second, stable inflation is to be achieved over the "medium-term", allowing the Governing Council to tolerate high inflation if it expects it to moderate. In fact, Canada is currently in such a period of inflation overshooting as the economy recovers from the Covid crisis. Higher inflation in 2021 and 2022 could compensate for very weak inflation in 2020. While AIT would make inflation overshooting more predictable, FIT has done well at keeping inflation stable over the past 25 years and is already well understood by Canadians. Accordingly, the BoC might avoid rocking the boat for an incremental improvement.

**In our view, other monetary policy frameworks have at best an outside shot at taking the crown.** A "dual mandate" framework, resembling the US Federal Reserve's approach, would force the central bank to aim for both an inflation and an employment target. This approach performed well in the BoC's horse race, but it complicates a central bank's decision-making process when the two objectives conflict. This approach seems unattractive for the BoC, which has always emphasized clear communication of its policy decisions. Price level targeting and nominal GDP targeting might also satisfy some monetary policy objectives, but the BoC is unlikely to be the first among major central banks to experiment with one of these untested frameworks.

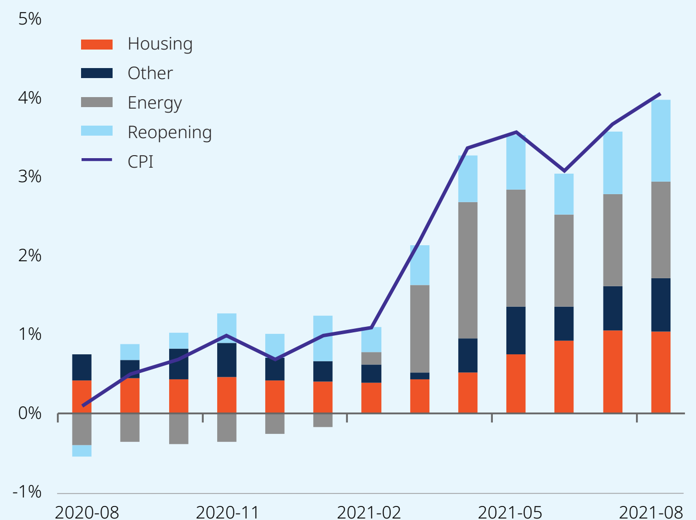
**Surprisingly, switching from FIT to AIT would have very little impact on the BoC's near-term policy stance.** With the three-year average inflation rate at only 1.7%, it seems at first glance like a switch to AIT would imply looser policy and an initial rate hike pushed beyond 2022Q2, the current market-implied timeline. But as Figure 1 shows, three-year average inflation is just about to reach 2%. In fact, the BoC's most recent CPI forecast implies that three-year average inflation is expected to keep rising well past the BoC's 2% target, up to 2.5% by 2023. If the BoC switched policy frameworks this year, it would still need to continue its current normalization process to hit its AIT target.

## Figure 1. "Average" inflation will keep rising as price pressures ease

**The Bank of Canada's CPI forecast implies rising 3-year average inflation**




**As transitory factors ease, inflation should moderate (contributions to year-on-year inflation)**




Notes: Left chart: Statistics Canada. Right chart: Statistics Canada, calculations by Mackenzie Investments, headline might not match contributions due to rounding error.

**With little effect on the timing of the BoC's next rate-hiking cycle, we do not expect the announcement to have a major impact on Canadian bond markets or the Canadian dollar.** Whether it sticks with FIT or switches to AIT, the BoC is on pace to finish tapering its direct asset purchases in a few months, and to raise its policy interest rate before the US Federal Reserve, likely supporting the CAD in the process. But even if the upcoming framework decision is unimportant for the current rate-hiking cycle, it could have tangible implications in the long term. A switch to AIT would likely mean slightly higher inflation over the next ten years and an increased chance of miscommunication about the BoC's policy intentions.

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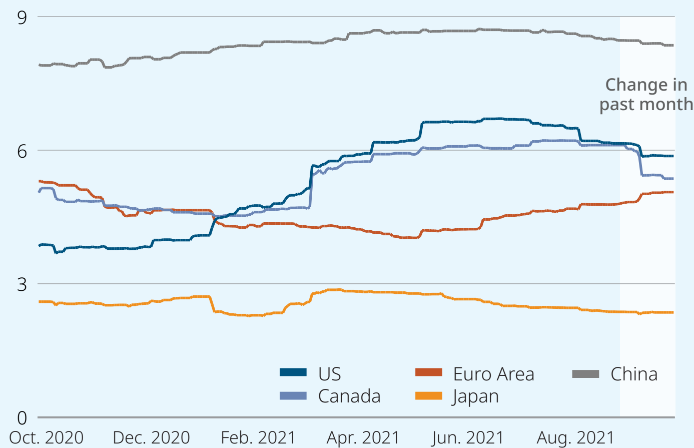
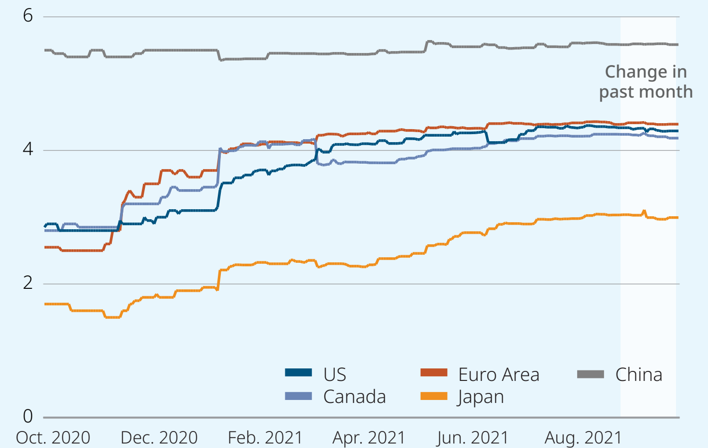
# Global macro update

- The consensus forecast for **Canadian growth** for the year were revised down from 6% to 5.5% after a disappointing GDP print for the second quarter (-1.1% vs. 2.5% expected). In our view, this negative print does not signal the beginning of a slowdown. Rather, a combination of global supply chain tightness, a cooling housing market and a healthy rebalancing from goods to services are key factors behind the Q2 pullback. Very strong employment numbers in June, July and August (+138k average) indicate that Canada is far from experiencing a demand-driven macro slowdown. Plus, with Canada still one of the most vaccinated countries in the world, its economy should be particularly resilient to the potential emergence of new Covid variants.
- There is much uncertainty around the path of **China's near-term growth.** Last month's *Global macro update* warned of the risk of fresh government stimulus further increasing leverage in the Chinese real estate sector. We had a preview of the consequences of such a debt build-up two weeks ago, when fears around property developer Evergrande's solvency contributed to a global equity sell-off. While the risks of an eventual Evergrande default spilling over to US financial markets are relatively low, the construction sector's necessary deleveraging could slow aggregate Chinese growth over the next few years. In fact, the private sector's high debt load has probably already contributed to slowing growth since the mid-2010s, as consumer and businesses failed to pick up the slack left by a pullback in government investment.

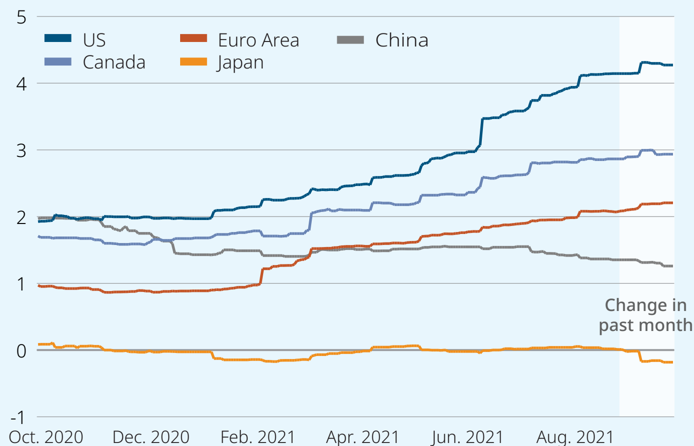
## 2021 real GDP growth forecast (%, consensus)



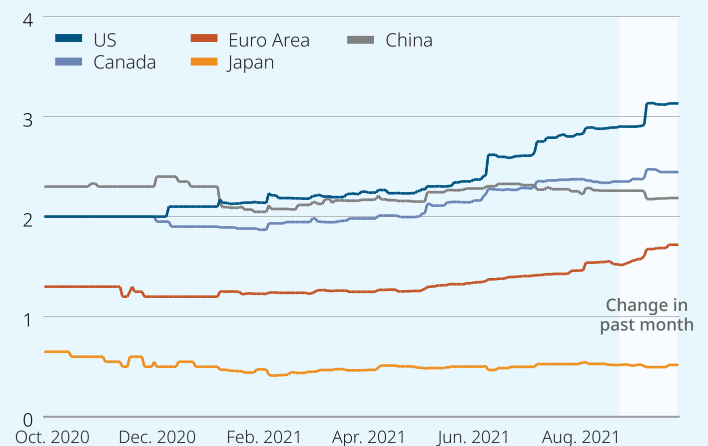

## 2022 real GDP growth forecast (%, consensus)




## 2021 inflation forecast (%, consensus)




## 2022 inflation forecast (%, consensus)




Notes: Forecast surveys from Consensus Economics as of September 30, 2021.

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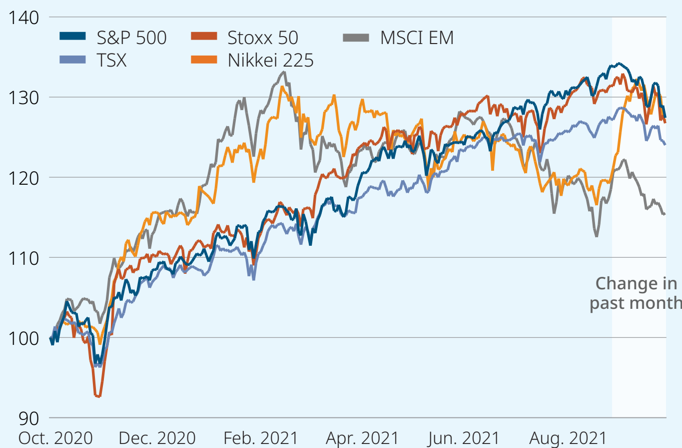
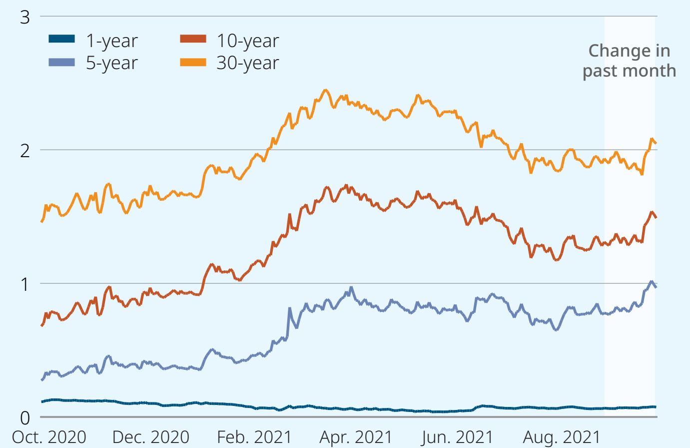
# Capital markets update

- After bull flattening in the hours following Fed Chair Powell's press conference on September 22, during which he hinted at a November taper, the **US yield curve** shifted up in subsequent days. The taper allusion and the publication of a more hawkish dot plot – a chart showing policymakers' rate expectations -- pulled forward expectations for the Fed's initial rate hikes. Covid cases rolling over in the US could also have contributed to higher long-term yields.
- **Japanese stocks** gained close to 8% in September, outpacing all other major equity indices. The Nikkei's surge in early September is partly explained by now-former Prime Minister Suga announcing his resignation for having failed to control the Covid pandemic in the country. Investors are betting that Suga's replacement, former Policy Minister Fumio Kishida, will expand government spending.
- **Emerging market equities** underperformed in September, dragged down in part by signs of weakness in the Chinese economy, including the Evergrande solvency fear (see Global macro update) and an energy "shortage". The power crunch is caused both by real constraints – soaring coal and natural gas prices are pushing power plants to slow outputs – and imposed curbs, as regulators force industrial producers to limit emissions.

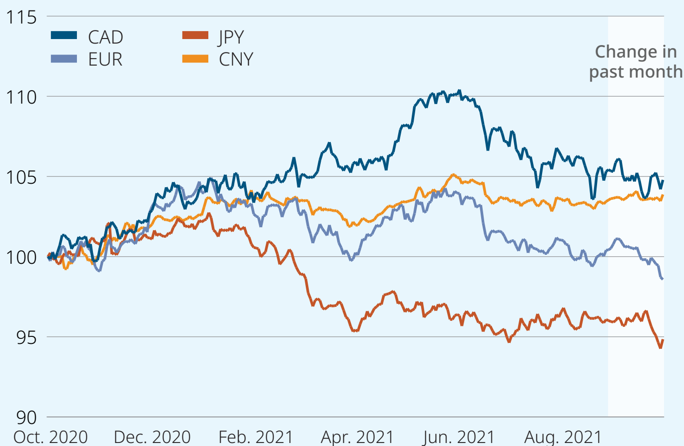
### Equity indices (one year ago=100)



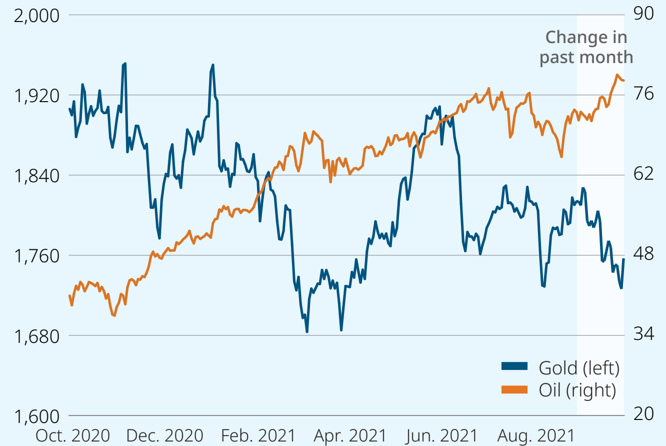

### US Treasury yields (%)




### Currencies (relative to USD, one year ago=100)




### Commodity prices (in USD)




Notes: Financial data from Bloomberg as of September 30, 2021.

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# What we'll be watching in October

### October 8: US nonfarm payrolls release

- August payrolls disappointed in the US, as only 235k jobs were created across the country (vs. 733k forecasted). Upwards revisions to previous months softened the blow in the overall employment picture, but on net the surprise was negative for labour markets.
- Since then, Covid cases have peaked in a large majority of US states, which may foreshadow a rebound in employment in September (+513k forecasted in Bloomberg survey), especially with job openings at an all-time high.

### October 27: Bank of Canada rate decision and Monetary Policy Report

- The Bank of Canada kept its rate and pace of asset purchases unchanged at its last policy decision on September 8.
- We expect the Bank to announce a new round of tapering, moving to $1 billion of weekly asset purchases, down from the current pace of $2 billion/week. In a recent speech, Governor Macklem pledged that the Bank of Canada would keep the size of its bond portfolio constant, rolling over maturing bonds, for the foreseeable future. The Bank will begin shrinking its balance sheet only after the rate hike cycle has begun.

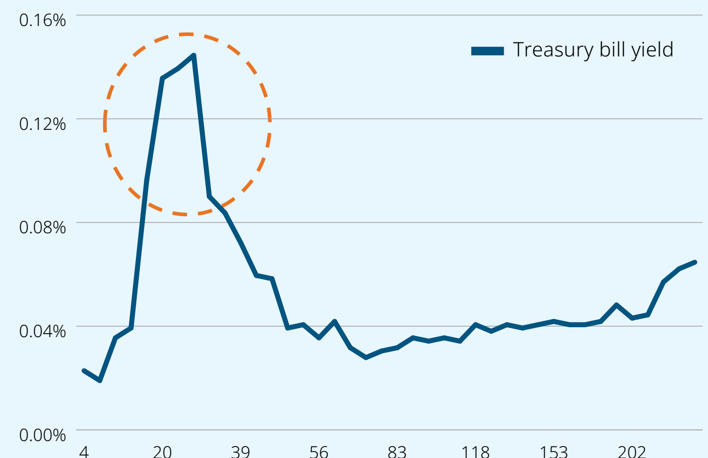
### October 28: European Central Bank rate decision

- With its counterparts in the US, Canada and the UK taking baby steps towards tightening, all eyes now turn to the ECB. Inflation averaged 3% in the Eurozone in August, which could push the ECB to discreetly suggest the possibility of a de-facto taper when its emergency pandemic QE program expires in March 2022.

# Emerging theme

- **The looming debt ceiling crisis** could see the US Treasury run out of funds as soon as October 16, although uncertainty around tax receipts muddles the picture.
- The **Treasury bill market** reflects this risk, as yields are a few basis points higher for bills maturing between mid-October and end-November, as investors shun maturities that risk not getting paid if Congress cannot come to an agreement to lift the ceiling. In fact, the discount in that portion of the yield curve might even be *understated*, as Treasury has slashed its issuance of bills maturing around its estimated debt crisis deadline.
- To delay the deadline, we expect Treasury to run down its cash account at the Federal Reserve to fund government spending. The resulting inflow of reserves in US banks, combined with the T-Bill default risk, may push banks to stash their excess reserves in money market funds and/or the Fed's reverse repo facility, paradoxically putting **downward pressure on short-term rates.**
- A **failure to lift the ceiling** would likely only be temporary, but the resulting technical default on US government bonds would deal a serious blow to Treasury debt's standing as the "global safe asset".

**T-bill curve shows discount for "debt ceiling" maturities**




Notes: Via Bloomberg as of October 1, 2021.

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# Appendix:
# Capital market returns in September

| Category | Index | Return |
|---|---|---|
| Major Asset Classes | Global Equity | -3.69% |
| | Global Bonds | -1.78% |
| Regional Equity (local) | S&P 500 | -4.65% |
| | TSX | -2.01% |
| | Nikkei | 5.50% |
| | FTSE 100 | -0.16% |
| | EuroStoxx 50 | -3.41% |
| | MSCI EM | -3.97% |
| Styles | US Small Cap - Large Cap | 1.75% |
| | US Value - Growth | 2.02% |
| Sovereigns | USA 10-year Treasury Future | -1.38% |
| | CAN 10-year Gov't Bond Future | -2.04% |
| | GBR 10-year Gilt Future | -2.41% |
| | DEU 10-year Bund Future | -1.59% |
| | JPN 10-year JGB Future | -0.49% |
| Fixed Income | US High Yield Bonds | 0.03% |
| | US Investment Grade Bonds | -1.30% |
| | US Leveraged Loans | 0.63% |
| | CA Provincial Bonds | -1.80% |
| | CA Corporate Bonds | -1.06% |
| | CA Inflation-Linked Bonds | -1.72% |
| Alt | Gold | -3.12% |
| | Oil | 9.64% |
| | Global REIT | -6.14% |
| | Global Infrastructure | -3.44% |
| FX Spot | CAD/USD | -0.52% |
| | GBP/USD | -2.04% |
| | EUR/USD | -1.94% |
| | JPY/USD | -1.14% |

-8 -4 0 4 8 12

Notes: Market data from Bloomberg as of September 30. Index returns are for the period: 2021-09-01 to 2021-09-30. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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