International Commentary — April 21, 2021

Bank of Canada Tapers, But Few Tantrums

Summary

- Matching widespread expectations, the Bank of Canada (BoC) opted to taper asset purchases by reducing the weekly purchases target to C$3 billion at its monetary policy meeting. We interpret today's announcement and Monetary Policy Statement as being relatively hawkish, as the BoC also expects the economic recovery to be stronger than its previous forecast suggested.
- With the economy expected to grow at a quicker pace and measures of inflation close to or above the BoC's 2% target, the central bank has been gradually scaling back monetary policy accommodative. To that point, more view more optimistic BoC growth forecasts as consistent with our view the BoC will start hiking policy rates in Q3-2022.
- In addition to monetary policy, the government's latest budget was released this week with indications of continued fiscal support. A combination of tighter monetary policy and easier fiscal policy is typically the most supportive backdrop for currencies, and we view these developments as supporting our view for a stronger Canadian dollar over the medium-term.
- As of now, we forecast the USD/CAD exchange rate to reach CAD1.1800 by the middle fo next year, while the balance of risks are tilted toward a faster pace of Canadian dollar appreciation.

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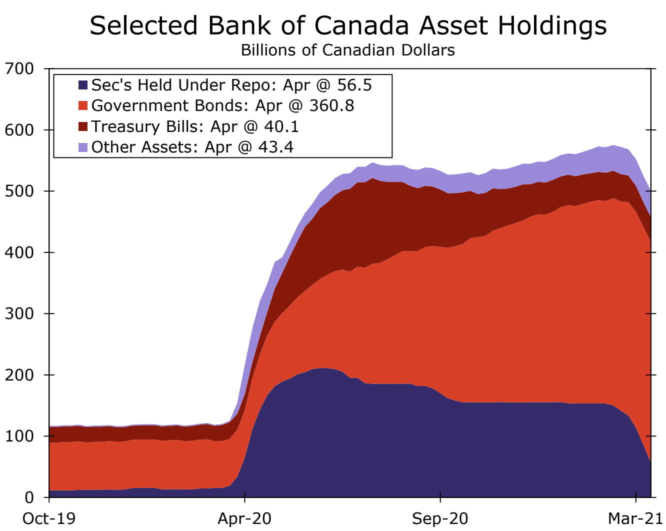
Bank of Canada Scales Back Bond Purchases, Signals Eventual Rate Hikes

In a widely expected move, the Bank of Canada (BoC) adjusted its monetary policy stance at today's announcement, saying that from late April it would reduce its weekly pace of net Canadian government bond purchases to C$3 billion per week, from the current pace of C$4 billion per week. The central bank also held its policy interest rate steady at 0.25%.

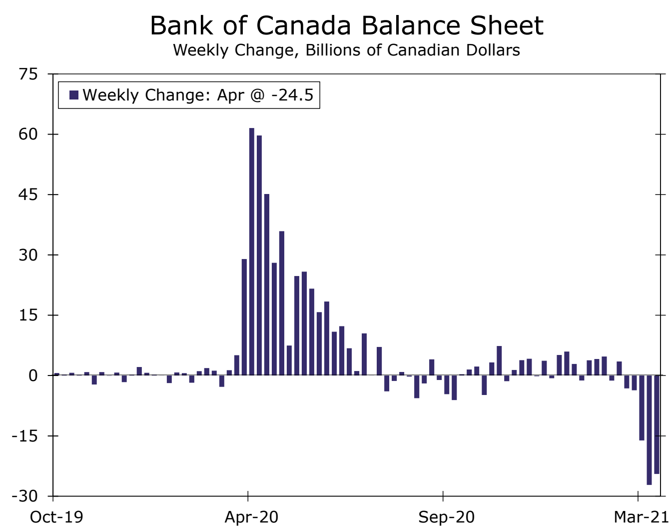
Nonetheless, in totality the BoC's announcement and accompanying Monetary Policy Statement was hawkish in tone. While acknowledging a new wave of COVID infections, the central bank still said it expects the economic recovery to be stronger than it forecast in January. In particular, Q1-2021 GDP growth looks to be much stronger than expected. For full year 2021, the BoC forecasts GDP growth of 6.5% (compared to a forecast of 4.0% in January), before GDP growth moderates to 3.7% in 2022 and 3.2% in 2023.

Given the stronger growth profile, the Bank of Canada now sees spare capacity within the economy being absorbed some time during the second half of 2022, earlier than its previous January forecast of 2023. That earlier return to the economy's productive potential is significant as the BoC has said it will not raise interest rates until economic slack is absorbed. Accordingly, the updated projections signal the possibility of rate increases beginning in the second half of next year (which would be in line with our own forecast for an initial rate hike in Q3-2022). With underlying inflation measures close to or above the central bank's 2% inflation target, CPI is another reason to expect a further move towards Bank of Canada monetary tightening over time.

While the reduced pace of bond purchases is the latest policy adjustment, it comes after several previous announcements that had seen a paring back of non-conventional policy measures. For example, the BoC has already scaled back its repo operations and discontinued many of its other asset purchases programs. As a result, the size of the Bank of Canada's balance has already fallen noticeably in recent weeks. The bottom line is that the Bank of Canada is already well along the path of moving towards less accommodative monetary policy.



Source: Bloomberg LP and Wells Fargo Securities



Source: Bloomberg LP and Wells Fargo Securities

Canadian Government Maintains Fiscal Policy Support

The Bank of Canada is not the only significant policy announcement this week, with the Canadian government releasing its 2021 Budget on Monday. We view that Budget announcement as supportive of the Canadian currency, and indeed Canadian economic growth. The federal government announced C$101 billion in new fiscal measures over the next three years, or approximately 1.5% of GDP per year. The most notable item is C$30 billion over five years for a national daycare system, while the government also extended COVID-related wage and rent subsidies until September. With the measures, the government projects a C$155 billion deficit this year, or around 6.4% of GDP, narrowing to a deficit of around 1.3% of GDP over the next four years.

With respect to the Canadian dollar, a tight monetary policy/easy fiscal policy mix is often considered the most currency supportive combination. While we are far from that mix in absolute terms, this week's announcements at least represent a move towards tighter monetary policy and easier fiscal policy. As a result we view this week's policy moves as entirely consistent with our constructive medium-term Canadian dollar view. Our base case currently anticipates the USD/CAD exchange rate reaching CAD1.1800 by mid-2022 though, as we noted in our March *International Economic Outlook*, we view the risks as tilted towards a faster pace of Canadian dollar appreciation.

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