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The Bank of Canada to Tighten Monetary Policy... Over Time

As is customary at this time of the year, the Bank of Canada released its Monetary Policy Report this morning. It contains the Bank's latest observations and projections for the global and Canadian economies and for inflation.

Highlights

- ✓ According to the Bank of Canada's estimates, the Canadian economy is nearing its production capacity faster than expected.
- ✓ The Bank of Canada expects 4.6% real growth in the US GDP in 2004, 3.7% in 2005, and 4.1% in 2006. This is a fairly optimistic scenario compared to our projections and the consensus of forecasters.
- ✓ Monetary authorities expect real growth in Canada's GDP to be slightly under 3% in 2005 due to the adverse impact of the rise in oil prices and the loonie's appreciation; it should be slightly above 3% in 2006. The Canadian economy will thus remain at close to production capacity until 2006.
- ✓ Ongoing strong growth in domestic demand is expected to make a significant contribution to economic expansion until the end of 2006. Business investment should intensify, particularly for companies exposed to international competition. Canadian business confidence remains high, especially in western Canada, which attests to some regional disparity. It must be noted that the increase in oil prices is of great benefit to western businesses, whereas Ontario and Québec manufacturers will have to deal with the challenge of the loonie's sharp appreciation.
- ✓ Since the Canadian economy will be operating at close to full capacity in the coming quarters, inflationary pressures should remain small. The Bank of Canada expects core inflation (according to the CPI-X) to move back to 2% by the end of 2005. Also, note that the Canadian dollar's rise will put slight downward pressure on core inflation. For its part, total inflation should be affected by the flip flops in energy prices, nearing the upper part (3%) of the Bank of Canada's target range at the beginning of 2005, and subsequently come back down.
- ✓ Consequently, the monetary tightening process will go forward over time, and further key interest rate hikes will be announced by 2006. But the size and speed of monetary tightening will depend on the Canadian economy's response to external blows.
- ✓ There are still many uncertainties. What impact will the loonie's appreciation have on foreign trade? What impact will the surge in oil and raw materials prices have on world economic growth? How will the current account imbalances in the United States and East Asia be corrected? What will happen with the geopolitical climate? The Bank of Canada's projections are consequently fraught with sizeable risks and uncertainties.

Conclusion: a scenario marked with sizeable risks

First, it is difficult to reconcile the Bank of Canada's outlooks. On the one hand, the monetary authorities are fairly optimistic about economic growth in the United States, which should have positive repercussions for our exports. On the other hand, the monetary authorities are betting that Canadian business will quickly adjust to the Canadian dollar's appreciation and significantly increase their investments. Domestic demand should thus continue to be strong. In the end, we could think that this scenario paints a very positive picture of the Canadian economy. However, the Bank's outlook for real Canadian GDP is fairly modest, with forecast growth slightly below 3% in 2005, well below our most recent economic scenario.

It thus seems the monetary authorities have opted for caution by including risks and uncertainties in their report. Although the Bank of Canada is firm in promising further key rate hikes, the evolution of risk factors (oil, the Canadian dollar and global demand) will be determinant for the extent and speed of monetary tightening. In the short term, nothing points to a pullback in oil prices and Canada's currency, so the Bank of Canada could choose to take a break for prudence's sake.