BANK OF CANADA

Monetary Policy Report: The Bank of Canada tempers its forecast slightly
But this will not prevent it from pursuing monetary tightening

ACCORDING TO THE BANK OF CANADA (BoC)

• The fact that households, banks and governments in some advanced economies are giving more attention to budget cutting should result in a slower rate of growth in the global economy than what the BoC was forecasting last April. In the United States, real GDP growth will be a little weaker than predicted due to the repercussions of the sovereign debt crisis in Europe and the slower turnaround in private domestic demand.

• Canada’s economic activity has for the most part progressed as expected, boosted by public and consumer spending.

• Canadian financial markets have been relatively resilient to the tensions on international markets. In particular, the bank financing markets have been barely affected by the pressures weighing on global short-term financing markets. Overall, financial conditions have remained favourable in Canada and have thus provided ongoing support to the economic recovery.

• Given the slight deterioration in the outlook for global economic growth and more modest growth in consumption domestically, the BoC now anticipates that the recovery will be more gradual in Canada than it had predicted in April.

• The monetary authorities are calling for Canadian real GDP to increase by 3.0% (at an annualized quarterly rate) in the second quarter of 2010, instead of the 3.8% that was forecast last spring.

• For the year 2010, the BoC expects real GDP growth to reach an average of 3.5%, after which it will slow gradually to 2.9% in 2011 and 2.2% in 2012.

• The Canadian economy should reach full potential by the end of 2011, two quarters later than projected.

• Inflation—in terms of both the total consumer price index and the core index—should remain close to 2% throughout the forecast period. It should be noted that the BoC will rule out the temporary effects on inflation stemming from changes to the indirect taxes collected by the provinces.

• The BoC feels that the risks prevailing over the projection period are fairly balanced.

COMMENTS

Even though most private analysts have, in recent months, upgraded their forecasts about Canadian real GDP in 2010 (in particular due to the evident vitality of domestic demand), the forecasts that the BoC issued last April were among the most optimistic. This new version of the Report allows the monetary authorities to make some adjustments and revise their forecasts downwards slightly. At 3.5%, the BoC’s prediction for Canadian real GDP growth for this year is now consistent with the most recent consensus of private forecasters. The same holds true for next year: the increase of 2.9% anticipated by the monetary authorities is comparable to the average predictions of other forecasters (+2.8%).

That being said, recent trends in economic indicators show that the apprehended slowdown in Canadian economic growth in the second quarter of 2010 may be more pronounced than initially anticipated. For example, retail sales fell by 0.2% last May, following a decline of 2.2% last April. Combined with the disappointing numbers of several other economic indicators in recent weeks, this paints a rather gloomy picture of the Canadian economy during the month of May, to the point where real GDP by industry could show practically zero growth in that month. If we add to that the decline of 0.03% observed in April, the carry-over achieved in the second quarter as a whole amounts to a mere 1.5%. In that context, the rise of 3.0% predicted by the BoC seems somewhat on the high side.

In general, the BoC seems well aware that economic growth will decelerate significantly in this country in the coming quarters. We must admit that the real GDP increases of 4.9% in the fourth quarter of 2009 and 6.1% in the first quarter of 2010 were extraordinary. A return to a pace of growth closer to the historical average is inevitable. It must be said that the real estate market, as expected, is showing signs of...
losing steam, and that the effect of government stimulus plans will gradually wear off. Therefore, average real GDP growth may hover around 3% in the next few quarters. That rate of growth remains far above that of the potential of the Canadian economy, estimated at 1.5% for 2010 by the BoC.

In these conditions, the negative output gap that currently prevails will gradually be absorbed between now and the end of next year. To prevent the development of inflationary pressures, the monetary authorities will no doubt wish to continue raising the key interest rates in this country. With a target for the overnight rate at 0.75%, the monetary conditions are still quite relaxed. In fact, if we assume that inflation stays around 2% as the BoC is predicting, the target for the overnight rate would have to be raised to slightly over 2% in order for short-term interest rates, expressed in real terms, to get back into positive territory. As the BoC mentions in its Report, its inflation projection “includes a gradual reduction in monetary stimulus consistent with achieving the inflation target.”

In short, we should expect further hikes in Canadian key interest rates in the months ahead. A pause is still anticipated starting in mid-2011, when the target for the overnight rate will have reached 2.50%—a rate that is slightly positive when expressed in real terms. Still, we cannot rule out the possibility of an earlier break in the current cycle of monetary tightening in the event of further deterioration in the global, American and Canadian economic outlooks.

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