Monetary Policy Report: The BoC downgrades its outlook substantially

Key interest rates will remain steady for several months

According to the Bank of Canada (BoC)

- The global economic recovery is entering a new phase, with the growth outlook weaker, reflecting the broad forces of household, bank and sovereign deleveraging. In the United States, the growth outlook is weaker than was anticipated in July due to the delayed recovery of the U.S. labour market, more protracted weakness in housing and a slightly more modest contribution from exports. Growth in emerging economies is expected to ease to a more sustainable rate.

- The economic outlook for Canada has changed as well. The economy is entering a period of more modest growth, following the robust expansion of domestic demand since mid-2009. The change reflects a more gradual global recovery and a somewhat more subdued profile for household spending. The BoC expects the composition of demand to shift away from government and household expenditures towards business investment and net exports. Among other things, the monetary authorities expect household debt considerations to become more important and, as a result, household expenditures to decelerate to a pace closer to the rate of income growth.

- According to the BoC, Canadian real GDP is projected to grow by 3.0% in 2010, 2.3% in 2011 and 2.6% in 2012.

- Canada's economy should return to full capacity by the end of 2012 rather than the beginning of that year, as had been anticipated in July.

- The inflation outlook has been revised downward. Both total consumer price index (CPI) inflation and core inflation are expected to converge at 2% by the end of 2012, as excess supply is gradually absorbed.

- This projection includes a gradual reduction in monetary stimulus over the projection horizon.

- Any further reduction in monetary policy stimulus would need to be carefully evaluated.

- The BoC judges that the risks to inflation are roughly balanced.

Comments

Based on the outline of the BoC’s new economic scenario released yesterday in the statement accompanying the decision to keep the target for the overnight rate at 1.00%, the new version of the Monetary Policy Report does not really feature any surprises. Yesterday, many investors were stunned by how much the BoC downgraded its economic outlook. Note that the previous scenario from Canada’s monetary authorities had been issued in July and economic conditions have deteriorated substantially since then. Most forecasters have gradually trimmed their growth outlooks over the last few months. With these adjustments, the BoC’s projections are now much more consistent with the latest consensus by forecasters.

Recent movement by the economic indicators shows a hesitant recovery in the United States and the rest of the world; the signs that Canadian domestic demand is flagging have proliferated in the last few weeks. The Canadian economy’s growth outlook is being hit on two fronts, that is, slower growth by consumer spending and government...
expenditures, and a clear deceleration by foreign trade. Given these uncertainties, the decision to keep the overnight rate at 1.00% is completely justified.

That said, the BoC is clear: further increases to the target for the overnight rate can be expected, as their economic scenario points to some acceleration by growth in 2011. The main assumption behind its projections involves a substantial improvement by net exports. This is a fragile scenario given the major uncertainties associated with exchange rate fluctuations and global demand’s ability to pick up a lot of speed. Among other things, how will the Canadian dollar move if some central banks (especially the Federal Reserve) put forward new quantitative measures? What will the consequences be for the relative value of the currencies that are currently the subject of many negotiations worldwide?

If everything goes as forecast, we must nonetheless expect Canadian key interest rates to go up further in 2011. The fact is that there is still considerable monetary stimulus. In our view, the current uncertainties could have eased sufficiently by next spring to allow a return to monetary firming. However, the risk of disappointment remains elevated, a situation that could potentially postpone the new key rate increases. As the BoC is clearly engaged in a gradual monetary firming cycle, i.e. one that is punctuated by pauses, we can rule out the possibility of taking a step back with cuts to the target for the overnight rate. It would take results that point to another recession in Canada for this possibility to be considered, a scenario that is quite unlikely at this point.

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