BANK OF CANADA

Monetary Policy Report: The Bank of Canada is a little more optimistic however, key interest rates will remain unchanged for a few more months

ACCORDING TO THE BANK OF CANADA (BoC)

• The global economic recovery is proceeding at a somewhat faster pace than the BoC had anticipated in its October Monetary Policy Report. Private domestic demand in the United States has picked up and will be reinforced by recently announced monetary and fiscal stimulus. Real GDP in the United States is projected to rise by 3.3% in 2011 and 3.2% in 2012. The global recovery, however, continues to be affected by a number of significant challenges. The broad forces of household, bank and sovereign deleveraging will continue to restrain growth in many advanced economies.

• The recovery in Canada is proceeding broadly as anticipated, with a period of more modest growth. Demand in Canada is expected to rely relatively less on household and government expenditures and more on business investment and net exports. The projected increase in net exports’ contribution to growth is supported by the improved near-term outlook for U.S. and global economic expansion. However, the cumulative effects of Canada’s poor relative productivity performance and the persistent strength of the Canadian dollar have eroded Canada’s competitiveness and are restraining the recovery in net exports.

• Growth in consumer spending is expected to evolve broadly in line with that of personal disposable income over the project horizon. The government’s recently announced mortgage insurance measures will contribute to a more balanced path for household expenditures.

• According to the BoC, Canadian real GDP is projected to grow by 2.9% in 2010, 2.4% in 2011 and 2.8% in 2012.

• The BoC continues to expect that the economy will return to full capacity by the end of 2012.

• The outlook for inflation has not changed much. Core inflation is projected to edge up to 2% by the end of 2012, as excess supply in the economy is slowly absorbed. Total CPI inflation is projected to remain slightly higher than the 2% target over the first half of 2011, as the HST and other changes in provincial indirect taxes continue to boost the 12-month rate of change in consumer prices.

• This projection includes a gradual reduction in monetary stimulus over the projected horizon. Any further reduction in monetary policy stimulus would need to be carefully considered.

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

COMMENTS

The BoC is slightly more optimistic compared with the projections set out in its October Monetary Policy Report. Among other things, Canada’s monetary authorities seem convinced that the recent monetary and fiscal policies will substantially stimulate growth in the United States. The forecast for U.S. real GDP has thus been raised substantially for 2011, from 2.3% to 3.3%. In our opinion, this upswing in confidence in the U.S. economy could be a little exaggerated. For one thing, several of the new fiscal measures the U.S. government has announced recently in fact consist in extending existing policies. This means that the additional impact on U.S. economic growth could be slighter than anticipated. For another, even excluding the contribution from government measures, the BoC is expecting U.S. real output to grow fairly substantially in 2011. However, given the job market’s slow recovery and persisting problems in the real estate market, U.S. private demand could stay fairly weak again this year.

For Canada, the monetary authorities have trimmed their real GDP growth projections for the fourth quarter of 2010 and first quarter of 2011. However, they increased them for the remaining quarters of 2011. All in all, the BoC’s projections for Canada’s real GDP have not changed much for 2011. The monetary authorities anticipate a slimmer contribution from consumer spending, as the issue of household debt loads is a growing source of concern. Housing and government

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Expenditures could eventually curb growth due to a lull in the real estate market and the withdrawal of stimulus plans. However, a number of factors, including advantageous financial conditions, will continue to foster sustained growth in businesses’ non-residential investment. We share this vision of Canada’s economy.

On the other hand, the rise in net exports the BoC is anticipating seems daring. Firstly, it is clear that Canadian exports will not advance as quickly if U.S. economic growth proves disappointing in 2011. As stated earlier, we are not ruling this out. Secondly, with a dollar that is close to parity and dismal productivity performance from businesses, the competitiveness of Canadian businesses is sorely tried. Under these circumstances, it is likely that the problems in exports will persist in the coming quarters.

In short, we must conclude that numerous uncertainties continue to surround the evolution of the global and Canadian economies. For prudence’s sake, the monetary authorities should therefore wait until July before returning to monetary firming. Note that core inflation is highly stable, giving the BoC some leeway in conducting its monetary policy.

That said, we cannot rule out the possibility that Canadian key interest rates will be raised earlier—next spring—in the event of a more robust global (especially U.S.) economic recovery and stronger Canadian demand than forecast.

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