BANK OF CANADA

Monetary Policy Report: Full production capacity could be reached sooner than expected
Key rates should rise in the months ahead

ACCORDING TO THE BANK OF CANADA (BoC)

• The global economic recovery should maintain a sustained pace until the end of 2013. In the United States, the gradual firming and broadening of private demand should support the economic expansion. However, the rise in energy should dampen advances in household spending slightly. In Europe, domestic demand will be stifled by efforts to restore fiscal balance, persistent concerns about the public finances of fringe nations and rising oil prices. That said, net exports should greatly contribute to ramping up activity, fuelled by strong demand in China and other trade partners. In Japan, growth should post a marked slowdown in 2011, given the winding down of budget stimulus initiatives, the yen’s previous appreciation and production declines due to the recent earthquake and subsequent tsunami.

• In Canada, economic activity was stronger than expected these past few quarters, but the pace of growth should be more modest going forward. The Bank of Canada expects overall demand in Canada to keep shifting during the forecast period from public administrations’ and household spending to corporate investment and net exports.

• Improvements in the terms of trade should have a somewhat stimulating effect on household incomes during the target period, helping increase household wealth. These favourable factors should translate into a consumer spending profile that is somewhat more upbeat than expected in January.

• The Bank continues to expect improvements in net exports over the projection period, namely due to the increase and expansion of exports related to the turnaround in international merchandise trade, and from the slowing pace of import growth. However, the Bank still expects the recovery in exports to be moderate compared to the rates posted in previous economic recoveries, since the higher Canadian dollar is intensifying the challenges of Canada’s competitiveness.

• The disaster that hit Japan is affecting other economies through commercial and financial ties, as well as commodity prices. Since the earthquake, Canada’s automobile manufacturers have had trouble getting supplies, and this has cut into production and the number of hours worked. These difficulties should cut the pace of Canada’s economic expansion by about half a percentage point in the second quarter of 2011, but any activity lost will probably be recouped in the quarters to come. Over the longer term, the reconstruction efforts in Japan, once they begin, will stimulate growth—and worldwide demand—for commodities.

• The BoC expects Canada’s economy to post an expansion rate of 2.9% in 2011 and 2.6% in 2012.

• The BoC expects the economy to resume full capacity by mid-2012, or two quarters ahead of what was forecast in January 2011.

• Inflation as measured by the core index was slightly lower than expected these past few months, but it should bounce back to 2% somewhat faster than the BoC had anticipated last January. The monetary authorities forecast that the total CPI’s pace of growth will reach about 3% in the second quarter of 2011. Inflation measured by the total CPI should converge with inflation measured by the core index at the 2% target by mid-2012, once energy prices have stabilized.

• This projection includes a reduction in monetary easing, which should take place gradually during the forecast period.

• The Bank considers that the risks weighing on inflation outlooks are relatively balanced.

COMMENTS

In a move that surprised no one, the BoC raised its forecast for Canada’s real GDP in Q1 2011. At 4.2%, this projection from the monetary authorities nevertheless appears somewhat conservative. With a 0.5% increase in real GDP by industry in January, the carry-over effect for the first quarter is close to 4.5%. Unless February or March sees declines in production, all signs point to a real GDP that is stronger than forecast by the BoC.

In contrast, real GDP advances in Q2 2011 may be a bit weaker than initially forecast. The problems in Japan are having an impact on supply chains around the world. Canada has not been spared, especially its automobile industry. These
jolts should be temporary, however, and their impact on Canada’s path to growth should be quite negligible in the end. As such, the BoC expects Canada’s real GDP to rise by 2.9% in 2011, representing a clear upward revision vs. the 2.4% originally forecast in January. Real GDP growth for next year has been revised downward slightly, but the downtick is much more modest: from 2.8% to 2.6%.

These projections take into account that the strong loonie will probably lead to a marked slowdown in Canadian exports. In addition, even if rising energy prices may rein in global economic growth to a certain extent, strong demand for commodities is not entirely bad news for Canada. This usually leads to a positive wealth effect, which spurs consumer spending and investment. In fact, the total impact on the Canadian economy will depend largely on the persistence of the shocks we are experiencing right now. On this front, the recent pullback in oil prices over the past few days is somewhat reassuring.

In the end, in spite of any major jolts we may see in the months ahead, the forecasts for Canada’s economy remain quite positive. As a result, we will reach full production capacity much sooner. We can therefore understand the monetary authorities who want to start raising key rates gradually in the coming quarters. In fact, we can count on the BoC to seize the very first opportunity it sees to start normalizing its monetary policy.

The question we now have to ask is: When will this opportunity occur? Will it be this May, in July or later this year? That will depend on how several risk factors unfold, with commodity prices and Canada’s currency at the top of the list. In our opinion, the current uncertainties may ease enough to see a first increase in Canada’s key rates in May.

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