BANK OF CANADA

Monetary Policy Report: The BoC’s scenario is still relatively optimistic

Key interest rates may be raised by the end of 2011

ACCORDING TO THE BANK OF CANADA (BoC)

• Global economic expansion is unfolding mainly as expected, with modest growth in the large, advanced economies and robust expansion in the emerging countries.

• In the United States, the economy has posted slower-than-expected growth, and it continues to be held in check by household balance sheet clean-up and moderate job growth. On the bright side, real GDP growth should firm up in the second half of 2011 and in 2012. Furthermore, consumption should advance at a stable pace of around 2% until the end of 2013, thanks to gradual recovery in the job market which will more than offset the moderating effect of the current household balance sheet clean-up and the pressure on individuals’ disposable income stemming from budget stabilization.

• In Europe, the budget austerity measures that are necessary in a number of countries will curb expansion over the projection horizon. Moreover, the budgetary and financial stresses associated with the debt crisis will likely have greater impact on the region’s outlook for growth in the next three years. In its projection, the BoC assumes that the authorities will be able to contain the sovereign debt crisis in Europe, even though clear risks are associated with that outcome.

• In Japan, a recovery boosted by reconstruction efforts is projected. In China, real GDP growth should remain vigorous, but it could slow down in 2012 and 2013 due to monetary firming and further appreciation of the Chinese currency’s real exchange rate.

• In Canada, economic expansion is by and large consistent with forecasts. The BoC estimates that economic growth slowed abruptly to 1.5% in the second quarter of 2011; this deceleration is a little more pronounced than what was predicted in April.

• Canada’s economic growth should rally in the second half of 2011, once supply chain disruptions are resolved, and then slow down closer to its potential during the projection horizon. The BoC still predicts that, during this period, overall demand in Canada will continue to move away from household and public-sector spending and towards fixed business investment and net exports. Thus, the BoC is still counting on improvement in net exports thanks to a recovery in exports linked to stronger international merchandise trade demand, and a deceleration in import growth linked with more moderate expansion of domestic demand. However, the recovery in exports will likely be modest, as Canada is still grappling with competitiveness problems arising mainly from the persistent strength of the loonie.

• Real GDP should rise by an annual average of 2.8% in 2011 and 2.6% in 2012; then, in 2013, the pace of expansion is expected to taper off to 2.1%. Production should return to full potential by mid-2012.

• Even though transitory factors are likely to push the core inflation index slightly above 2% for a while, the BoC expects that core inflation will stick at around 2% during the projection horizon. In the coming quarters, the BoC anticipates that the total consumer price index (CPI) will relax the pace of its ascent compared with the high level recorded recently, in particular due to the disappearance of repercussions that the introduction of the HST (harmonized sales tax) in July 2010 had on the annual variation. Furthermore, energy prices, after falling back from their peak, should remain relatively stable and increase only slightly. Therefore, it is still expected that inflation as measured by total CPI will converge with inflation as measured by the core index towards the 2% target by mid-2012.

• The BoC’s projection includes a gradual move away from monetary easing through the projection horizon, in a manner that is compatible with reaching the inflation target.

COMMENTS

The new version of the BoC’s economic and financial scenario presents little change from the prognosis issued last April. Moreover, the growth forecasts for the Canadian economy are similar to those issued by the majority of private forecasters. Nonetheless, this vision of the Canadian economy is relatively optimistic. Among other things, it assumes that the numerous swings that have impeded Canadian and global economic expansion in recent months will settle down significantly in the second half of 2011. It is with this scenario in mind that the monetary authorities are expressing willingness to resume raising key interest rates.
If we focus on the Canadian situation alone, many factors are already supporting an increase in the overnight rate. The total annual inflation rate is above the upper target; the labour market is doing quite well; economic growth is maintaining a relatively fast pace, to the point where the surplus supply will likely be absorbed within a year. Moreover, keeping interest rates at such an historically low level is promoting some imbalances, as shown by the high level of household debt.

However, Canada’s economy is very open to the world; therefore, the BoC must also take what is going on abroad into consideration. We must not lose sight of the fact that many of the risks currently hanging over the global economy are still on the downside. The sovereign debt problems in Europe could be prolonged, and could even spread. The public finances crisis in the United States could take longer to iron itself out. Moreover, the acceleration in economic growth in the United States, expected by mid-2011, might disappoint us, given that recent trends in several U.S. indicators show that some problems have not been resolved. In particular, the job market is struggling to create employment, and improvement in the job market is critical to any definite improvement in economic conditions in the United States.

Given the circumstances, we should expect the BoC to wait a few more months before raising its key interest rates, to allow time for the numerous problems that are currently hindering the global economy to subside to a sufficient degree. An initial hike in the target for the overnight rate could be ordered before the end of this year.

Benoit P. Durocher
Senior Economist