The global economy has suffered a sharp downturn, and several of the downside risks discussed in July’s Monetary Policy Report have materialized. The acute financial and budget difficulties in Europe and concerns about the vitality of global economic activity have led to increased volatility on financial markets, a drop in corporate and consumer confidence and a widespread decline in risk appetites.

In the euro zone, financial strains, the decline in banks’ ability to leverage debt, budget austerity measures and eroding confidence will cause a slight recession as of the end of 2011. In its benchmark scenario, the BoC assumes that the crisis in the euro zone will be contained and additional measures will be adopted to ensure the sustainability of its debt, strengthen capital reserves held by banks and create a bigger and more effective fund to stabilize, at viable levels, the financing costs of the sovereign countries affected. This assumption is tainted with downward risks.

In the United States, real GDP growth should remain weak until the first half of 2012. U.S. economic growth should, however, firm up gradually as of the second half of 2012, provided that monetary conditions are softened and the situation in Europe improves.

In Canada, the economic outlook has darkened, given the global economy’s stark deterioration. The weaker and more uncertain global economic and financial situation will affect Canada’s economy through financial channel, confidence and merchandise trade. The BoC therefore expects final domestic demand and exports to post more modest growth throughout the forecast period.

Overall, the BoC anticipates real GDP expansion in Canada to be slow until mid-2012. Growth should improve thereafter, in line with a more vital economic situation internationally. Canada’s real GDP is expected to expand by 2.1% in 2011, on average, followed by a 1.9% gain in 2012 and 2.9% rise in 2013.

A weaker economic outlook translates into greater and persistent excess production capacities. Canada’s economy should, however, get back to its full potential by the end of 2013.

The BoC expects inflation, as measured by its core index, to remain around 2% in the short term, before it starts to trend downward throughout 2012. The core index should rise back to 2% by the end of 2013. The BoC expects inflation, as per the global consumer price index (CPI), to continue to fall over the next few quarters, given the gradual impact of sliding oil prices on gas prices. Inflation, as measured by the global CPI, should decline to around 1% by mid-2012 before edging up back to the 2% by the end of 2013.

The BoC’s projection includes a gradual reduction in monetary stimulus over the projection horizon, consistent with achieving the inflation target.

**COMMENTS**

The BoC’s downgraded forecast comes as no surprise. July’s projections quickly became overoptimistic considering the deterioration in Europe’s budgetary and financial situation, disappointing results in the U.S. and heightened volatility in financial markets. The BoC’s new scenario is much more in line with the latest consensus of private forecasts.

The main issue in the coming quarters is obviously Europe. Negotiations are still underway all around and everyone is betting that the situation will more or less get worked out in the quarters ahead, although the problem will take years to fully resolve. That said, many uncertainties remain and, as the BoC rightly states, there is a significant downside risk to the economic projections.

Since Canada is a very open economy, it is feeling the fallout of the current slowdown in Europe and the U.S. This is especially true where international merchandise trade is concerned. What’s more, the Conference Board’s consumer confidence index continued its downward trend in October and is now at its lowest level since July 2009. We can therefore expect consumer spending to grow modestly in the quarters ahead.

As for inflation, the monetary authorities don’t seem overly concerned by the fact that total inflation is over its target and that core inflation is rising and reached 2.2% in
September. In fact, the BoC believes inflation will slow in the next few months as a result of the negative output gap and a reduction in gas prices. Under these circumstances, the BoC certainly feels that it has considerable leeway in its monetary policy.

In light of all these economic and financial uncertainties, we expect the target for the overnight rate to remain at 1.00% for some time to come. However, based on its statement about reducing monetary stimulus, the BoC is still envisioning increases by the end of 2013. This supports our prediction of a gradual rate increase in 2013, probably beginning mid-year. Moreover, the odds of a rate cut in the near future are now much slimmer. It would take a major economic or financial backslide for the Bank to move away from its game plan.

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