Monetary Policy Report: The BoC stays the course, slightly modifying its scenario for Canada’s economy

The target for the overnight rate should remain at 1.00% until 2013

ACCORDING TO THE BANK OF CANADA (BoC)

• The outlook for the global economy has deteriorated and uncertainty has increased since the October Monetary Policy Report. The sovereign debt crisis in Europe and the associated pressures on the banking sector have intensified, and the global ramifications through financial, trade and confidence effects are expanding. The recession in the euro area is now expected to last longer and to be somewhat deeper than anticipated in the October Report.

• In the United States, economic growth is expected to be relatively modest through 2013, owing to ongoing household deleveraging, fiscal consolidation and negative spillover effects from the European crisis.

• Outlook for the Canadian economy is little changed relative to the October Report. Although growth in the second half of 2011 was stronger than anticipated, the weaker external outlook is expected to affect the Canadian economy through confidence, financial and trade channels. The BoC continues to expect that these headwinds will limit economic growth in Canada in 2012 to a modest pace, after which growth is projected to pick up as the global environment improves.

• On an average annual basis, growth in real GDP is projected to moderate from 2.4% in 2011 to 2.0% in 2012, before picking up temporarily above the rate of the economy’s production potential to 2.8% in 2013.

• The economy is anticipated to return gradually to full capacity by the third quarter of 2013, one quarter earlier than expected in the October Report.

• Core inflation is projected to moderate through 2012 to a level somewhat below 2%. Total consumer price index inflation is projected to continue to decline to around 1.5% by mid-2012. Both total and core inflation are expected to start to rise gradually by the end of 2012, reaching 2% by the third quarter of 2013.

• This projection includes a gradual reduction in monetary stimulus over the projection horizon, consistent with achieving the inflation target.

COMMENTS

The increase in Canada’s real GDP in Q3 2011 (+3.5% annualized) largely surpassed BoC expectations (+2.0%). Monetary authorities were therefore expected to make a few changes to their economic scenario. Thus, the BoC now seems somewhat less optimistic about quarterly changes in real GDP for 2012. Surprisingly, these downside adjustments only had a very slight impact on the average expected for 2012 due to the base effects impacting real GDP.

The BoC also made a few changes to the sources of growth in Canada’s economy. The monetary authorities now agree that the housing sector is likely to continue its ascent, meaning that its contribution to real GDP could be higher than originally anticipated. This additional support should be offset however by a somewhat weaker advance in non-residential investment, a sharper correction in inventory levels and a slightly more modest pace in consumer spending. In the end, the BoC’s new forecasts are quite similar to our most recent scenario. So while Canada’s economy should skirt the recession that has Europe in its grip, Canada will not be spared the effects of deteriorating global economic conditions and economic growth in this country will be relatively modest in the quarters ahead.

With forecasts like these, it seems more than likely that the monetary authorities won’t make any changes to their key rates in 2012. The fairly limited effect of contagion on Canada’s economy to date and concerns about high household debt allow us to dismiss the possibility of cuts to key rates in the next few months. Especially now that the monetary authorities have upgraded their forecasts slightly about the low point that inflation was expected to reach in the second quarter of 2012 (when the effects of major increases recorded in the spring of 2011 should disappear from the
annual change calculation). On the other hand, the difficult economic conditions around the world and their impact on Canada’s output argue in favour of maintaining considerable monetary easing. That said, all signs point to an overnight rate holding steady at 1.00% until mid-2013, unless the financial system ceases to function properly.

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