BANK OF CANADA

Monetary Policy Report: The Bank of Canada upgrades its economic outlook, but downside risks remain elevated

ACCORDING TO THE BANK OF CANADA (BoC)

- The profile for global economic growth has improved since the Bank released its January Monetary Policy Report. The uncertainty surrounding the global outlook, which had been very high, has abated, but volatility can be expected to persist.
- The economic situation in the euro zone has improved somewhat recently. A modest recovery in economic activity is expected in the second half of 2012. Compared with what was indicated in the January report, the recession should be less steep, due to the smaller than forecast negative impacts from bank deleveraging and low confidence levels. However, the growth outlook for the remainder of the projection horizon remains consistent with January’s forecasts.
- In the United States, the economic growth outlook is more encouraging. Notwithstanding this stronger outlook, U.S. real GDP is projected to grow at a relatively modest pace through the first half of 2013, dampened by fiscal consolidation and continued household deleveraging.
- Economic momentum in Canada is slightly firmer than the Bank had expected in January. The external headwinds facing Canada have abated somewhat, with the U.S. recovery more resilient and financial conditions more supportive than previously anticipated. Business and household confidence are improving faster than forecast in January. The Bank judges that, in the coming quarters, global uncertainty will do less to moderate spending by Canadian households and businesses. The BoC projects that Canada’s economy will grow by 2.4% in both 2012 and 2013 before moderating to 2.2% in 2014.
- The BoC thinks the economy was operating about 0.5% below full capacity in the first quarter of 2012, a smaller excess capacity margin than anticipated in January. The economy should gradually return to full capacity by the first half of 2013, earlier than the Bank forecast in January.
- Core inflation is projected to stay close to 2% over the projection horizon. The Bank forecasts a slight decline in core inflation in the near term, reflecting the unwinding of the effects of higher prices for food and clothing on year-over-year inflation, as well as lower electricity prices. Total consumer price index inflation is also projected to decline in the near term to close to 2%, in part reflecting lower core inflation, and to remain around the target over the balance of the projection horizon.
- The projection includes a gradual reduction to monetary stimulus over the projection horizon, consistent with achieving the inflation target.
- Despite recent improvements to the outlook for the global and Canadian economies, risks remain elevated. Significant steps have been taken to address the sovereign debt and banking crisis in the euro zone, reducing the chances of an extreme negative event, but risks in this regard still rest clearly on the downside.

COMMENTS

The worst is apparently behind us, at least, according to the latest economic and financial projections from Canada’s monetary authorities. The negative impacts of the problems in Europe and difficulties in the U.S. economy were smaller than the Bank anticipated in January. Among other things, therefore, the Bank raised its growth outlooks for the U.S. and euro zone economies. The fact that global economic and financial conditions are better also prompted the monetary authorities to raise their projections slightly for Canadian household and business spending. Although many risks persist, the BoC increased its growth outlook for Canada’s real GDP to 2.4% for 2012 from 2.0% in its January outlook. Under these conditions, the output gap could close as of the first half of 2013.

As monetary authorities mentioned yesterday, a modest withdrawal of monetary stimulus may become appropriate. When would these key interest rate increases be ordered? The BoC will certainly wait for further economic indicators before it becomes more definite. Still, monetary authorities seem to have some desire to jump on the first opportunity to firm up the country’s monetary conditions.
In our opinion, it will take a few more quarters for such an opportunity to materialize, however. On one hand, we are a little less optimistic than the BoC about Canada’s economic outlook. Our latest scenario calls for Canada’s real GDP to increase by 2.1% in 2012. Moreover, of the 17 private forecasters involved in the consensus, only one anticipates growth higher than the BoC’s projection for Canadian real GDP in 2012. On the other hand, we must not underestimate the magnitude of the persisting risks—in Europe, the United States and emerging markets. These risks will not dissipate all that quickly, with the result that the uncertain climate will persist for several more quarters. In fact, the crisis in Europe seems to be taking a turn for the worse lately. Lastly, in a context in which U.S. key rates are likely to stay where they are until at least 2014, it is hard to picture an early rise in Canada’s key rates given the impact this would have on the loonie and international merchandise trade. Barring a convincing upturn, Canada’s monetary authorities will have to wait a few more quarters to raise the target for the overnight rate.

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