MONETARY POLICY REPORT: the Bank of Canada expects a sharp rebound after the recession

ACCORDING TO THE BANK OF CANADA (BoC)

- The leading advanced economies, including Canada’s, are in recession, and the emerging countries are increasingly bearing the brunt of it.
- The public decision-makers reacted to the drop in global economic activity by taking swift and concerted action. Central banks have made deep cuts to key interest rates since last fall and several countries are currently adopting major programs to target fiscal boost.
- The economy in Canada should continue to be sluggish until mid-2009. The measures enacted by the public authorities should start to have their desired effects, and economic growth should gain some speed in the second half of 2009. In addition, the loonie’s recent depreciation will support the recovery.
- The BoC expects Canada’s real GDP to decline by 1.2% in 2009 due to the steep decline in production between Q4 2008 and Q2 2009.
- A sustained economic recovery is anticipated however as of Q3 in 2009. Moreover, the BoC estimates that the real GDP could grow on average by 4.7% on an annual basis in the first half of 2010 and by 4.9% in the second half. As such, annual average growth for 2010 overall is pegged at 3.8% (advances of less than the average of both six-month periods due to the recession’s negative base effects).
- The total inflation rate should be in negative territory in Q2 and Q3 2009. The annual change in the total consumer price index should climb to about 1.6% at the start of 2010, reaching the mean target, or 2%, in the first half of 2011.
- The risks in the BoC’s scenario are relatively balanced. However, the outlook remains tainted by uncertainty.

COMMENTS

The BoC is setting itself apart with this new scenario. Like most forecasters, the monetary authorities agree that Canada’s economy entered a period of recession in Q4 of 2008. The BoC diverges in its stance on the recovery to follow the recession. With an average increase of 3.8% in real GDP for 2010 overall, the BoC’s scenario is clearly more optimistic than that of most forecasters in the private sector. According to the BoC, the expected recovery of financial conditions, the stimulus provided by cuts to key interest rates and injections of liquidity (graph 1), the support provided by the government’s plan to kick-start the economy and the drop in the loonie (graph 2) should contribute massively to economic growth as of mid-2009.

The BoC expects consumer spending to contribute massively to real GDP growth in 2010. Given the very low level of household confidence noted in Canada at the moment, this...
will require a major reversal of the current situation (graph 3). Such an improvement will not be possible until the financial markets get back to normal. If the situation has shown some slight improvement in the past few weeks, it is still too soon to hope for a full recovery in the near term. In addition, the BoC is obviously also counting on tax relief to kick-start consumption. This hypothesis is confirmed by examining the progress in public spending anticipated by the BoC. Despite the major fiscal stimulus plan, public spending should contribute no more than 1.3% in 2010, a somewhat weak improvement compared to the 0.9% recorded in 2008 and 2009. According to the BoC, the bottom line of these new measures could be based on tax cuts instead of major increases in public investments. Questions on the effectiveness of such a plan could be raised should this be the case. The next federal budget, slated for January 27, 2009, will shed some much needed light on what this much anticipated recovery plan will look like.

From a monetary policy management point of view, the risks in our opinion remain largely tilted toward the downside. To limit the severity of the recession in Canada and bring core inflation back in line with the mean target in the medium term, it appears obvious that other rate cuts will be made in the months ahead. We anticipate a rate of 0.50% as of March 2009.

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