ACCORDING TO THE BANK OF CANADA (BoC)

• In Canada, as expected, the composition of aggregate demand is shifting towards final domestic demand and away from net exports. In the third quarter, the balance of these shifts resulted in weaker-than-projected GDP growth.

• Core inflation in recent months has been slightly higher than the BoC had projected, although total CPI inflation remains close to projections.

• The BoC continues to expect economic growth to become more solidly entrenched over the projection period and inflation to return to the 2% target in the second half of 2011.

• Conditional on the outlook for inflation, the target overnight rate can be expected to remain at its current level until the end of the second quarter of 2010 in order to achieve the inflation target.

COMMENTS

Although a number of economic statistics have improved in recent weeks, this morning’s meeting left little room for surprise. The BoC was widely expected to keep its key rate at 0.25%. The interest was in the statement’s nuances, and they contain nothing to please those who are in favour of an imminent interest rate hike.

The BoC is maintaining its heading. The Canadian economy continues to develop in line with the projections in October’s Monetary Policy Report, in that domestic demand is gaining importance over net exports. But, with annualized real GDP growth at just 0.4% last summer, the BoC’s concerns have materialized. The strong loonie’s impact on foreign trade has offset the improvement in domestic demand. With September’s rebound, economic growth gets the fourth quarter off with a head start; however, keep a close eye on the potential backlash from the end of the Cash for Clunkers program on North America’s auto industry.

The mention of slightly higher than projected core inflation does not mean this is a source of concern for the BoC. It mainly stems from base effects, which should dissipate in the coming months. The loonie’s strength and the lagged effects of the widened output gap will keep downside pressure on core inflation.

Under these circumstances, the BoC unsurprisingly repeated its conditional commitment to keeping its key rate at 0.25% until June 2010. The omission of the recent improvements, particularly the substantial rebound by the job market and, more generally, the increase in home prices, signals that the BoC wants to make sure the recovery is sustainable before it changes its monetary policy.

Moreover, with the Federal Reserve (Fed) not in much of a hurry to initiate a monetary firming cycle, the BoC will have to be careful not to send a premature message that it is getting ready to raise its interest rates. This would only exacerbate portfolio shifts toward Canada and trigger type-2 Canadian dollar appreciation, i.e. appreciation that is associated with factors external to Canada’s economy.

Implications: The recovery is still too precarious for the BoC to change its conditional commitment to keeping its key rate at 0.25% until June 2010. With the Fed likely on the sidelines until 2011 and inflation risks still tilted to the downside, we think the BoC has the leeway to only kick off its monetary firming cycle in the final quarter of next year.
EXCERPT FROM THE BANK OF CANADA PRESS RELEASE

“[…] In Canada, as expected, the composition of aggregate demand is shifting towards final domestic demand and away from net exports. In the third quarter, the balance of these shifts resulted in weaker-than-projected GDP growth. Core inflation in recent months has been slightly higher than the Bank had projected, although total CPI inflation remains close to projections.

The main drivers and the profile of the projected recovery in Canada remain consistent with the Bank’s views in the October MPR. The Bank continues to expect economic growth to become more solidly entrenched over the projection period and inflation to return to the 2 per cent target in the second half of 2011.

Conditional on the outlook for inflation, the target overnight rate can be expected to remain at its current level until the end of the second quarter of 2010 in order to achieve the inflation target. In its conduct of monetary policy at low interest rates, the Bank retains considerable flexibility, consistent with the framework outlined in the April MPR.

The risks to the outlook for inflation continue to be those outlined in the October MPR. On the upside, the main risks are stronger-than-projected global and domestic demand. On the downside, the main risks are a more protracted global recovery and persistent strength in the Canadian dollar that could act as a significant further drag on growth and put additional downward pressure on inflation. The Bank views all of these risks through the prism of achieving the 2 per cent inflation target […]”