The Bank of Canada’s tone remains positive: Key rates unchanged

According to the Bank of Canada:

- The overnight rate and the Bank Rate remain unchanged at 4.25% and 4.50%, respectively.
- Output growth in Canada decelerated, likely averaging about 1.6% in the second half of 2006.
- At the end of 2006, the Canadian economy was operating at, or just above, its production capacity.
- There are signs that a significant amount of the adjustment in the U.S. housing and automotive sectors has already taken place.
- The risks to the Bank’s inflation projection are roughly balanced but have diminished somewhat.

Commentary:

Canada’s economy has certainly been tested by some difficulties in recent months. For example, Ontario’s real GDP shrank by 0.3% in the third quarter, Québec’s GDP advanced by a bare 1.1% during the same period, and economic activity in western Canada seems to have lost a little of its vitality.

And, as expected, the Bank of Canada revised its scenario for short-term growth downward. Canada’s monetary authorities are thus looking for average growth of 1.6% in the second half of 2006, implying growth of about 1.5% in the fourth quarter (following the third quarter’s 1.7%); this projection is similar to ours and is much weaker than the Bank’s original outlook of 2.8%.

In spite of these adjustments, the tone remains fairly positive. The Canadian economy’s output appears to have evolved at close to full production capacity at the end of 2006, even if real GDP growth has been below it since last spring. Note that productivity gains have been very small, which no doubt cuts into the economy’s estimated production potential.

What’s more, the Bank of Canada believes that the current negative adjustments in the U.S. housing and automotive sectors have already occurred to a great extent, and that Canada’s inventory adjustment is already well under way. Bank of Canada leaders thus remain relatively optimistic about the outlook for growth for 2007 and 2008. Their scenarios for real GDP and inflation are in fact almost identical to where they were last fall with, among other things, real GDP growth of 2.5% in the first half of 2007 and inflation just over 1.0% for the same period. In this context, it can come as no surprise that the Bank of Canada is once again stating that the risks to inflation’s evolution are balanced. Further detail on the scenario will of course be provided next Thursday when the semi-annual Monetary Policy Report Update is published.

Clearly, today’s statement leaves no room in the short term for key interest cuts in Canada. For the Bank of Canada, key rates that are low in both nominal and real terms, and solid profits for most businesses do not call for any change in monetary policy direction. However, we still believe (even if the likelihood is smaller in light of today’s information) that a small downward adjustment could be needed and, as a result, that a key interest rate cut could be initiated next spring or summer. The loonie has, of course, depreciated in the last few months, but the damage to foreign trade has already been done. Also, the U.S. real estate market could take longer to correct, prolonging North America’s economic troubles.
Global economic expansion has remained robust, although economic growth in the United States slowed during 2006. With weaker U.S. growth, output growth in Canada decelerated, likely averaging about 1.6 per cent in the second half of 2006. This was largely due to reduced U.S. demand for building materials and motor vehicles — which has adversely affected Canada’s exports — and to the need for Canadian businesses to adjust inventories. Final domestic demand in Canada has continued to contribute strongly to growth. Inflation has evolved largely in line with the Bank’s expectations in the October Monetary Policy Report (MPR), with total CPI inflation slightly lower than projected and core inflation slightly higher. The Bank judges that at the end of 2006, the Canadian economy was operating at, or just above, its production capacity.

There are signs that a significant amount of the adjustment in the U.S. housing and automotive sectors has already taken place and that the inventory correction in Canada is well advanced. Accordingly, the Bank projects that economic growth in Canada will pick up to about 2 1/2 per cent in the first half of 2007, and that the economy will continue to operate near its production capacity throughout 2007 and 2008. Total CPI inflation should average just above 1 per cent in the first half of 2007, returning to the 2 per cent inflation target in early 2008. Core inflation should return to 2 per cent in the first half of 2007 and remain there. The Bank continues to judge that the risks to the inflation projection are roughly balanced, but the main upside and downside risks outlined in the October MPR have diminished somewhat. In line with the Bank’s outlook, the current level of the target for the overnight rate is judged, at this time, to be consistent with achieving the inflation target over the medium term. [...]