The American slowdown and tighter credit conditions make the Bank of Canada opt for prudence

According to the Bank of Canada:

- It now seems likely that the adjustment in the U.S. residential housing sector will be more pronounced and protracted, exacerbated by recent developments in financial markets.
- The pace of economic growth in the first half of the year was above the Bank of Canada’s expectations. It now appears that the Canadian economy is operating further above its production potential.
- Recent developments in financial markets have led to some tightening of credit conditions for Canadian borrowers, which should temper growth in domestic demand.
- For inflation risks, on the upside, there is a possibility that household demand could be stronger than expected, while on the downside the ongoing adjustment in the U.S. housing sector could be more severe.

Commentary:

As expected, the Bank of Canada (BoC) left its key rate unchanged at 4.50% this morning. It should be said that, in recent days, the BoC had stated its concern about the risk posed to our economy by an American economic slowdown, on one hand and, on the other, the risk of potential tightening of credit conditions in Canada. Despite stronger than forecast growth in this country in the first half of the year, therefore, it would have been very surprising for the monetary firming initiated in July to go forward.

The BoC seems to be keeping all its options open by stating that the economy is operating further above potential but, in our view, the risks are more to the downside than the BoC is intimating. In a context in which the U.S. real estate market’s adjustments are promising to be more pronounced and long lasting, Canadian exports are likely to be weaker than expected. Domestic demand is very strong, but there is also a risk that tightening credit conditions will make household spending and investment slow in the coming quarters.

As a result, we have downgraded our outlook for economic growth to just under 2.5% on average for the next two quarters, a pace that is slightly below potential. This should help to gradually ease the pressure on Canada’s production capacity. With core inflation having already backed off last June’s peak slightly, it seems likely that the BoC’s mean inflation target of 2.0% will be reached sooner than expected. In a context in which the financial markets have already priced in cuts of nearly 75 basis points in the U.S. Federal Reserve’s target rate for federal funds over the next six months, it would be astounding for the BoC to dismiss the current uncertainties and return to monetary firming in October. In our opinion, the most likely avenue as of today is an extended status quo, lasting until 2008.

Underlying inflation should shrink to below the BoC’s 2.0% target earlier than expected

* The CPIX excludes the eight most volatile components and the effect of indirect taxes.
Sources: Bank of Canada, Statistics Canada and Desjardins, Economic Studies
[Excerpt from the Bank of Canada press release]

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[...] Near-term prospects for economic growth outside North America appear to be slightly stronger than anticipated in the July Monetary Policy Report Update (MPRU), while near-term economic prospects for the United States are weaker than expected. It now seems likely that the adjustment in the U.S. residential housing sector will be more pronounced and protracted, exacerbated by recent developments in financial markets. On balance, this implies weaker demand for Canadian exports than had been expected at the time of the July MPRU.

In Canada, total and core CPI inflation in July, at 2.2 per cent and 2.3 per cent respectively, continued to be above the inflation target but generally in line with the Bank's expectations. The Canadian dollar has also largely traded in the range assumed in the July MPRU. At the same time, the pace of economic growth in the first half of this year was above the Bank's expectations. It now appears that the Canadian economy is operating further above its production potential than was estimated in July. Domestic demand remains robust, buoyed by a continuing strong labour market and higher-than-expected increases in home sales and prices. However, recent developments in financial markets have led to some tightening of credit conditions for Canadian borrowers, which should temper growth in domestic demand. [...]