BANK OF CANADA

Monetary Policy Report: The Bank of Canada’s outlook has barely changed
The Bank of Canada stays on course for a gradual increase to key rates

ACCORDING TO THE BANK OF CANADA (BoC)

- The global economy has unfolded broadly as the BoC projected in its July Monetary Policy Report. Europe is in recession and activity should continue to contract in the second half of 2012. The economic expansion in the United States is progressing at a gradual pace, consistent with the experiences of other advanced countries that have undergone severe financial crises. The BoC projects U.S. real GDP growth to be slightly higher in 2012 than previously anticipated, owing to historical revisions for late 2011 data that affect the average annual growth rate for 2012 and more offset the negative effects of the severe drought on farm output.
- The BoC’s base-case scenario is still built on the following two important assumptions: the crisis in the euro zone will remain contained and sharp tightening of U.S. budget policy in early 2013, known as the “fiscal cliff”, will be avoided.
- While global headwinds continue to restrain Canadian economic activity, domestic factors are supporting a moderate expansion. Following the recent period of below-potential growth, the BoC expects the economy to pick up in the coming quarters, returning to full capacity by the end of 2013.
- The expansion will be driven mainly by growth in consumption and business investment, reflecting very stimulative domestic financial conditions. The BoC expects housing activity to decline from historically high levels, and household debt ratios are expected to rise further before stabilizing by the end of the projection horizon.
- External demand for Canada’s exports, as estimated by the BoC’s foreign activity measure, remains sluggish. Despite the relatively subdued outlook for global economic growth, the foreign activity measure is projected to grow steadily over the next two years, reflecting a gradual recovery in the U.S. housing market and an anticipated increase in the growth of U.S. business investment once the uncertainty related to the fiscal cliff and the situation in Europe dissipates.
- Canadian real GDP growth is estimated to have been weaker than anticipated at around 1.0% in the third quarter, partly reflecting the impact on Canadian exports of transitory disruptions in the energy sector. Consistent with these dynamics, the BoC’s conventional measure of the output gap widened slightly to -0.7% in the third quarter.
- Core inflation is expected to remain subdued in the near term before increasing gradually in coming quarters to reach 2% by the middle of 2013, as the economy gradually absorbs the current small degree of slack and inflation expectations remain well anchored. Total CPI inflation is expected to remain below 2% for a somewhat longer period than previously anticipated, converging to the target by the end of 2013.
- The BoC’s projection includes a gradual reduction in monetary stimulus over the projection horizon, consistent with achieving the inflation target.

COMMENTS

Those who had been expecting a change to the BoC’s message will be disappointed with the latest issue of the Monetary Policy Report. All in all, the statements made by the monetary authorities have changed very little, with their economic and financial outlooks only slightly modified. The BoC still judges that non-residential investment and consumer spending will support real GDP growth, while the contribution from government expenditures will remain subdued and residential construction could gradually wane. This vision of the economy is perfectly consistent with our economic forecasts. The BoC anticipates real GDP growth of 2.2% in 2012 and 2.3% in 2013. Our economic scenario also calls for growth of 2.2% this year, followed by another 2.2% gain in 2013. Note that, like the BoC, our projections assume that the crisis in Europe will dissipate. On the other hand, the Federal Reserve’s third quantitative easing program could have a less positive impact on the U.S. economy.
than the BoC anticipates, especially when considering the limited effects of the previous two programs.

However, the path the BoC sets out for Canadian real GDP growth over the coming quarters differs from our projections. The BoC expects real GDP to rise by just 1.0% in the third quarter of 2012. This is a very conservative projection, given what the economic indicators have been doing lately. Real GDP by industry rose 0.2% in July, and the results to date suggest that August will end with a gain of about 0.3%. This means that, after two months, the carryover for the third quarter will be around 1.9%. Everything thus suggests that the third quarter’s real GDP growth will be close to that of potential (2.0%). The output gap could therefore remain nearly flat and not close slightly as the BoC expects. That said, the BoC seems slightly more optimistic than most forecasters for the end of 2012 and the quarters of 2013. The total impact of these differences on the evolution of the output gap is therefore marginal. According to our projections, the output gap could close in the fourth quarter of 2013, an outlook that is similar to the BoC’s.

Although the BoC’s report reiterates its phrase on the gradual withdrawal of monetary stimulus, yesterday’s statement included a few modifications that suggested a slight change to the warning about eventual key interest rate increases. On one hand, the addition of the phrase “over time” suggests that the BoC will have to wait longer before reducing the level of monetary stimulus. At today’s press conference, Mark Carney mentioned that rate increases were less imminent. On the other hand, the concept “some withdrawal [...] may become appropriate” has been replaced by “withdrawal [...] will likely be required”. This change seems to illustrate the BoC’s increased desire to eventually raise key rates. Household debt loads also remain at the heart of the BoC’s concerns. Under these conditions, we maintain our outlook for key rate increases, but only in early 2014.

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