Semi-annual Report: The Bank of Canada lowers its growth scenario but remains optimistic

According to the Bank of Canada:

- The projection for growth by the Canadian economy has been lowered to 2.8% for 2006, compared to 3.2% in the previous scenario, and to 2.5% for next year, compared to the initial 2.9%.
- The downward revision is mainly due to the deterioration of the nearterm outlook for the United States and a decrease in the production capacity growth rate for 2006 to 2008.
- The Bank judges the Canadian economy to be operating just above its production capacity.
- The total annual inflation rate has come down sharply due to the combined impact of lower gas prices, the cut to the federal Goods and Services Tax (GST) and the tumble by natural gas prices. The monetary authorities are expecting total CPI inflation to average about 1.5% between the last quarter of 2006 and the second quarter of 2007, and then return to around 2%.
- The annual change in core inflation (CPIX) should move a bit above the 2% target until mid 2007 due to slightly excess demand and the ongoing strength of housing prices. It is expected to fall below the 2% mark in the second half of 2007, however.
- The Bank deems the upside risks (momentum of household spending, high housing prices, substantial regional and sectoral disparities) and downside risks (slowing U.S. economic expansion and slower global demand for commodities) to its projection to be balanced.
- As a result, the target for the overnight rate is at a level consistent with achieving the inflation target.

Commentary:

The fact that the Bank of Canada’s outlook for the economy has been revised down is not really a surprise: not only has real GDP growth been well below the monetary authorities’ expectations in the second quarter (2.0% instead of 3.2%), but the data released to date allow us to anticipate fairly modest progress for the third quarter. However, even though forecast growth is weaker, the Bank still judges the Canadian economy to be currently operating at slightly above full capacity. Note that the monetary authorities also took advantage of the exercise to reduce their measure of the Canadian economy’s full potential.

The decrease in the Canadian economy’s potential is due to weaker labour productivity than the Bank expected. The reallocation of capital and labour following the loonie’s appreciation and price increases for energy and other commodities is curbing productivity growth during the ongoing period of adaptation that was made necessary by these structural changes. Yet Statistics Canada’s upward revision of 2005’s productivity data on April 26 had instead suggested that the Canadian economy’s potential had increased.

A rare occurrence, the Bank of Canada also stresses regional disparities, mentioning that pressures on production capacity and, by ricochet, prices, are stronger in the western provinces. These regional disparities are also present in the risks weighed by the monetary authorities.

The Bank of Canada’s balanced risk scenario also means that monetary authorities intend to leave key interest rates where they are in the months to come. In our view, the downside risks, which are responsible for the changes to the Bank’s economic outlook, could become dominant and thus call for a slight cut to the target for the overnight rate in the first half of 2007, just like the U.S. Federal Reserve’s key rates.