Global risks are a headache for the Bank of Canada
How will it manage monetary policy?

The practice of monetary policy has become considerably more complex since the last financial crisis. Several central banks have had to resort to unconventional policies to deal with severe macroeconomic impacts and almost three years after the shock of the Lehman Brothers’ bankruptcy, they have yet to be able to refocus their monetary policy on the use of conventional tools.

Thanks to Canada’s relatively more resilient economy and financial system, the Bank of Canada (BoC) did not have to seek recourse through unorthodox policies, but it still had to drop its policy rate to a historically low levels. Unlike in the United States, Canadian monetary policy was effective at stimulating the economy growth and employment have both recovered satisfactorily. With Canada now in expansion mode and with inflation signs starting to show, it is becoming increasingly clear that a high level of monetary stimulation is no longer necessary. Yet, the instable global economy and the presence of serious macroeconomic and financial risks around the world complicate the situation for the BoC.

The BoC is thus at a crossroads: on one hand, current conditions in Canada and its own forecast scenario argue in favour of continuing the process of monetary policy normalization started last year. However, the threats that continue to hover over the global economy call for a prudent approach. Ahead of the upcoming monetary policy decision on July 19, we attempt try to answer the following two questions in this Economic Viewpoint: What should the BoC do? What will the BoC do?

1. WHAT SHOULD THE BoC DO?
Several factors currently justify reducing the level of monetary easing, mostly rising inflation, an output gap that is expected to close sometime next year and the elimination the incentive towards excessive indebtedness.

1.1. Inflation is accelerating
After remaining comfortably within the BoC’s target range of 1% to 3% for most of the recovery, headline inflation jumped over the top of the range in March. After a lull in April, the consumer price index (CPI) posted another major jump in May to the order of 0.7%, the biggest change since May 2009. At 3.7%, the year-over-year change in the CPI was the highest recorded in more than eight years.

While the rise was largely due to global pressures affecting food and energy prices, core inflation still made a spectacular jump. The BoC’s core CPI (CPIX), which excludes eight volatile components (like gas) rose by 0.5% in May, pushing the year-over-year change from 1.6% to 1.8%. Since January 2009, the CPIX has broken above the 0.5% barrier only four times (in 29 months of observations), and twice in the past three months (graph 1 on page 2). In the first five months of 2011, the CPIX has grown at an annualized pace of 3.8%, clearly above the top of the target range, compared to only 1.0% in the last five months of 2010. There is little doubt that inflation pressures are escalating, and are not confined to temporary elements such as rising energy and food prices ¹.

¹ The CPI measure that corrects the effect of changes to indirect taxes posted an annual change of 2.1% in May. Even if this index paints a less alarming picture of inflation, it is still above the target, and has clearly accelerated since the start of 2011.
In its last Monetary Policy Report, the BoC established its forecast for core inflation at 1.4% for the second quarter. This forecast is likely to be exceeded and relatively significant base effects should keep applying upward pressure on year-over-year inflation measures. The BoC expects core inflation to return to the 2.0% mid-point of its target range, in the second quarter of 2012. Yet, inflation could easily hit 2.0% as early as the third quarter of 2011 if other upside surprises were to materialize in the months ahead.

The BoC regularly reiterates that inflation expectations are stable. However, one cannot overlook the increase in inflation expectations observed on financial markets last spring. The implicit 10-year expected inflation rate, deduced from the spread between 10-year nominal bond yields and real return 10-year bond yields, jumped from 2.3% at the end of 2010 to a peak of 2.7% at the end of April. This was the highest level recorded since 2008 (graph 2). The slowdown noted in the United States in the past few months has tempered expectations somewhat, but we can assume expectations to show an upswing by the fall if the scenario for an improved economic situation materialized in the coming months.

Meanwhile, the BoC expects the CPIX to converge closer to the 2% target within a year, but if the recent trend continues to hold, this level could be reached as early as this summer. To this end, the BoC states on its Web site that “when the rate of inflation consistently comes in higher than expected, it is typically a sign that demand for goods and services is pushing against the limits of capacity.” Indeed, some indicators do show that the excess capacity is gradually being taken up.

1.2. Less excess capacity

The output gap—and its forecast—is among the key indicators that guide the BoC in the formulation of its monetary policy. In 2010, real GDP growth of 3.1% helped narrow the output gap by 1.3 percentage points (taking it from -2.8% in Q4 2009 to -1.5% in Q4 2010). With real GDP growth of 3.9% (annualized), we estimate that the output gap was around -1.0% in the first quarter 2.

We should point out that the output gap is determined based on the real GDP’s potential growth, an estimated variable that is subject to some level of uncertainty. To offset this shortcoming, the BoC takes several other variables into con-

---

Graph 1 – Core inflation above 0.5% for the fourth time since January 2009

Graph 2 – Inflation expectations rose quickly during last spring

Graph 3 – Most businesses expect the pace of inflation to top the BoC target

---

2 With GDP growth of only 1.0% in the second quarter, the spread could widen briefly, but in the scenario of a rebound in the third quarter, this effect will be quickly wiped out and the output gap is still expected to be closed by mid-2012.
sideration, such as the capacity utilization rate, the unemployment rate and wage growth to better evaluate the level of excess supply in the economy.

The industrial capacity utilization rate rose to 79% in the first quarter (graph 4), exceeding most forecasters’ expectations. This is the highest utilization rate seen since the fourth quarter of 2007, deep into the 2000s expansionary cycle. Meanwhile, the unemployment rate reached 7.4% in May. Even if this rate remains high vs. the low point of 5.9% reached in 2007, the drop in the unemployment rate since the recession has been nearly as rapid as the one recorded between 2003 and 2007.

According to the BoC’s Business Outlook Survey, businesses are not having any trouble finding workers, contrary to the situation that existed before the recession. However, the survey shows that hiring intentions are currently at their highest levels since the start of 1999 (graph 5). Looking forward, this situation could eventually lead to a shortage of workers. As it is, the number of companies that are having trouble recruiting, ticked up in the second quarter. If this number keeps rising, this could end up exerting upside pressures on wages. And while wages are growing fairly moderately right now, if the labour market continues to improve and inflation stays on its upward trend, an increase in inflation expectations could end up exerting upward pressure on labour compensation. These pressures could occur even if inflation expectations remained stable, but they are more likely to intensify if expectations are heightened. In this context, it is essential for the BoC to maintain its credibility vis-à-vis its capacity to control inflation, and by extension, expectations.

1.3. Households are taking on debt

Few will dispute that Canadian household debt is not a significant concern; some indicators, such as the ratio of personal debt to disposable income even show that Canadians are currently carrying more debt than Americans. The BoC has frequently expressed worry about high household debt levels. In a speech on June 15, Governor Mark Carney stated that, “households will need to be prudent in their borrowing, recognizing that over the life of a mortgage, interest rates will often be much higher.”

It remains that the soaring debt levels of the past few years have been largely driven by low interest rates, which encourage debt taking and offer little incentive to save. Consumers have simply acted rationally, borrowing at low rates and investing in assets yielding higher returns, such as real estate.

The BoC and the federal Department of Finance may have worked to raise public awareness over the last two years, but other than the legislative measures already in place, the best way to reduce the size of household debt loads in our view is still to reduce the main stimulant, that is historically low rates. A rapid and sudden increase in interest rates would obviously put some households at risk of financial difficulties. Yet, the impact would probably be more manageable from a borrower’s perspective if interest rates were to climb gradually, enabling income growth to offset some or even the entire rise in borrowing costs. Conversely, leaving rates low for too long could encourage consumers to take on even more debt, and many households could have trouble meeting their financial obligations when rates subsequently would go up, perhaps more quickly.

We should also note that low interest rates make it easier for financial institutions, including banks, to take excessive risks. Unwarranted bank exposure to high-risk assets could render Canada’s financial system vulnerable, much like we saw in the United States and Europe during the last financial crisis.

2. Reasons for putting off rate hikes

Despite the arguments for imminent rate hikes, the BoC has been particularly hesitant in its last few communications.
Despite rising inflation, the drop in the unemployment rate, healthy hiring intentions and a sound growth scenario, the BoC has shown some discomfort in the face of developing global risks. Among the factors causing the most concern right now are the strong loonie, the interest rate spread between Canada and the United States, the behaviour of the global economy, and concerns about the vulnerability of the global financial system.

2.1. Strong dollar

The BoC has recently heightened the emphasis on the impact of a strong dollar on the trade sector. The BoC’s recent dovish tilt coming against relatively sound domestic fundamentals, highlights strong concerns regarding the loonie’s strength. The BoC may in fact have assessed that the strong dollar has already tightened monetary conditions, giving the BoC the flexibility to maintain rates at low levels.

This view could be supported by looking at the differential between the Federal Funds rate and the Canadian overnight rate. In the past five years, this differential has mostly stayed in a range of between -100 and 100 basis points (graph 6). This differential is currently 75 basis points and any further widening could have repercussions on Canada’s currency. In a recent Economic Viewpoint, we analyzed changes in the loonie’s sensitivity to two-year bond yield spreads (which in part reflect expectations on policy rates for the next two years). We observe that over the course of the past year, this sensitivity has been much higher than normal: a 100 basis point increase in the Canada-U.S. two-year yield spread could cause the Canadian dollar to appreciate to the tune of five to nine cents (graph 7). By comparison, through the last decade, this sensitivity has been for the most part less than three cents.

The BoC may be implicitly taking this phenomenon into account and calibrating its monetary policy accordingly. Since the interest rate spread is at stake, the BoC may elect to wait for more concrete signals that the Federal Reserve (Fed) is getting ready to kick start its own normalization cycle, which would apply upside pressures on U.S. bond yields and pave the way for rate increases in Canada without exerting excessive pressure on the currency. However, there is little doubt that the U.S. economy would need to show significant improvement for this scenario to play out.

2.2. An unsteady global economy

The United States is currently in a tough situation. After soft growth in the first quarter, indicators gathered to date point to an even more sluggish second quarter. A number of factors are weighing on growth, most notably the impact of the Japanese earthquake on supply chains, the effect of cumulative gas price increases on consumer spending and the never-ending housing market slump. This, in addition to major budget cuts by state and local governments and a worrisome standstill on talks to raise the debt ceiling at the federal level. At the same time, sentiment indicators reveal that households and businesses, especially small ones, are about as pessimistic as they have been during the Great Recession. This prevents consumer spending from picking up and considerably hinders job market improvements.

The risks of a slowdown are being felt around the globe. China saw its industrial production and exports decelerate sharply in the second quarter. At the same time, growth remains weak in many European countries that are grappling with debt woes. Drastic austerity measures will cloud the outlooks in the short and near terms.
These conditions apply heavy downside risks to the Canadian external sector but the main question is whether this is only a soft patch, similar to the one observed at about the same time last year, or whether this is a broader phenomenon. To this point, the assumption of a slack period has been retained as the impact of Japan’s earthquake is starting to wane and supply chains are gradually getting back to normal, but indications of a pickup have yet to be seen.

For the BoC, the context is complicated. Its latest projection calls for net exports to make a slightly positive contribution in 2011, but the latest developments heighten the downside risks to this forecast. One thus wonders whether the BoC would dare put the external trade sector at greater risk by increasing pressure on the loonie?

2.3. **A vulnerable global financial system**

Europe narrowly escaped the worst in July when Greece came this close to defaulting on its debt and triggering a major financial crisis. The Greek government’s adoption of austerity measures and the disbursement of the fifth bailout tranche by the European Union and the International Monetary Fund (IMF) prevented this scenario from happening, but clearly, risks emanating from Greece remain elevated. This is because Greece will soon need a second bailout and the European governments, the IMF and the European Central Bank are not on the same page about the degree to which private sector creditors should participate. Besides Greece, concerns remain about Portugal, which is late in rolling out its austerity plan. The governments of Italy and Spain are also highly indebted and facing rising borrowing costs (graph 8), which threaten the fight against deficits.

2.4. **Weak points in domestic demand**

Even though Canada’s economy is in relatively good shape, some risks still require close monitoring. For example, consumer spending growth has been quite weak since the beginning of the year, and like in the United States, Canadian households were hit by sharp increases in gas prices, while weaker growth in consumer credit suggests that many households have begun the debt deleveraging process, thus implying more moderate spending.

Meanwhile, like in most developed countries, the Canadian federal government instituted significant stimulus measures to prop up the economy during the last recession, leaving it with a budget deficit to eliminate. The government’s objective is to get back to a balanced budget by the 2014-2015 fiscal year, meaning that government expenditures as a percentage to GDP will fall. With a majority Conservative government driving this austerity exercise, we will likely see budget cuts that will eat into GDP growth over the next few quarters and years. This is in addition to similar plans announced by provincial governments.

If thriftiness is the new mantra for consumers and governments alike, if the moderation seen in the real estate market since the start of the year continues and if the U.S. economy’s underperformance weighs on trade, business spending will be the last remaining lever for growth. Even if corporate balance sheets are looking good and the necessity to catch-up in productivity argue for ongoing investment, this is still a very cyclical component that is particularly vulnerable to a slowdown in U.S. demand.

These are some of the domestic issues that the BoC could be grappling with right now, pushing it to adopt a more prudent approach toward monetary policy normalization.

3. **WHAT WILL THE BoC DO?**

Having listed the arguments for and against the monetary policy normalization process, the question is: What is the most probable scenario right now? Financial markets are putting a lot of emphasis on the scope of global risks, betting for no BoC rate hike in 2011 (graph 9 on page 6). For 2012, bankers’ acceptance futures indicate that markets are only expecting two hikes. These expectations can change very quickly however, depending on sentiment shifts.

Desjardins Group’s *Economic Studies*’ outlook has so far been calling for the U.S. economy to improve in the third...
Economic Viewpoint
July 18, 2011
www.desjardins.com/economics

quarter. Signs that Japan is gradually emerging from the earthquake shock are already emerging (graph 10), which will have, in principle, positive repercussions on industrial production in the United States and Canada via the normalization of supply chain operations. A resolution in the impasse on debt ceiling talks may also give a little boost to markets. In a previous Economic Viewpoint, we substantiated why we believe American politicians will come to an agreement before the deadline on August 2.

We acknowledge, however, that downside risks have risen significantly recently. The BoC will likely remain patient and vigilant against risk factors that will probably remain elevated in upcoming months. Whether we like it or not, the destiny of the U.S. economy will have a great influence on Canadian monetary policy. The Fed has recently qualified the pace of the job market recovery as “frustratingly slow” and it will take many quarters before the unemployment rate falls to a level that would be deemed satisfactory by Ben Bernanke and colleagues. We do not expect the Fed to be able to raise the Fed Funds rate before the fall of 2012.

As long as hints towards rate hikes will be absent in the United States, the BoC is likely to remain hesitant. If the case where the U.S. economy performs a bit better in the second half of the year, we see the possibility for two 25 basis point hikes next winter. However, subsequent tightening moves will likely be done only in sync with those expected south of the border, that is, in the fall of 2012.

Given all the uncertainties currently in flux, this scenario may evolve. In trying to determine the path of Canadian monetary policy, it will be probably best to evaluate a broad variety of drivers likely to be of interest for the BoC in the near future. Table 1 on page 7 shows our evaluation of what those drivers are, how relevant they are and how they are likely influencing the BoC in the near term.

In conclusion, it should be stressed that maintaining such an accommodative monetary policy over an extended period is not without risks. Low rates encourage consumers to rack up debt and discourage saving. The Fed has long been criticized for participating in the real estate bubble in the United States by keeping rates too low for too long during part of the last decade. In the current case, the control of inflation and central bank credibility could be at stake. As swiftly as central banks eased monetary policy during the last recession, they may have to squeeze just as aggressively should they wait for too long. We thereby share the opinion expressed by the Bank for International Settlements in its latest annual report: “Inflation risks have increased globally as a result of the productivity decline and rising prices for food, energy and other commodities. After affecting the larger emerging economies, inflationary dangers are now threatening advanced economies, strengthening arguments in favour of widespread key rate increases. However, some countries must weigh the need to proceed with monetary tightening and balance sheet vulnerabilities against a still fragile banking sector. That said, once the central banks start raising their key rates, they may have to raise them at a faster pace than in previous tightening phases.”

Jimmy Jean
Senior Economist

---

<table>
<thead>
<tr>
<th>Factor</th>
<th>Estimated degree</th>
<th>Monetary policy likely reaction</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation</td>
<td>High</td>
<td>Tightening</td>
<td>Increased pressures on inflation argue in favour of policy normalization.</td>
</tr>
<tr>
<td>Output gap</td>
<td>High</td>
<td>Tightening</td>
<td>A narrowing of excess production capacity usually sees the key rate move closer to its neutral level within a reasonable period.</td>
</tr>
<tr>
<td>Household indebtedness</td>
<td>Low</td>
<td>Moderate tightening</td>
<td>Debt incentives must be reduced, but at a fairly moderate pace so that income growth can offset higher borrowing costs.</td>
</tr>
<tr>
<td>Employment</td>
<td>High</td>
<td>Tightening</td>
<td>Good results on the labour front and solid hiring intentions give the go-ahead for rate normalization.</td>
</tr>
<tr>
<td>Wage growth</td>
<td>High</td>
<td>Statu quo</td>
<td>Despite the job market recovery, wage growth is still moderate, especially in the public sector. Weak wage inflation could relieve the pressure on total inflation, giving the BoC some leeway.</td>
</tr>
<tr>
<td>Canadian dollar</td>
<td>High</td>
<td>Statu quo</td>
<td>The strength of the Canadian dollar is hurting exports and is doing part of the tightening job, leaving the BoC some flexibility in setting monetary policy.</td>
</tr>
<tr>
<td>Interest rate spread</td>
<td>Medium</td>
<td>Statu quo</td>
<td>The loonie’s heightened sensitivity to interest rate spreads could limit the capacity to hike the overnight rate without putting undue pressure on the Canadian dollar.</td>
</tr>
<tr>
<td>U.S. economy</td>
<td>High</td>
<td>Statu quo</td>
<td>The sluggish recovery in the United States is increasing the risk that the Fed will remain on the sidelines. The BoC may be prompted to do the same to contain the pressures on the loonie.</td>
</tr>
<tr>
<td>Sovereign debt crisis</td>
<td>High</td>
<td>Easing</td>
<td>Should a Lehman Brothers type of financial shock occur, the same response may be required, i.e. aggressively easing monetary policy combined with liquidity injection into the financial system.</td>
</tr>
<tr>
<td>Emerging countries</td>
<td>Low</td>
<td>Moderate tightening</td>
<td>Canada’s external trade sector has relatively limited exposure to emerging countries. Even though a slowdown in China would likely cause a retrenchment in commodity-related capital spending, a drop in commodity prices and Canada’s currency could lend support to the manufacturing sector. With a fairly healthy domestic economy, and all things being equal, the BoC could firm up its policy nominally.</td>
</tr>
<tr>
<td>Budget cuts</td>
<td>Medium</td>
<td>Moderate tightening</td>
<td>Budget cuts will rein in growth, which may dampen pressures on inflation. This could prompt the BoC to ease the pace of normalization.</td>
</tr>
<tr>
<td>Low interest rate levels across the curve</td>
<td>High</td>
<td>Tightening</td>
<td>A high level of monetary stimulation encourages excessive risk-taking on financial markets and increases the financial system’s vulnerability. Beyond regulatory efforts, monetary tightening might help in controlling destabilizing incentives.</td>
</tr>
</tbody>
</table>

* Influence on Canada’s monetary policy.

Source: Desjardins, Economic Studies