Canada loses steam: How will the Bank of Canada react?

The latest economic statistics in Canada have been disappointing, to the point where investors are questioning whether a rate cut by the Bank of Canada (BoC) is possible. This Economic Viewpoint highlights the reasons why monetary easing seems unlikely, from the angle of a pessimistic scenario of moderate magnitude. We believe that investors should bank primarily on the possibility of other changes to the language of the BoC.

The BoC will release its monetary policy statement on Wednesday in a context that differs somewhat from that which prevailed at its last meeting in January. Recall that earlier this year, equities recorded their best month of January since 1997 as the avoidance of the fiscal cliff was cheered by financial markets, and as in Europe, large repayments of cash borrowed by banks from the European Central Bank (ECB), sent an encouraging signal on the health of the banking and financial system in Europe.

The enthusiasm, however, did not take long to fade, as the failure of an agreement to replace the sequestration cuts in the United States confirmed the high degree of dysfunction that still prevails in Washington, while political deadlock in Italy reminded that the European crisis was still marked by ups and downs. While most global risks were known in advance, there is little doubt that the performance of the Canadian economy at the end of 2012 added a further element of uncertainty and concern. The annualized growth of 1.0% of Canadian GDP in the second half of 2012 was the lowest since the last recession. It was also significantly lower than the latest projections of the BoC, which themselves had required several downward adjustments.

NOT-SO-SMOOTH ROTATION

One might be led to believe that the economy is just undergoing a few bad days, which will give way to a rebound. However, it is now clear that the Canadian economy is only left with a limited number of growth drivers. The downturn in the housing market, which began with the introduction of new mortgage rules, is expected to continue for about another two years, while high household debt points to relatively modest future growth of consumption. Governments remain committed to eliminating their deficits and thus, one should not expect them to chip in meaningfully. Thus, only business investment and net exports remain as credible sources of growth. The BoC’s outlook has been based for some time on the precept of rebalancing sources of growth, whereby additional contributions from exports and business investment would fill the void left by the lower contribution of consumption, residential investment and government spending.

Unfortunately, this long-awaited rebalancing has not materialized as expected. Exports languish below their pre-recession level, while Canadian business investment are growing more modestly compared to recent years. Meanwhile, the immediate outlook offers little encouragement. The rebalancing thesis was even challenged when Statistics Canada’s Survey of private and public investment intentions for 2013 showed the lowest appetite for capital spending since the recession, a bad omen for the forecast scenario pertaining to this component of GDP (graph 1 on page 2). In addition, the survey indicated a decline in investment in the mining, oil, and gas industry, at a time when significant logistical problems hamper the profitability of producers. In the fourth quarter, profit margins in the industry fell to their lowest level since 1998 (graph 2 on page 2). Recall that investment in

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commodity-related industries occupy a large share of total investment in Canada (graph 3). All in all, in a situation of global uncertainty hampering global trade and encouraging companies to prudent management, growth rotation stands to remain a slow process.

**IMPLICATIONS FOR MONETARY POLICY?**

Quite evidently, the BoC does not hold many arguments to maintain a hawkish bias. In our opinion, the BoC is likely to soon withdraw its forward guidance from its policy statement. Should this be the case, and in the event of the materialization of other downside risks in the coming months, must we believe in possible rate cuts? At least, that is what investors have begun to mull. Overnight index swaps currently indicate that a slight probability of rate cuts is being priced in (graph 4) over a period of 6-month timeframe. This contrasts markedly with the view that prevailed at the beginning of the year, as a first increase was rather being anticipated for the end of 2013. The level of short-term bond yields is also revealing. At the end of February, the 2-year yield slipped below the overnight rate (graph 5), a situation that has not been observed since the summer of 2012, when tensions in Europe were at their highs. The Canadian dollar has not been left out, ending February at US$0.97, lowest in eight months.

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**Graph 1 – Non-residential investment growth will continue to decelerate in 2013**

- Business investment
- Source: Statistics Canada – Excluding housing
- Investment in non-residential construction, machinery and equipment – current dollars

**Graph 2 – Historical lows for the oil and gas extraction profit margin**

- Operating profit margin in oil and gas extraction, and support activities
- Historical average
- Source: Statistics Canada and Desjardins, Economic Studies

**Graph 3 – Extraction of natural resources carry a large share of total investment**

- Canada – Capital expenditures by sector

**Graph 4 – Investors evaluate that a rate cut by September has become more probable**

- Implied probability of the BoC overnight rate in September 2013*
- Source: Bloomberg and Desjardins, Economic Studies

**Graph 5 – The 2-year yield has crossed the psychological level of the overnight rate**

- Spread between the 2-year yield and the BoC overnight rate
- Source: Bloomberg and Desjardins, Economic Studies

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* Average between 2010 to 2012.

**Sources:** Statistics Canada and Desjardins, Economic Studies
While it is understood that the recent uptick in global financial tensions, combined with the weakness of the Canadian economy, advocates for a more dovish BoC, we believe that the bar remains relatively high for rate cuts, for at least five reasons:

1. **Debt**

In our opinion, household debt remains a very powerful argument against further rate cuts. While an adjustment is in progress in the housing market, the high level of current debt is the result of several years of rising house prices, under the stimulating effect of low interest rates. Even though prices have begun to stabilize, it will take several quarters of income growth in excess of that of house prices to see indebtedness measures trend convincingly downwards. Clearly, the BoC, which has expressed satisfaction with regards to certain behavioural changes by borrowers, would send quite an inconsistent message by lowering the cost of credit, in light of a deleveraging process still at its infancy.

2. **Current monetary policy is far from being restrictive**

In fact, the current level of rates continues to provide stimulus through mortgage renewals. Most borrowers who renew their mortgage now benefit from a lower rate than their last term (graph 6), and this will continue for some time. The fact that monetary policy continues to be accommodative is an argument frequently conveyed by the BoC, and we can expect it to continue trumpeting it. In fact, the BoC might even contend that the recent depreciation of the Canadian dollar have made monetary conditions more accommodating to downplay the need for any kind of intervention.

3. **A slight easing would not cause any miracle**

Even in the implausible case where the BoC wanted to increase the credit take-up, it might well be that it would be less able to than in the past. The ownership rate in Canada is already among the highest in the world and the low growth in the number of young households expected over the next few years points to more moderate demand for housing (graph 7). This means that one of the economic sectors typically most sensitive to interest rate could react less meaningfully to monetary easing than in the past, especially with the more rigid rules in place, designed to influence the behaviour of first time buyers in particular.

In addition, other indicators tend to support the idea that lower rates, compared to an already low level, would probably have little effect on growth and inflation. For example, even if the BoC has not adopted a policy of quantitative easing, the velocity of money has weakened in Canada (graph 8), a trend also observed in countries where non-conventional policies were adopted. Given the low circulation of money, it would likely take very aggressive monetary expansion to exert a significant impact on macroeconomic variables.
The use of powerful tools to inflate the money supply remains unlikely, except in a new paradigm characterized by undeniable deflation in Canada. Excluding this thesis, one observes that the BoC’s flexible approach to inflation targeting allows it to tolerate sub-target price pressures (as has been the case recently) for a while.

4. The BoC is not at war
One could argue that trade would benefit from lower rates, however slight a cut would be, via a depreciation of the currency. However, in the hot topic of currency war, do not expect to see the BoC at the front line. In February, Mark Carney mentioned that a devaluation policy was not only difficult to carry out from an operational point of view, but represented a poor lever of sustainable prosperity. Simulation work from the BoC has also shown that beyond a positive impact in the short term, even for just a policy of countering upward pressure on the nominal exchange rate, the ultimate outcome would be lower growth and higher inflation. And as mentioned above, the recent depreciation of the currency makes intervention even less relevant.

5. Financial stability
While financial tensions have increased somewhat in recent weeks, they are of no common measure with episodes recorded in the last two years. Specifically, the Outright Monetary Transactions program implemented by the ECB last fall seems to have had the effect of limiting outbreaks of panic. So long as this remains the case, and that the “headwinds” remain relatively contained, the BoC is unlikely to see any merit in adopting a very proactive leaning approach.

IMPLICATIONS FOR BOND MARKETS
It is thus clear that a rate cut is hardly possible, except in a scenario of very acute crisis. However, in a case where some moderate downside risks were to materialize, would the Canadian economy then be left on its own? Not quite. As mentioned, monetary policy remains very accommodative, with an overnight rate that has remained fixed at 1.00% for the last 30 months. In addition, communication may be an effective tool for the BoC to use if conditions continued to deteriorate. Without signalling an upcoming easing, the BoC may indicate a longer horizon for the first tightening move. It has already taken some steps in this direction, indicating that the increases were less imminent, and could further emphasize this point going forward.

In terms of markets, in a scenario where the BoC altered its message in such fashion, all things being equal, expectations for the first rise in Canada would be delayed. In particular, the prevailing consensus view that the first tightening move in Canada will take place long before the first hike in the United States, could be called into question. The Canadian dollar would then be subject to additional downward pressure, while rates in the short end of the Canadian curve would remain at low levels for an extended period, anchored by the prospect of a long horizon before hikes. Yields in the belly of the curve may also experience downward pressure, just as spreads between Canadian and U.S. yields. The bias for the curve would be flatter, unlike the steepening that occurs typically when investors anticipate rate cuts. In our opinion, a move of short yields upwards, from the troughs they have recently achieved, can be reasonably envisioned, especially if the BoC were to insist that it has no plans for rate cuts.

CONCLUSION
Although some downside risks to the forecast scenario Canada seem to have gained in magnitude, rate cuts remain confined to a very serious negative outcome (recession in the United States, very sharp rise in tensions in Europe, contraction and temporary deflation in Canada). In a pessimistic scenario of moderate amplitude, such as the one referred to in this discussion, we believe that the BoC would operate first and foremost via the channel of communication. At present, it is not illogical that investors incorporate a slight chance of easing. This is consistent with a slightly more negative interpretation of global and domestic events. These expectations can quickly change either way, all depending on the evolution of the major current themes (U.S. fiscal crisis, governance in Italy, European growth). However, looking beyond the event risks, investors should keep in mind that from a fundamental perspective, the bar is high for a scenario of monetary easing in Canada to become credible.

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