

Essentials of the Monetary Policy

July 16, 2014

BANK OF CANADA

Inflation risks now seem balanced

ACCORDING TO THE BANK OF CANADA (BoC)

- Total CPI inflation has moved up to around the 2% target in recent months, sooner than expected. Core inflation has also increased but remains below 2%. Recent higher inflation is attributable to the temporary effects of higher energy prices, exchange rate pass-through and other sector-specific shocks, rather than to any change in domestic economic fundamentals.
- The global economy is on a lower growth track than was foreseen at the time of the April *Monetary Policy Report*.
- Given the downgrade to the global outlook, economic activity in Canada is now projected to be a little weaker than previously forecast. However, the BoC still expects that the lower Canadian dollar and a projected strengthening in global demand will lead to a pickup in Canadian exports and business investment and, eventually, a more sustainable growth track. Real GDP growth is projected to average around 2.25% during 2014–2016. Consequently, the economy is expected to reach full capacity around mid-2016, a little later than anticipated in April.
- The monetary policy stance remains appropriate and the target for the overnight rate remains at 1%. The BoC is neutral with respect to the timing and direction of the next change to the policy rate, which will depend on how new information influences the outlook and assessment of risks.

COMMENTS

As analysts predicted, the BoC did not change its monetary policy this morning. The release of the July *Monetary Policy Report* was anticipated nonetheless, as we wondered how the BoC would alter its stance in light of the recent rebound in inflation which, at 2.3%, is now above its target.

To begin, the BoC recognized that inflation was rising faster than forecast. Core inflation remains below its target, but even it saw a stronger-than-expected increase. However, the BoC insists on the fact that the pronounced acceleration in inflation was caused by temporary factors, including the surge in energy and meat prices and the loonie's depreciation. It therefore expects that the recent rise in prices will not continue and that inflation will fluctuate

around the 2% target in the coming quarters. A new upward revision of inflation forecasts nonetheless led the BoC to remove from its statement the mention that downward risks on the outlook for inflation were predominant.

While the BoC's outlook for inflation has been revised upward, the outlook for economic growth has been lowered. Adjustments for the Canadian economy were limited, with a 0.1% reduction per year in real GDP growth, while U.S. growth has been lowered more than 1% for 2014 compared with April's report. Note that despite the U.S. economy's major difficulties at the beginning of the year, Canadian exports are showing encouraging signs. It is clear from the BoC's stance that it believes that a firming up of exports and business investment over the coming quarters is critical. While inflation no longer seems to be a problem on its own, we can assume that changes in the BoC's stance in the coming months will reflect changes in these two components of the Canadian economy.

Implications: By removing comments on the downside risk on inflation, the BoC is really taking a neutral position. The overall tone of the report confirms that it will be some time before the BoC raises its key rates, however, especially as it seems to be counting on a relatively weak loonie to support exports. We still call for an initial increase in key rates in October 2015, a little after the Federal Reserve.

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Schedule 2014 of Central Bank meetings

	<u>Decision</u>	<u>Rate</u>		<u>Decision</u>	<u>Rate</u>		
JANUARY			JULY				
9	European Central Bank	s.q.	0.25	1	Reserve Bank of Australia	s.q.	2.50
9	Bank of England	s.q.	0.50	3	European Central Bank	s.q.	0.15
15	Bank of Brazil	+50 b.p.	10.50	3	Bank of Sweden	-50 b.p.	0.25
21-22	Bank of Japan	---	---	10	Bank of England	s.q.	0.50
22	Bank of Canada	s.q.	1.00	11	Bank of Mexico	s.q.	3.00
29	Reserve Bank of New Zealand	s.q.	2.50	14-15	Bank of Japan	---	---
29	Federal Reserve	s.q.	0.25	16	Bank of Canada	s.q.	1.00
31	Bank of Mexico	s.q.	3.50	16	Bank of Brazil		
FEBRUARY			AUGUST				
3	Reserve Bank of Australia	s.q.	2.50	5	Reserve Bank of Australia		
6	European Central Bank	s.q.	0.25	7	European Central Bank		
6	Bank of England	s.q.	0.50	7	Bank of England		
13	Bank of Sweden	s.q.	0.75	7-8	Bank of Japan		
17-18	Bank of Japan	---	---	SEPTEMBER			
26	Bank of Brazil	+25 b.p.	10.75	2	Reserve Bank of Australia		
MARCH			OCTOBER				
3	Reserve Bank of Australia	s.q.	2.50	2	European Central Bank		
5	Bank of Canada	s.q.	1.00	6	Reserve Bank of Australia		
6	European Central Bank	s.q.	0.25	6-7	Bank of Japan		
6	Bank of England	s.q.	0.50	9	Bank of England		
10-11	Bank of Japan	---	---	22	Bank of Canada		
12	Reserve Bank of New Zealand	+25 b.p.	2.75	23	Bank of Norway		
19	Federal Reserve	s.q.	0.25	28	Bank of Sweden		
20	Swiss National Bank	s.q.	0.00	29	Reserve Bank of New Zealand		
21	Bank of Mexico	s.q.	3.50	29	Bank of Brazil		
27	Bank of Norway	s.q.	1.50	29	Federal Reserve		
31	Reserve Bank of Australia	s.q.	2.50	31	Bank of Japan		
APRIL			NOVEMBER				
2	Bank of Brazil	+25 b.p.	11.00	3	Reserve Bank of Australia		
3	European Central Bank	s.q.	0.25	6	European Central Bank		
7-8	Bank of Japan	---	---	6	Bank of England		
9	Bank of Sweden	s.q.	0.75	18-19	Bank of Japan		
10	Bank of England	s.q.	0.50	DECEMBER			
16	Bank of Canada	s.q.	1.00	1	Reserve Bank of Australia		
23	Reserve Bank of New Zealand	+25 b.p.	3.00	3	Bank of Brazil		
25	Bank of Mexico	s.q.	3.50	3	Bank of Canada		
30	Bank of Japan	---	---	4	European Central Bank		
30	Federal Reserve	s.q.	0.25	4	Bank of England		
MAY			NOVEMBER				
6	Reserve Bank of Australia	s.q.	2.50	5	Bank of Mexico		
8	European Central Bank	s.q.	0.25	10	Reserve Bank of New Zealand		
8	Bank of England	s.q.	0.50	11	Bank of Norway		
8	Bank of Norway	s.q.	1.50	11	Swiss National Bank		
20-21	Bank of Japan	---	---	16	Bank of Sweden		
28	Bank of Brazil	s.q.	11.00	17	Federal Reserve		
JUNE			NOVEMBER				
3	Reserve Bank of Australia	s.q.	2.50	18-19	Bank of Japan		
4	Bank of Canada	s.q.	1.00	DECEMBER			
5	European Central Bank	-10 b.p.	0.15	1	Reserve Bank of Australia		
5	Bank of England	s.q.	0.50	3	Bank of Brazil		
6	Bank of Mexico	-50 b.p.	3.00	3	Bank of Canada		
11	Reserve Bank of New Zealand	+25 b.p.	3.25	4	European Central Bank		
12-13	Bank of Japan	---	---	4	Bank of England		
18	Federal Reserve	s.q.	0.25	5	Bank of Mexico		
19	Bank of Norway	s.q.	1.50	10	Reserve Bank of New Zealand		
19	Swiss National Bank	s.q.	0.00	11	Bank of Norway		

NOTE: Certain banks may decide to change rates in-between the scheduled meetings. The abbreviations s.q. and b.p. correspond to status quo and basis points respectively.