



## CANADA

### Weaker inflation expectations worry the Bank of Canada

As expected, the Bank of Canada (BoC) left the target for the overnight rate at 0.50% on October 19. However, the monetary authorities came close to causing a surprise—a potential key rate cut was seriously discussed.

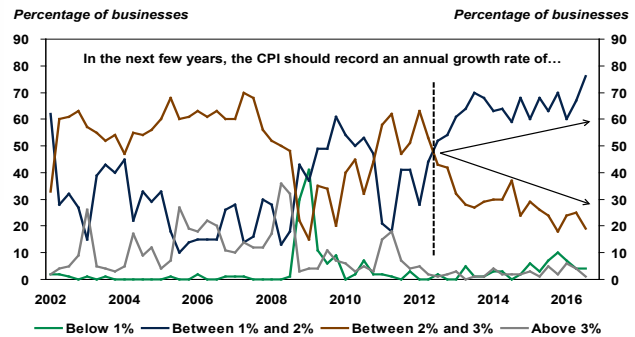
This type of possibility is difficult to grasp in an environment where the BoC expects economic growth to accelerate in the quarters ahead; it also expects total inflation to return to its median target sometime in 2017. The monetary authorities did mention however that considerable uncertainties and many downside risks remain. We can conclude that the BoC seems prepared to impose a cut to key rates if the economic conditions in the next few months disappoint.

Furthermore, the monetary authorities have one concern in particular: seeing the inflation expectations of consumers and businesses move away from the median target of 2%. For example, the BoC survey on business outlooks shows a downtrend in the number of respondents who expect inflation to remain close to the top of the range (between 2% and 3%) vs. a higher number who expect inflation to shift in the lower part of the band (between 1% and 2%). This change undoubtedly reflects how expectations have adapted after several years of a total annual inflation rate below the median target of 2%.

This type of change is obviously a concern for the BoC, whose primary mandate is price stability. Several factors in the last few years have certainly played in favour of weaker inflation, such as the decline in energy prices. The effects of these factors should soon dissipate, which should push inflation up gradually. If this scenario takes hold, inflation expectations should eventually settle closer to 2%.

**Implications:** The BoC's credibility rests on its capacity to maintain inflation at close to the median target. It is easy to understand how the drop in some inflation expectations has the BoC on edge. In these conditions, the monetary authorities will not hesitate to reduce the target overnight

#### Business inflation expectations have adjusted somewhat to weaker inflation in recent years



Sources: Bank of Canada and Desjardins, Economic Studies

#### The total annual inflation rate has hovered below its median target since 2012



Sources: Statistics Canada and Desjardins, Economic Studies

rate if the anticipated rise in inflation fails to materialize. As far as the financial markets are concerned, the likelihood of a key rate cut by May 2017 has shot up significantly—from about 10% in mid-October to more than 30% right now.

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