Canada: Heading Toward Slower Growth?

Canadian economic growth has accelerated rapidly since summer 2016, immediately following the Alberta forest fires. Quarterly real GDP growth held steady at 3.5% (annualized) on average between the third quarter of 2016 and the first quarter of 2017. Second-quarter results will not be released before August 31, but it is clear that growth is expected to be quite vigorous again. Annual change in real GDP by industry was 4.6% last May, its strongest advance since October 2000. According to Bloomberg’s most recent survey, the consensus forecast called for Canadian real GDP to increase 3.7% in the second quarter of 2017.

There is now reason to wonder if the Canadian economy will maintain such a fast pace of growth in the second half of 2017 and in 2018, which could have major impact on how the country’s key interest rate moves. The leading indicator compiled by the Organisation for Economic Co-operation and Development (OECD) is a very useful tool on this front, as it signals business cycles’ turning points between six and nine months in advance.

According to the OECD’s Business Cycle Clock, the leading indicator (the green curve in the graph), has for some time been in the lower right quadrant. That corresponds to an index below 100 (or below the long-term trend), but with a six-month variation in positive territory (or above 100). This acceleration ended up bearing fruit, and the leading indicator moved above 100 in fall 2016, attesting to growth above its long-term trend.

As is usually the case, the leading indicator continued its counter-clockwise progression in recent months, even with a net slowdown in its growth rate. This signals that real GDP (the grey curve in the graph) could eventually follow the same path. This means that economic growth could slow in the coming quarters. Therefore, our scenario predicts that the quarterly change in real GDP could fall to around 2% on average in the second half of 2017 and in 2018.

IMPLICATIONS

The Canadian economy’s strength prompted the Bank of Canada to move up its key rate hike, with an initial 25 basis-point increase on July 12, 2017. Another increase should be ordered in October. Following this, the recent movement in the leading indicator and the expected slowdown in economic growth should prompt monetary authorities to proceed more gradually. As such, only two increases in the target for the overnight rate are expected for 2018, followed by two more increases in 2019.

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