Data Release: 'Divine coincidence' used to support not-so-divine intervention

- Today, Bank of Canada Senior Deputy Governor Carolyn Wilkins spoke in support of the Bank of Canada's recent decision to cut the overnight rate by 25 basis points to 0.75%. According to Ms. Wilkins, without this intervention, lower oil prices would have led the output and labour gaps to take longer to close, as investment and employment growth slowed. This would leave the economy operating below its potential into 2017, thereby keeping inflation below its 2% target for longer. Further, with lower oil prices increasing risks to both housing and overall household financial stability, the additional 'insurance' provided by lower rates was warranted.
- Ms. Wilkins also stated that the excess capacity in the labour market (the 'labour gap') is currently about 1.5% - roughly double the excess capacity suggested by the Bank of Canada's output gap. This view is broadly supported by the Bank of Canada's structural estimates of labour market variables and its labour market indicator (LMI). With many of the LMI's component pieces also pointing to continued labour market slack, the Bank felt that the downside risks to inflation were too great to ignore.
- Ms. Wilkins acknowledged that there are positive consequences of lower oil prices (i.e. lower gasoline prices) that offset some of the negative impacts in Canada while supporting U.S. and global growth. However, these are not considered sufficient to offset the negative impact of lower oil prices on the Canadian economy, such that "[s]tiffling the rebuilding phase of the recovery could mean lost economic opportunity" had rates not been cut.

Key Implications

- Senior Deputy Governor Wilkins speech today reiterated what many already knew – the Bank of Canada is looking to the labour market for guidance in setting the path of monetary policy. According to recently published analysis using TD's Labour Market Indicator, we also found that slack in the labour market exists. With output growth forecast to soften in 2015, labour market slack can be expected to increase as well, albeit modestly.
- While it can be argued whether the size of the output and labour gaps (both unobserved concepts) justified an interest rate cut in January or not, what is clear is that the oil price the Bank of Canada based its analysis on (US$55 per barrel for WTI) was higher than that prevailing and most near-term expectations. As such, we expect that the Bank of Canada will take out additional insurance and reduce the overnight rate by a further 25 basis points at its upcoming interest rate announcement in March 2015.