PERSPECTIVE

Beata Caranci
Vice President & Chief Economist
TD Bank Group

TO CUT OR NOT TO CUT, THAT IS THE QUESTION

The Bank of Canada's policy meeting is fast approaching on January 20th, and a rate cut at that time is very much on the table. However, at present, the majority of economists and market participants are not formally calling for a cut at that meeting. Indeed, Governor Poloz's speech last week was neutral in tone and offered no hint that the Bank was leaning towards a rate cut.

So, all eyes turned to this week's Bank of Canada's Business Outlook Survey (BOS), which reinforced many of the themes that were in the speech. In particular, the needed economic adjustment is occurring towards export-oriented industries and away from resource-producing industries, but that process is far from complete or devoid of pain. The BOS indicated that the tentacles of the oil price shock have reached out across supply chains and impacted households, touching every province and region that stands in its way.

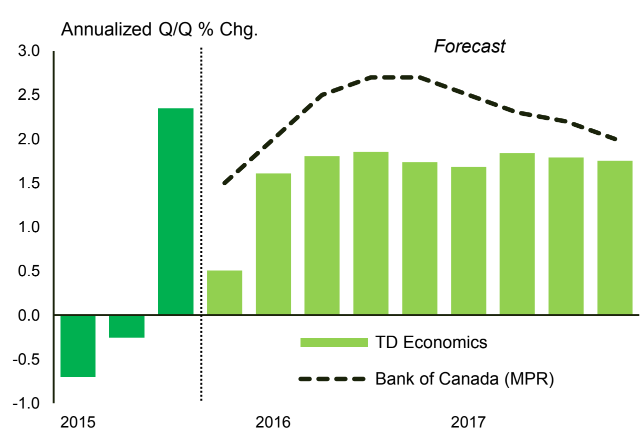
In this context, a natural question to ask is what would a 25 basis point rate cut achieve, when the overnight rate is already extremely accommodative?

Let's put our cards on the table and start with what a rate cut will not achieve. First, a quarter-point rate cut will not kick start Canada onto a significantly higher GDP growth trajectory. The rotation to export-led growth is being facilitated by a Canadian-US exchange rate that has depreciated roughly 25% in two years, two-thirds of which occurred in the past year alone. Moreover, outside of the energy sector, historically low bond yields are keeping credit cheap for businesses and households. This was reinforced in the BOS, which noted that "while tighter credit conditions continue to be linked to the commodity sector, reports of easier conditions were more widespread than in the autumn survey."

Second, the Bank does not influence global supply and demand forces, and consequently prices within global commodity markets. As such, it can do little to alleviate the economic pain occurring within the oil and gas industry: its workers, investors and, by extension, related suppliers.

So, what can a rate cut do? In the Bank's world of risk management, it offers a measure of insurance within an economy experiencing a more protracted adjustment amid heightened global risks; it continues to ensure the currency as a shock absorber to mitigate the negative hit on commodity prices to producers; and it continues to facilitate low lending rates and export rotation.

CHART 1: REAL GDP GROWTH PROJECTIONS

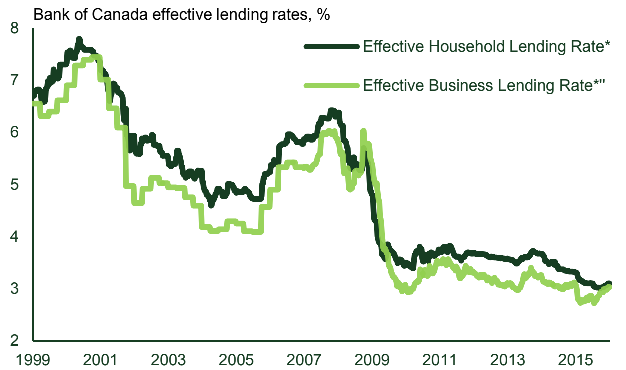


Source: Statistics Canada; Bank of Canada Monetary Policy Report (MPR) as at October 2015; TD Economics forecast as at January 2016.

No simple solution to a complex problem

Ultimately, it is broadly recognized that the economy is undergoing a structural adjustment, but perhaps less appreciated is the time it could take to play out. Governor Poloz alluded to this during the Q&A session following his speech when he commented that 10,000 export-oriented firms were lost in the past decade, and Canada will need to rebuild capacity. This takes time, and the adjustment can take 3-5 years.

CHART 2: EFFECTIVE LENDING RATES



Source: Bank of Canada. *The effective interest rate for households is a weighted-average of various mortgage and consumer credit interest rates. The weights are derived from residential mortgage and consumer credit data, adjusted for additional information provided by financial institutions. **The effective interest rate for businesses is a weighted-average borrowing rate for new lending to non-financial businesses, estimated as a function of bank and market interest rates. The weights are derived from business credit data.

The problem for policy makers is that the shift towards export strength, which eventually becomes a catalyst for non-energy investment, typically occurs at a slow and measured pace. But, the trauma to energy-related businesses and household incomes is occurring immediately, and appears to be more persistent than many analysts expected. In particular, global financial volatility has intensified regarding China's transition to a slower growth path and oil analysts cannot seem to find the bottom in prices. When the Bank of Canada detailed their economic forecasts in the October Monetary Policy Report (MPR), WTI oil prices were assumed at a constant level of $45/bbl. Today that price is hovering at $31/bbl and our analysts in TD Securities believe that WTI is unlikely to deviate far from that mark over the first half of this year, averaging $35/bbl. This heightens the risk of production shutdowns and a larger shock to the economy through knock-on effects.

We agree wholeheartedly with the Bank of Canada that the rotation of growth to export drivers is indeed occurring, and that the foundation exists for it to persist and strengthen with time via improved foreign demand (i.e. from the United States). But, we believe that Canadian GDP growth will track a shallower trajectory than what the Bank was expecting in October, reinforcing the notion that 2016 can turn into another year of "serial disappointment". Already, the hand-off from 2015 is weak. Fourth quarter real GDP is tracking a negligible 0.5% (annualized) by our estimation, with the risks tilted to the downside. The Bank had penciled in an estimate of 1.5% in the MPR. This could be brushed off as an immaterial gap if it was solely related to temporary, one-off factors such as refinery and pipeline maintenance shutdowns. These indeed occurred in the quarter, but not sufficient in scale to stall aggregate GDP growth for Canada during the quarter. Non-energy exports, the linchpin to all of our outlooks, has maintained an uneven and somewhat disappointing performance relative to expectations, non-energy manufacturing shipments have been weak for several months, and inventory-to-sales ratios look toppish for a number of sectors.

None of this is good news for a significant resurgence in momentum in 2016, even with an improvement in exports that averages 4% growth. And, given the recent dive in oil prices and broadening knock-on effects on supplier chains, the drag to business investment could certainly end up being deeper and/or more persistent. In fact, we believe the economy will see an overall contraction in business investment for 2016, with the positive feedback linkage from non-energy exports unlikely to noticeably materialize within equipment & IPP investment until 2017. There is some economic relief in store from fiscal spending initiatives that will be embedded in the upcoming Federal budget, with infrastructure already telegraphed as one recipient. However, we estimate the bulk of the growth impulse on this front will be realized in 2017, rather than 2016. And, as a measure of caution, our real GDP forecasts already embed a 0.3 percentage point boost to growth for 2017 from this potential fiscal driver.

Pulling the lens back even further, it's important to remember that the shift in economic drivers within the current cycle is occurring amidst an intensification of demographic trends. By our estimation, in the best of times, this influence alone leaves the Canadian economy with a 1.6%-1.8% running speed, let alone when all the factors discussed above are in play. The Bank noted in the October MPR that they believe growth in potential output for 2016 is in a wide range of 1.4%-2.2%, and that in the near term, growth is more likely in the lower part of their range. This means that the cushion that growth sits upon is thin to absorb disappointments in data and additional shocks. By extension, it also means that the economy needs highly accommodative monetary settings relative to historical norms in order to weather the adjustment.

Bottom line

To cut, or not to cut? The question for analysts and policy makers alike is "whether 'tis nobler in the mind to suffer the slings and arrows of outrageous fortune, or to take arms against the sea of troubles?" From a risk management perspective, a quarter-point cut in the overnight rate won't be a game changer to the fundamental challenges within the economy. But, it does offer some insurance to combat persistent weakness and second-round downside risks within the economy from the oil sector. And, who could fault the Bank of Canada for taking arms?

Putting the pieces together, economic growth is poised to underperform the Bank's projections from the October MPR, potentially by a wide margin through 2016. Our real GDP growth forecast is now estimated to be 1.5% for this year versus the Bank's 2% estimate. In light of the more protracted nature of the rotational adjustment, a more severe shock to the energy sector, and frequent bouts of imported financial market stress from emerging markets, a case exists for a rate-cut at the January 20th meeting. However, if the Bank decides to stand pat to observe the degree to which recent economic weakness is transitory in nature, the focus will turn to the forecasts within the MPR, and a rate cut down the road remains entirely plausible. We suspect the upcoming MPR will adopt a set of growth expectations consistent with a lower trajectory to guide in that assessment.

Beata Caranci
VP & Chief Economist
416-982-8067