TD Economics

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Canadian recession likely to drive another Bank of Canada rate cut

- Canadian forecasters have consistently underestimated the impact of the sharp decline in oil prices on the Canadian economy. As recently as May, the consensus view was that real GDP growth wouldn't fall into negative territory, though it would be greatly hampered by the pullback in investment in the energy sector. The Bank of Canada was no exception, with its April Monetary Policy Report (MPR) suggesting growth in the first half of 2015 would average around 1%.
- But, economic developments haven't evolved as expected. Q1 real GDP growth surprised on the downside, contracting by 0.6% (annualized) as opposed to an expected 0.3% expansion. There is now a risk that Q1 will be revised even further into negative territory. Following a barrage of negative economic releases, growth in April real GDP (-0.1% m/m) also came in below consensus (+0.1%). Data released since then, such as the Bank's most recent Business Outlook Survey, haven't shown much promise. Combining this with the anticipated drag from the recent wildfires in Alberta, it is likely that the Canadian economy was in recession in the first half of the year. It is commonplace to define a recession as two consecutive quarters of negative real GDP growth and output now looks to have fallen by about 1.0% in Q1 and 0.6% in Q2. The second half of the year is also likely to be weaker than previously expected, reducing annual real GDP growth to around 1.2% in 2015. This would mark the weakest pace of real GDP growth outside of a recession in over 20 years.
- The economy is tracking well below the 1.9% pace expected by the Bank of Canada in its April 2015 MPR. Indeed, growth in H1 2015 is likely to be roughly 1.8 percentage points below the Bank's latest forecast. In the absence of another interest rate cut, this means it could take a year longer than the Bank of Canada expected for the Canadian economy to return to its trend level of output. With this in mind, the balance of probabilities has tipped in favour of another quarter-point rate cut at the Bank's next interest rate announcement on July 15.
- While two negative quarters satisfies the technical definition of a recession, it's likely that the Bank's Monetary Policy Report next week will need to reconcile this outcome with other economic features that have been surprisingly resilient. In particular, the labour market continues to defy gravity, posting advances in recent months in which GDP has contracted. This buoyancy in part reflects the relatively narrow sectoral impact of the decline in oil prices. CPI inflation, particularly the core measure that the Bank of Canada uses as its operational target for monetary policy, also remains around target and does not reflect the features of an economy in recession. But, with the economy moving further away from its potential, it's only a matter of time before the effects filter into employment and inflation, which are both lagging indicators. To mitigate this impact, it is likely that the Bank will use the only means it has at its disposal – another interest rate cut.
- The implications of an interest rate cut will be multifold. Canadian 2-year bond yields are likely to edge lower by 10 to 15 basis points, causing the spread to their U.S. counterparts to widen with the Federal Reserve expected to start raising rates in September. This will also reinforce our view that the Canadian dollar will be sustained below 80 cents through the second half of this year. The lower loonie should benefit exporters, while a further decline in borrowing rates is likely to spur renewed housing market activity. While the Bank of Canada has flagged the Canadian housing market as a financial stability risk, its focus has tended to be more concentrated on the evolution of Canadian incomes since the decline in oil prices began last summer. As such, we place less weight on this consideration than on the outlook for output, employment, and incomes, thereby further supporting the argument in favour of a July 2015 rate cut.

- Looking further ahead, the yawning output gap in Canada due to the weak economic performance in 2015 has also push back our expectations for any future hiking cycle. We now expect the Bank of Canada to stay its hand on this front until mid-2017.

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