



March 1, 2011

## HIGHLIGHTS

- Despite an improving Canadian economic outlook, the Bank of Canada held its view that considerable slack still exists in the Canadian economy.
- We believe the Bank of Canada will underscore this view with an upward revision to its potential GDP estimate.
- Our own estimates suggest that potential economic growth may have been closer to 2.0% in 2010, and could be around 2.0% in 2011 and 2.1% in 2012, slightly stronger than the Bank of Canada's estimates for 1.6% in 2010, 1.8% in 2011 and 2.0% in 2012.
- The implications are that the Bank of Canada has plenty of room to both upgrade its Canadian economic outlook in 2011, and remain on the sidelines until July of this year.

## PLAYING WITH POTENTIAL OUTPUT

When it was all said and done, the Bank of Canada's communiqué today was a relatively staid affair. But what did come as a slight surprise—especially given the solid 2010Q4 real GDP report released yesterday—was that the Bank continues to see “considerable slack in the economy”. Recall that in the January Monetary Policy Report (MPR), the Bank noted that the output gap was expected to close by the end of 2012. When this expectation is updated to incorporate 2010Q4 growth (as well as the upwards revision to 2010Q3 and the strong handoff to 2011Q1), we estimate that the output gap could be closed a full year earlier. At face value, this observation is inconsistent with the Bank's characterization of an economy with considerable economic slack.

To resolve this apparent contraction, we need to delve into the arcane calculation of the output gap. In simple terms, the output gap measures the difference between actual economic activity and the level that would prevail if all of the economic resources were fully employed (inspirationally called potential output). Given that potential output is not directly observable in the economy, it must be estimated and is typically done so with little precision. As a result, there is some room for the Bank to incorporate a stronger growth outlook and continue to see a considerable amount of slack in the economy if the growth rate of potential is also revised higher.

Estimates of Canadian Potential Economic Growth			
	2010	2011	2012
<b>Bank of Canada's estimate of p</b>	<b>1.6</b>	<b>1.8</b>	<b>2.0</b>
<i>from January's MPR</i>			
Labour input growth	1.0	0.9	0.9
Labour Productivity	0.6	0.9	0.9
<b>TD Economics' estimate</b>	<b>1.9</b>	<b>2.0</b>	<b>2.1</b>
<i>as of March 2011</i>			
Labour input growth	1.0	1.1	1.1
Labour Productivity	0.9	0.9	1.0

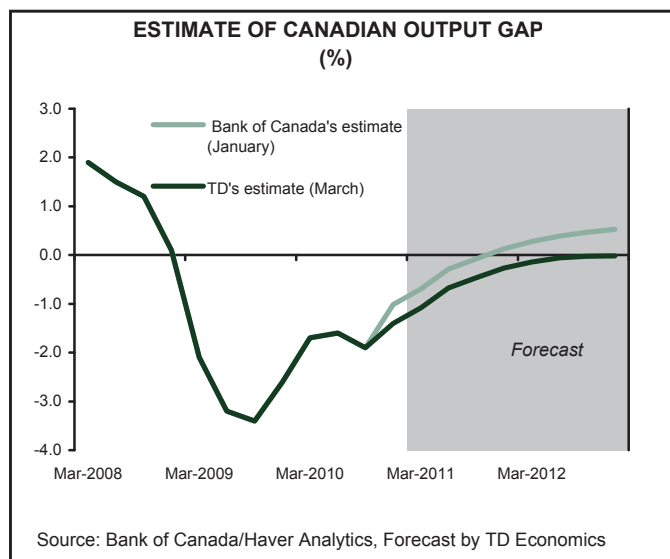
Source: Bank of Canada, TD Economics

In light of the anaemic pace of potential growth observed in recent years (1.2% in 2009 and 1.6% in 2010), there is a case to be made for an upwards revision. Our own estimates suggest that potential economic growth may have been closer to 2.0% in 2010, and could be around 2.0% in 2011 and 2.1% in 2012 (the Bank expects potential output to average 1.8% in 2011 and 2.0% in 2012). These estimates are based on the following observations:

- The labour force has grown strongly over the last year – and a low participation rate suggests that labour force growth in 2011 will remain healthy, as workers who left the job market are enticed to return by improving employment prospects. Given Statistics Canada's recent population estimates, labour force growth could contribute up to 1.1% to potential real GDP growth over the next two years. The Bank of Canada's estimates of potential assume labour input growth of 0.9% over 2011 and 2012.
- Labour productivity, while still weak relative to history, is expected to show a cyclical improvement in tandem with the economic recovery. Thus far we have yet to see the typical response where firms ramp up production at a faster rate than

**David Tulk, Chief Canada Macro Strategist**  
416-983-0445  
david.tulk@tdsecurities.com

**Diana Petramala, Economist (Canada)**  
416-982-6420  
diana.petramala@td.com



they add to their workforce. Given the upward revision to growth in Q3 and the strength in Q4, we expect that stronger productivity will contribute 0.9% to potential economic growth in 2010, slightly faster than the Bank of Canada's estimate for a 0.6% gain. Turning to 2011 and 2012, the positive impact of the recent restructuring in the manufacturing (especially in the auto sector) will become apparent as well as the recent increase in business investment. Both the Statistics Canada survey of business intentions and the Bank of Canada's own Business Outlook Survey suggest that investment will remain well supported in 2011. We expect business investment to contribute approximately 0.8% to the Canadian potential growth rate in 2011 and 2012.

The bottom line is that the Bank can finesse potential output growth (within reason) to align its outlook with the current state of the economy. The message to draw from the communiqué today is that the Bank remains hesitant to resume withdrawing stimulus until it gets further confirmation of several of the economic themes that underpin its forecast:

- Several months of strong Canadian export growth

that will prove (as opposed to the “early evidence” cited today) the rotation in the drivers of economic growth towards net exports has occurred. Keep in mind that trade data is quite volatile, especially around the end of the year.

- The impact the Canadian dollar will have on the export recovery. With the Federal Reserve on hold through 2011, the Bank of Canada will be hesitant to raise Canadian interest rates too far ahead of US interest rates in light of the impact it would have on the currency. While exporters have had sufficient time to plan for a Canadian dollar near-parity vis-à-vis the US dollar, any further appreciation in the Canadian dollar could put undue strain on Canadian exporters, and threaten the recovery in this sector.

- A more sustainable recovery in the United States that is led by private sector growth. On this front, we were comforted by comments today by Federal Reserve Chairman Bernanke in his semi-annual testimony in front of the Senate but remain of the opinion that the Bank needs to see several months of payrolls growth before they consider the recovery sustainable.

- Some resolution in the geopolitical backdrop in the Middle East and North Africa and its lasting impact (if any) on the price of oil and financial markets more generally. The Bank is also concerned about developments on the sovereign risk front in Europe given the heavy refinancing and meeting schedule between now and the April interest rate decision.

When paired with an inflation outlook that continues to unfold as the Bank expects, it has the luxury of time to monitor the above developments. As such, we remain comfortable with our July starting point but note that once the Bank does move it will likely be more aggressive than many in the market currently expect. We expect that the overnight rate will increase to 2.00% by the end of the year and could reach 3.00% as early as the middle of 2012.