

TD Economics

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Data Release: Bank of Canada Raises Rates with a Cautious Tone

- As was widely expected, the Bank of Canada raised its benchmark overnight rate target by 25 basis points to 0.75% this morning.
- The hike was accompanied by a communiqué that was outright dovish in its analysis of both domestic and international risks. Most interestingly, the Bank downgraded its forecast for real GDP growth from 3.7% in 2010 to 3.5% and from 3.1% in 2011 to 2.9%.
- The output gap is now expected to close at the end of 2011, two quarters later than was originally anticipated by the Bank.
- The rest of the communiqué highlights that the domestic economic recovery is proceeding largely as anticipated while international factors form most of the downside risks. The Bank noted that while policy actions on the part of European governments and central banks have reduced the risk of an “adverse outcome”, those actions will likely hamper the pace of recovery in the global economy. In addition, the economic recovery in the U.S., while proceeding, is uneven in its composition.

Key Implications

- At this point in the economic recovery, the Bank of Canada has the precarious job of balancing the robust domestic strength in the Canadian economy, with the external downside risks centered on a slowing U.S. economic recovery and continued financial uncertainty stemming from Europe.
- Domestically, though a number of sectors have taken a step back in recent months, in particular the housing sector, the overall pace of economic growth has not. The labour market continues to post red hot gains, having regained more than three-quarters of the jobs lost to the recession in less than a year, real GDP is still on track on to post another strong quarter of growth in-line with the past two quarters, and measures of slack in the economy continue to shrink. Most notably, core inflation has not deviated from around the Bank’s 2% target, averaging about 1.9% so far in 2010.
- The downgrade in the Bank’s forecast for the pace of real GDP growth falls more in-line with most private sector forecasts, and indeed our own, due to a moderation in consumption growth. In late 2009 and early 2010, households boosted their expenditures by taking advantage of the low level of interest rates, but are now more indebted than at any other point on record and will likely take a breather in the coming quarters. TD Economics expects a broadly equivalent 3.6% growth in 2010 and a more modest 2.5% pace in 2011.
- However, this is still an upside risk and an overnight rate target at this emergency level is largely inappropriate given how far along the economic recovery is already.
- That being said, it would be folly to consider that Canada is isolated from its advanced counterparts down south and across the Atlantic. In the U.S., stimulus-fuelled growth has now given way to the private sector and the transition is not proceeding as smoothly as many had hoped. Private sector job gains have been fairly muted in the past few months, with jobless claims back on the rise, while credit conditions have yet to improve tangibly. The Bank expects net exports to play a larger role in contributing to Canadian real GDP growth, but an uneven improvement in U.S. domestic demand is certainly the big question mark here.

- Lastly, though the probability of a sovereign debt default in Europe has reduced dramatically, it has not been eliminated entirely and the fiscal austerity that is necessary to avert one will certainly have a tangible impact on the global economic recovery.
- Overall, we continue to expect that the domestic factors will play an overwhelmingly dominant role in the Bank's future decisions. With core inflation remaining fairly sticky to the 2% target, it is imperative that the Bank raise interest rates off the floor relatively quickly and remove a portion of the monetary stimulus floating around the economy, while simultaneously balancing the risk of an undesirably high Canada-U.S. rate spread. We expect a combination of 25 basis point hikes over the next year and a half with the overnight rate reaching 1.25% by the end of the year and 2.5% by the end of 2011.

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