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TD Economics

Data Release: Policy interest rate kept unchanged, with caution the Bank of Canada's watchword

- As widely expected, the Bank of Canada kept its key policy interest rate unchanged at 0.5%, while upgrading their growth forecast relative to January forecasts, largely as a result of the 2016Q1 pop in growth.
- The Canadian economy is now forecast to expand by 1.7% in 2016, a marked upgrade from January's outlook for 1.4% growth. The pace of expansion is expected to pick up further in 2017, reaching 2.3%, before slowing to 2.0% in 2018.
- Relative to prior expectations, the Bank of Canada sees a shift in the drivers of growth: business investment has been revised down for both 2016 and 2017, while housing and government spending have been upwardly revised. Trade is expected to remain supportive of growth this year, however, it is now expected to drag on 2017 growth as a result of currency moves and a less favourable composition of global growth.
- Inflation is expected to remain stubbornly below the bank's 2 per cent target, but return to the Bank's 2% target by the end of 2017 as the factors currently weighing it down, such as energy prices, dissipate. Core inflation, conversely, is expected to remain at or near the 2% mark over the next few years as exchange rate pass through to consumer prices is dampened by soft fundamental inflationary pressures. Indeed, the Bank sees the degree of economic slack as 'significant', and is present despite downgrades to the economic 'cruising speed', which the Bank now estimates to be around 1.5%. This lowered expectation for potential growth means that the output gap is expected to close slightly earlier than previously thought, reaching zero in the second half of 2017.
- The Bank cited a number of risks to the outlook, both on the upside and downside. Stronger GDP growth in the U.S., or better momentum in exports are both seen as potential upsides. Conversely, more cautious consumer behaviour, a larger adjustment to low energy prices, and slower growth in emerging markets are all seen as potential economic headwinds.

Key Implications

- In an unsurprising decision, despite noting an improvement in the economic outlook, the Bank of Canada kept its foot on the accelerator, leaving its policy interest rate unchanged at 0.5%. Indeed, even with the upgraded outlook, the Bank's view is best characterized as cautious, particularly for the near-term outlook. This likely reflects the uncertainty about the speed and eventual outcome of Canada's current economic adjustment. At the same time, sizeable economic slack remains, and external risks to growth persist, all of which necessitate the current accommodative monetary policy stance.
- Indeed, despite the upgraded domestic forecast, the Bank of Canada now sees a weaker global economy, marking down its growth forecast for the U.S., as well as emerging markets. Beyond the growth downgrade, the Bank continues to point to risks to Canada that can emanate from emerging markets both via trade and financial linkages, in line with our own analysis.
- Domestically, attention will undoubtedly be focused on the Bank's estimate that the Federal Government's April budget stimulus will boost economic growth by 0.3 percentage points in both 2016 and 2017. Our analysis, based on the experience of the 2009 Economic Action Plan,

suggests that the impacts may be smaller; we expect a boost of 0.1 and 0.3 p.p. to 2016 and 2017 respectively stemming from the April budget spending plans.

- The near-term outlook for Canada has certainly brightened since the Bank of Canada's last Monetary Policy Report. Our view is that near-term growth may come in ahead of the Bank's expectations as exports and manufacturing more generally continue to benefit from past movements in the loonie and strong U.S. domestic demand. However, over the longer-term a number of structural headwinds are likely to persist, not least of which is expected to be business investment, which we do not expect to recover meaningfully until at least 2018. This, alongside a weaker outlook for housing, leaves us expecting 2.0% growth for 2017, somewhat below the Bank of Canada's 2.3% forecast. As a result, we remain comfortable in our view that it is will be some time before we see any movement in the policy interest rate.

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