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TD Economics

Data Release: Bumps on the road not enough to move Bank of Canada off course

- As expected, the Bank of Canada left its key policy rate unchanged at 0.50%. At the same time, the outlook for economic growth has been revised down, reflecting the impacts of the Alberta wildfires, Brexit and a recent weakness in underlying economic activity.
- In the central bank's revised forecast, the Canadian economy is now forecast to expand by 1.3% in 2016, a downgrade of 0.4 percentage points from the April Monetary Policy Report (MPR). Growth of 2.2% is expected for 2017 (April MPR: 2.3%), while expectations of 2.1% in 2018 are up slightly relative to the April report.
    - The Bank of Canada expects the Alberta wildfires to reduce second quarter growth by 1.1 percentage points, while the recovery is forecast to boost the third quarter by 1.3 percentage points. As a result, the Bank expects growth of -1.0% and 3.5% in the second and third quarters, respectively. With an outlook that is largely unchanged thereafter, the output gap is now expected to close slightly later, towards the end of 2017.
    - The impact of Brexit is somewhat smaller, expected to reduce the level of Canadian GDP by 0.1% over the projection horizon.
- The revisions to economic growth are concentrated in trade, with weaker exports, partially offset by softer import expectations, resulting in a 0.5 percentage point reduction in growth for this year. Slightly offsetting this are modestly improved outlooks for consumption and housing activity. The revisions to 2017 result largely from a softer outlook for business investment, mitigated somewhat by an improved net trade forecast.
- Turning to inflation, headline CPI is expected to remain slightly below the Bank's target of 2% this year, before commodity prices begin to push inflation higher early in 2017. Inflation is expected to trend around the target thereafter. Interestingly, there was again no discussion of 'underlying inflation' in the latest MPR.
- As usual, the Bank has provided a laundry list of risks to the economic outlook. Among the upside risks are higher oil prices and stronger than expected GDP growth south of the border. On the other side of the coin, sluggish business investment, weaker household spending, and slower growth in emerging markets may all present headwinds to economic growth.

Key Implications

- While Canada has faced its share of unanticipated bumps this year, most are expected to either prove temporary and, thus, have not taken the Bank of Canada meaningfully off course. That said, these bumps reinforce the expectation that the Bank of Canada's foot will remain firmly on the accelerator, with the benchmark overnight rate likely to be held at 0.50% for some time to come.
- In our view, the central bank may be slightly optimistic in its near-term outlook given the length of supply disruptions resulting from the Alberta wildfires. As a result, we expect growth this year of 1.2%, slightly below the Bank's expectations, and are also less optimistic regarding 2017 (TD: 1.9%; Bank of Canada: 2.2%). Given our outlook, we expect that it may take longer for the output gap to close, and thus see no impetus for a rate move before 2018.
- Further underscoring this view is the Bank's judgement that financial vulnerabilities are elevated and rising (particularly in Vancouver and Toronto). Past communication has emphasized that the bar for a rate cut is quite high, and this emphasis on financial vulnerabilities would point to a bar that is yet higher still.

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